

## The Fed must not play Santa to the markets

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US Federal Reserve officials were jolted last week by the cacophony of booing that greeted their quarter-percentage-point interest [rate cut](#). Markets badly wanted double the amount. It is part of a growing town/gown rift between a model-oriented Fed and a profit-oriented financial community.

Market commentators, including some former Federal Open Market Committee members, almost unanimously expressed deep disappointment that the Fed did not seem more attuned to the growing risk of recession. The critics were especially peeved that the Fed's statement did not contain a clear acknowledgement that short-term growth risks easily trump short-term risks to core inflation.

The negative rhetoric cooled a bit later in the week as the big central banks announced new measures to maintain market liquidity, and as high November inflation readings made the Fed's balance of risk assessment seem somewhat more plausible.

Nevertheless, markets remain extremely sceptical. As housing prices sink and the credit crunch grinds on, top private forecasters have been scurrying to downgrade their 2008 growth estimates.

Many now buy into the prediction by Alan Greenspan, former chairman of the Federal Reserve, that the odds of a US recession are at least even money. Is today's Fed living on a different planet, they ask? One popular complaint is that the Fed's academic modellers pay far too much attention to slow-moving macroeconomic variables and fail to keep pace with the fast-shifting information embodied in financial markets.

Markets are right to be concerned about recession risks, but there is an awful lot of whining mixed in here. After all, most traders' year-end bonuses stand to benefit a lot from an even softer Fed policy stance. The markets were not satisfied with one dessert; they wanted two.

It is true the Fed has been repeatedly wrong-footed by the subprime crisis. It badly underestimated both the size of the losses and the virulence of the ensuing global contagion.

Of course, few market analysts have been much further ahead on the curve, which is why so many private forecasters have been tripping over each other in recent weeks to knock down their overly optimistic projections for 2008 US growth.

The real town/gown problem is one of horizon rather than perspective. Monetary policy has long and variable lags, particularly on slow-moving inflation expectations. Sharper Fed interest rate cuts today might well mute the housing price collapse, at least in nominal terms. However, if the Fed should ease too far, too fast, it could get hit by a boomerang a couple of years down the road, in the form of sustained higher inflation.

For the Fed, two to three years is the medium term, and it matters. For many financial market participants, two to three years is an eternity, and it does not matter.

Did markets complain when third-quarter US gross national product came in at (an annualised rate of) 4.9 per cent, when the economy's trend growth rate is probably only half that? Did markets whine about the Fed's misreading of the economy when it "allowed" growth to slip into a boom? Other than a few internet bloggers who think we are heading for inflation Armageddon anyway, it is hard to find too many complaints about the third-quarter output overshoot.

Let us face it. Most investors think a good central bank should always drive as fast as it can above the economy's speed limit without crashing or breaking the inflation speedometer. Never mind inflated asset prices and higher inflation expectations that sow the seeds of a later crisis. As long as the benefits are here today and the risks materialise only in the future, the typical "streetwise" investor wants to see the central bank keep its foot on the gas pedal.

Unfortunately, we live in an era where trend US productivity growth is clearly down and the housing bubble could be deflating for years.

We are no longer in the technology boom years of the 1990s Greenspan era. No matter how much the Fed steps on the gas pedal, it is going to be hard to keep US trend growth much above the 2 per cent levels Europeans and Japanese have come to think of as normal. With baseline growth lower than it was 10 years ago, it takes less to

push the economy into recession.

This is hardly a fun message for the Fed to have to deliver, particularly when markets seem to believe that central banks are virtually omnipotent, at least when it comes to ramping up year-end bonuses.

Indeed, most of the Fed's bad reviews of late come from having to tell markets that, in some years, returns and bonuses are going to be weak. Epic productivity growth spurts do not last for ever. Housing booms often end in busts. When credit risk spreads collapse, they are likely to rise again.

Yes, Fed communication could be improved, particularly by announcing decade-long inflation targets that would give greater clarity to Fed objectives. But as long as trend growth stays weak and housing prices keep dropping, great clarity alone is not going to make markets happy.

Markets do not want to see academic robes on the Federal Open Market Committee; they want Santa Claus suits.

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