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FOMC HAS MORE APPARENT HAWKS IN 2004, BUT....

Annual rotation of votes among district Fed presidents and the departure of William McDonough from the New York Fed appear to make the Federal Open Market Committee voting membership for 2004 more inclined to raise rates than the FOMC's 2003 lineup would have been under the same circumstances. Nevertheless, a more-hawkish FOMC this year is hardly a given. Opposing and/or complicating factors include: lingering effects on policymakers' thinking from a prolonged period of disinflation combined with sharply higher trend productivity growth; the growing influence of a relatively new member of the Board of Governors with well-articulated dovish leanings (Ben Bernanke); potential impact of the 2004 presidential election timetable on monetary decision-making; and the question of who will lead the Fed beyond June, when Greenspan's current term as Chairman expires.

This year is shaping up as a transition period for US monetary policy, whose resolution is sure to have major implications for global financial markets. We focus here on how the makeup of the Fed's monetary policy committee (the FOMC) may affect decision making in 2004.

After enduring year after year of rapid turnover and unfilled vacancies, the Fed Board of Governors enters 2004 for the first time in recent memory with a full complement of 7 Fed governors who were in their posts 12 months earlier. As a result, the most-obvious change in the Fed for 2004 is the annual rotation of 4 FOMC votes among 11 district bank presidents. This year's voters are Sandra Pianalto of the Cleveland Fed, William Poole of St. Louis, Thomas Hoenig of Kansas City and Cathy Minehan of Boston. They replace 2003 voting members, Robert Parry of San Francisco, Alfred Broaddus of Richmond, Jack Guynn of Atlanta and Michael Moskow of Chicago. A fifth Fed district, New York (whose president is a permanent voting member), also has a new representative this year. Ex-Treasury official Timothy Geithner was named NY Fed president in November after predecessor William McDonough left to head the Public Company Accounting Oversight Board.

A thumbnail comparison makes clear that the new district-president voting group skews more hawkish than their 2003 counterparts – at least if past track records are a reliable guide.

District President Voters On Federal Open Market Committee

January 2004	January 2003	January 2002
Timothy Geithner (New York; Unknown)	William McDonough (New York; Dove)	William McDonough (New York; Dove)
Cathy Minehan (Boston; Centrist/Dove)	Michael Moskow (Chicago; Centrist/Dove)	Robert McTeer (Dallas; Dove)
William Poole (St. Louis; Centrist/Hawk)	Jack Guynn (Atlanta; Centrist/Dove)	Anthony Santomero (Philadelphia; Centrist)
Thomas Hoenig (Kansas City; Centrist/Hawk)	Alfred Broaddus (Richmond; Centrist)	Jerry Jordan (Cleveland; Centrist/Hawk)
Sandra Pianalto (Cleveland; Centrist (?))	Robert Parry (San Francisco; <i>Hawk based on prior record; see below</i>)	Gary Stern (Minneapolis; Centrist/Hawk)

Of course, the judgments reflected by our labels in the table can be debated, and many readers may agree with the policy makers themselves, who tend to reject such labels as oversimplifying their views. More important, Fed decision makers, like Supreme Court justices, can change (or at least, appear to change) their philosophical emphasis when evolving conditions force them to grapple with new sets of facts.

In fact, such shifts did occur in both 2002 and 2003. Starting in 2002, Richmond Fed President Broaddus cast aside a long-standing reputation as an inflation hawk (who had cast dissenting votes for higher rates more often than any other FOMC member in the 1990s). He went on to embrace wholeheartedly the Fed's policy emphasis over much of 2003 on fending off "an unwelcome substantial fall in inflation."

While Broaddus voted with the FOMC majority throughout 2003, another erstwhile hawk, San Francisco Fed's Robert Parry, emerged last year as the panel's most persistent advocate of additional easing. Not only did Parry dissent in favor of easing 50bps in June, vs. the majority's 25bps ease – the only dissenting vote cast at any FOMC meeting in 2003 – his SF Fed also asked the Fed Board of Governors to lower the primary credit rate (which replaced the old "discount rate") several times during the spring and summer.

Among the 2004 voting contingent, Cleveland Fed's Pianalto and St. Louis Fed's Poole merit special attention as potential early advocates of any move to tighten policy.

