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FED SHADOW

Advice and Dissent

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Donald Luskin

Hoenig's protest notwithstanding, jobs and politics have the Fed on hold all year.

The chatter is that yesterday's FOMC statement was a hawkish surprise, but we don't see it that way, and apparently either do markets. The most notable response yesterday was the small downtick in the fed funds futures markets, where the implied funds rate a year ahead rose 5 bp to 94 bp -- about where it was a month ago. What was the surprise? The statement's description of the economy accurately mirrored the economy itself -- some things slightly improving, some things slightly deteriorating. The announcement of the termination of various credit support programs is old news -- it was all announced at the December 2009 meeting, and doesn't imply any net shrinkage in the Fed's balance sheet (see "Sucker Trade: Inflation for Jobs" December 17, 2009).

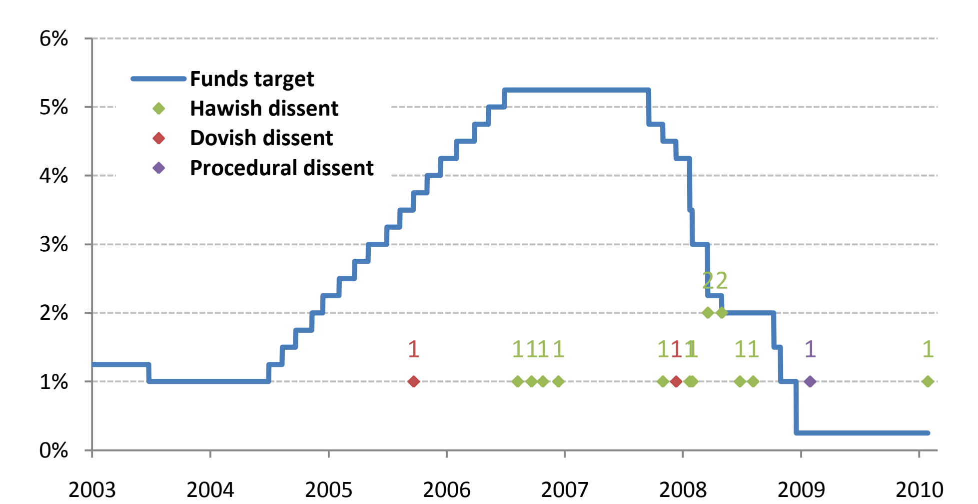
Update to strategic view

FED FUNDS: Yesterday's FOMC statement was not a hawkish surprise, and Thomas Hoenig's dissent should not be taken as a harbinger of the committee's changing sentiment. The Fed is hostage to the deeply stagnant jobs market, and to the volatile political environment, which together will work to keep the funds rate on hold near zero all this year.

[see Investment Strategy Dashboard]

FOMC dissents versus the fed funds target

Number of dissents, by type, at FOMC meetings



Source: Reuters, Federal Reserve Board of Governors

Was the hawkish dissent by Kansas Fed president Hoenig a surprise? Only to those who haven't been following his public statements. The only reason he's dissenting *now* is because this is his first FOMC meeting as a voting member since 2007. His dissent says

