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Attack of the Kohn-heads

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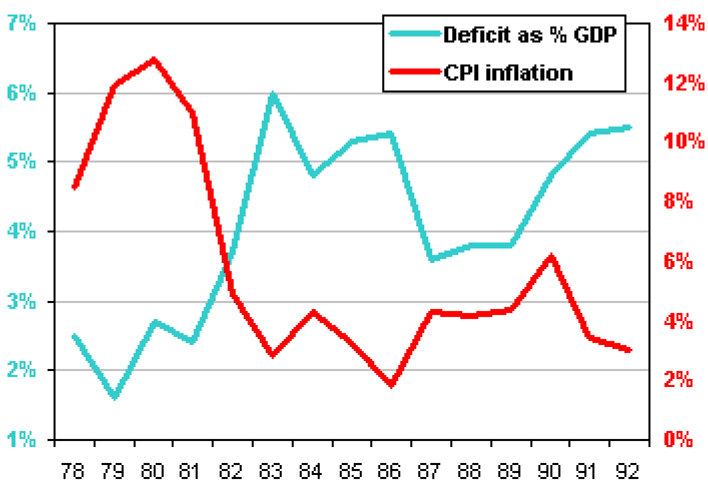
The emergence of deficit-hawks on the FOMC presents a new prospect for monetary policy risk.

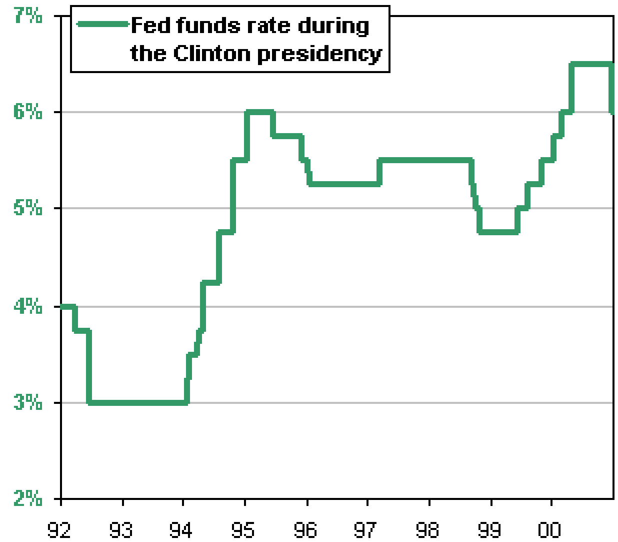
You'd think that by now the Fed would have run out of ways to make **monetary policy errors**, but the minutes of the September 20 **FOMC** meeting, released yesterday, revealed a new one. The good news in the minutes is that the FOMC didn't make the **inflationary** error of succumbing to the conventional wisdom which, a month ago, took it as a foregone conclusion that the Fed's **rate normalization** regime would be paused or ended in light of expected **economic weakness** in **Hurricane Katrina's** aftermath (see "Katrina and the Fed" September 2, 2005). Instead, the FOMC treats that as "essentially temporary," and, instead, is fretting about the longer term inflationary effects of **deficit-financed government spending** for reconstruction. The minutes note,

> "The expansion of federal spending implied an increase in fiscal stimulus at a time when the margin of unutilized resources in the overall economy was probably thin. ...widening federal deficits were mentioned as a factor that could further stir inflationary concerns."



There are plenty of sensible reasons to object to spending growth, and to **federal budget** deficits. But inflation isn't one of them. **Regression analysis** shows that contemporaneous inflation and federal deficits are actually somewhat ***negatively* correlated**. When inflation is **lagged** by one or more years the correlation vanishes almost entirely. Statistics aside, one has only to recall the experience of the 1980s to prove the point. As the chart at left shows, inflation *collapsed* from all-time highs at the same time as federal deficits *soared* to all-time highs, and remained at high levels for a decade. Yes, if the Fed were to **monetize federal debt** -- *that* would have serious inflationary consequences. But absent that, deficits and debts have no necessary connection to inflation.

The myth that deficits cause inflation is accompanied by an urban legend about a grand bargain supposedly struck in the early 1990s between **Alan Greenspan** and **Clinton administration Treasury Secretary Robert Rubin**. As the legend goes, Greenspan promised to keep **interest rates** low on the condition that the Clinton administration would rein in the deficit. If that bargain was ever actually made, Rubin should demand his money back -- the reality is that the Fed generally *increased* interest rates throughout the Clinton presidency (as the chart on the following page shows). It was *that*, not the reduction in deficits, that brought inflation down to such low -- indeed **deflationary** -- levels by the end of the 1990s and early 2000s. Be that as it may, the legend has salience because there are factions within the Fed that do believe deficits cause inflation, and if that faction becomes ascendant in the post-Greenspan world, we could see a period of unnecessarily high interest rates, and pressure on the **White House** to raise **taxes** to reduce the deficit.



The leader of that faction at the Fed is **Donald Kohn**, a long-time Fed **staff** member elevated to the **Board of Governors** several years ago on the recommendation of Alan Greenspan. One recent press account cited Kohn as Greenspan's choice of successor as **chairman**, speculating that Kohn "could be expected to continue raising interest rates, in part to punish the president for not raising taxes and failing...to pay enough attention to the budget deficit." Idle speculation perhaps, but Kohn's conceptions of the nature and causes of inflation are indeed dangerous. In a speech yesterday he stated,

> Inflation...will be determined by the interactions of aggregate demand, potential supply, and the expectations of businesses and households about future inflation.

In other words, for Kohn inflation is -- to invert **Friedman** -- nowhere and never a monetary phenomenon. For Kohn, the quantity of **liquidity** provided by the Fed has nothing to do with it. Indeed it would seem the Fed itself has nothing to do with it -- except that it may attempt to manipulate in various ways **aggregate demand**, potential **supply** and **expectations**. And "punishing" the **president** until he raises taxes would certainly count as manipulating.

The potential ascendancy of **deficit hawks** on the FOMC is a new worry, especially as Alan Greenspan's term as chairman is about to end. Normally we would have said that Kohn was an impossibly unlikely candidate (indeed, the online **political futures markets** at **Tradesports** assess his probability of nomination at only about 3%). But then again we would never have said that **Harriet Miers** would be nominated to the **Supreme Court**, either. And if you'd asked us what one quality **President Bush** would highlight as most important in a Fed chairman, we would never have said "independence" -- yet that's just what Bush said in a press conference last week. With his staff background, Kohn is, if nothing else, certainly independent. Dangerously so.

Bottom line: Markets have a lot of **policy risk** to worry about right now (see "What's Spooked Stocks?" October 7, 2005). The emergence of deficit hawks on the FOMC worsens the risk environment, especially as Alan Greenspan's term as chairman nears its end just as the nomination process has become so politically tricky and unpredictable. Responding to these growing risks, **stocks** have been in persistent decline for two weeks against a still-rising **earnings expectations** backdrop. They are now almost as cheap as they were at the bottom in October 2002. With the worst already discounted, we think the smart bet is to see stocks as a bargain here -- the king of the **carry trades** (see "The King of Carry Trades" June 14, 2005). Any alleviation of perceived risks would have enormous upside potential from these levels. TM