Pianalto assumed her post early in 2003 following the retirement of Jerry Jordan, a monetarist who cast frequent dissents for higher rates in the late 1990s. Pianalto did not have an FOMC vote in 2003, and her speeches to date have steered away from monetary-policy topics, focusing instead on education, productivity, and free trade.

However, it is worth noting that the Cleveland Fed annual report for 2002 – prepared while the bank’s presidency was in transition from Jordan to Pianalto – includes a lengthy essay arguing that “deflation is an acceptable economic outcome, so long as it is occasional, small in magnitude, and accompanied by strong productivity growth.” The article further argued that, “while zero, or very low, nominal interest rates that often accompany deflation can be a problem, many of the problems attributed to deflation are not unique to falling prices per se.” If Pianalto pursues this stance as a voting FOMC member, she could emerge as a leading voice for tighter policy as the year unfolds.

William Poole starts 2004 as a voting FOMC member with an established hawkish track record. However, he, like many of his colleagues, has been wrestling lately with the dilemma posed by the past decade’s upward shift in trend productivity growth. On the one hand, more-rapid sustainable productivity growth translates into faster sustainable GDP growth, which implies higher real interest rates in the long run. In the short run, however, productivity can restrain employment, creating a need for accommodative policy until slack resources are eventually absorbed.

In a speech in October 2003, Poole concluded that in theory, a trend break toward higher productivity growth such as occurred in the late 1990s and early in this decade, should lead to a higher equilibrium real interest rate. This speech was viewed bearishly by the market, even though Poole carefully avoided any suggestion as to the timing of rate hikes, and described current policy as appropriate. Yet in a Bloomberg News interview just one month later, Poole stunned the markets by declaring that low rates could be maintained ‘well beyond March’ of 2004. He went on to state his belief that, with productivity growth still accelerating and employment lagging, the economy could safely grow ‘in the 5% range’ for a couple of years, and the jobless rate could fall below 5% without fueling inflation.

As a monetarist, Poole has long been guided by money-supply trends. He also pays close attention to inflation expectations extracted from surveys and real Treasury (TIPS) yields. It will be interesting to see whether the views detailed in the November 2003 Bloomberg interview will dissuade him from advocating higher rates in advance of a sustained fall in unemployment or the appearance of measurable inflation pressures (both are usually regarded as lagging indicators).

Another noteworthy development in the FOMC over the past year is the emergence of Ben Bernanke as a leading voice for prolonged stimulative policy. Bernanke, who joined the Board of Governors in August 2002 from Princeton University where he was economics department chairman, has visibly associated himself with various milestones of deflation concern. He was one of the first FOMC members to assert publicly that inflation would probably continue declining for awhile even after growth recovered to trend. He also was closely identified with the Fed’s controversial flirtation with the idea of unconventional easing – buying long-term treasury securities to force down long-term rates, once short-term rates had fallen near zero. And, the Wall Street Journal (10/27/2003) named him the leader of an FOMC faction

that favors maximum openness in communicating Fed intentions to the public. By implication, that would make Bernanke an architect of the FOMC's also controversial commitment to maintain accommodative policy "for a considerable period."

Voting membership aside, the experience of the past several years will exert a pervasive (although perhaps subtle) influence over the Fed's response to the economy as it evolves through 2004. The 2001 recession and subsequent jobless recovery, the continuing productivity revolution, and the steady decline in measured inflation, have combined to push inflation off the front burner as a policy concern. This is the external backdrop that brought some long-time hawkish FOMC members to take the surprising actions and comments detailed above.

Notwithstanding a seemingly more-hawkish group of district Fed presidents this year as compared with last, various policy makers' public statements uniformly indicate that in launching the next tightening cycle – whenever that may come – the panel will be far less disposed to act proactively than it did during the last few cycles.

Yet at some future point, policy will have to return to neutral – and probably will have to turn restrictive some time after that. Unfortunately, generals usually end up fighting the last war. The challenge for the FOMC in 2004 will be to avoid allowing the disinflationary forces that came to prominence since the late 1990s – zooming productivity, intensified global competition, enhanced price discovery via the Internet, and cyclical excess capacity and slack labor demand – to lull policy makers into falling behind the curve.