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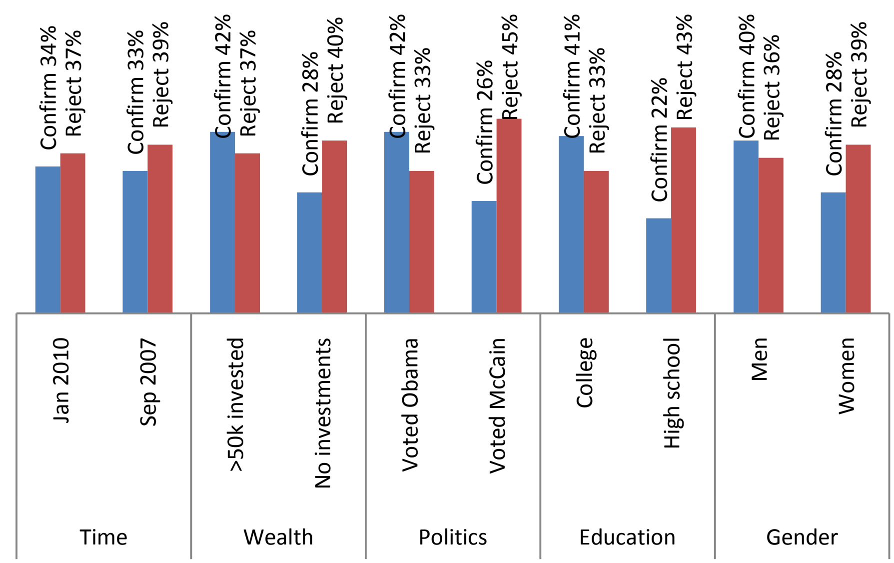
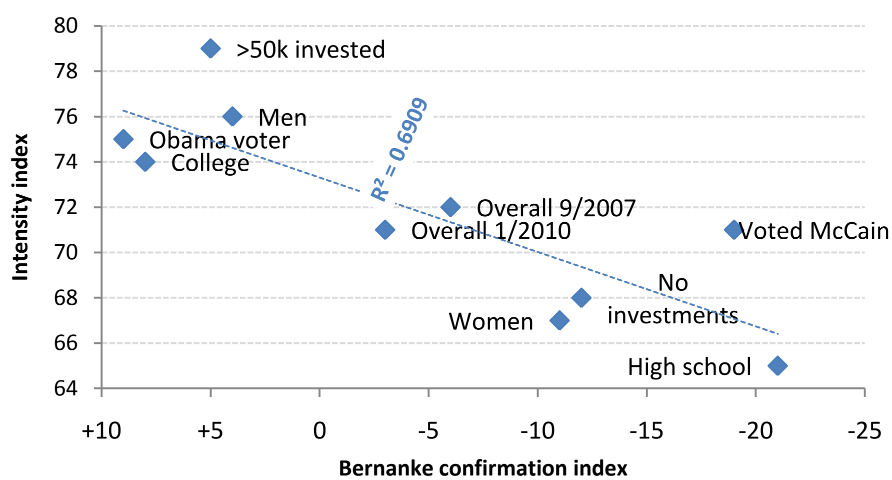
nothing whatsoever about the balance of opinion on the FOMC, which is formed by a tiny core of key individuals who are close to Ben Bernanke -- [Hoenig's hawkish dissent in October 2007] meant nothing either. In fact, throughout this cycle of tightening and easing, dissents have meant nothing, be they hawkish or dovish, and no matter how often repeated (see the chart on the previous page).

Bernanke confirmation endorsed by rich, liberal, educated, male
Polling January 23-25, 2010, 800 adults (margin of error 3.46%)



Those who know more and care more also approve more
Intensity index: confirm + reject Confirmation index: confirm - reject
Neutral and no opinion are discarded



Source: Hart-McInturff [NBC/Wall Street Journal poll]

A far more consequential dissent is the political lynch mob that has assembled around the confirmation of Bernanke to a second term as Fed chair. We don't question that there could be principled reasons for objecting to his confirmation, as there could be for supporting it. But the sudden widespread move against him has been nothing but political theater, in which opportunistic senators of both parties find it useful to be seen as anti-Wall Street populists in the wake of Republican Scott Brown's upset win last week's Massachusetts special election (see ["On Obama's Bank Regulation Proposal"] January 21, 2010).

The charts at left show the voter mind-map of the Bernanke issue. Overall, the sentiment for confirming him or rejecting him is about evenly balanced, within the margin of error of polling -- and surprisingly, it has improved in his favor since his re-appointment was announced last summer. Within that, confirmation is favored by wealthier and better-educated Americans, and opposed by the poorer and less-educated -- the classic populist target audience. As it happens, confirmation also favored by men and opposed by women -- and favored by liberals and opposed by conservatives. We don't know why this would be so, except that those two demographics do share one important point in common with the poor and the less-educated. All four have larger number of people who are "neutral" or have "no opinion." As the bottom chart on the previous page shows, there is a very high correlation between supporting confirmation and even having an opinion at all. The populist forces arrayed against Bernanke's confirmation seem aimed at those who, for whatever reason, haven't thought much about the governance of the Federal Reserve System of the United States.

Bernanke seems likely to survive the populist attack -- the online political futures markets at Intrade puts his chances at 97%. But the populist attack against individuals and institutions is ongoing. Yesterday the probability of Tim Geithner's leaving his post at Treasury by year end jumped to 60% at Intrade -- a risky thing indeed, as Geithner is an effective technocrat who may be the administration's best economic mind. And the Fed itself remains under serious attack. In the frustrated Obama administration's drive to deliver a legislative accomplishment, it is vigorously pushing financial reregulation -- and the Senate version of such legislation, put forward by Chris Dodd (D-CT), strips the Fed of its bank regulatory powers, and politicizes its time-tested regional structure. Don't kid yourself that enactment of such legislation -- or something even worse, like Obama's proposed "Volcker rule" -- is out of the question. When a populist movement get started -- like any lynch mob -- it can be very hard to stop, even when its participants know full well it should be stopped. Remember Sarbanes-Oxley. And remember in March 2009, the current crop of Republicans led the howling against bonuses paid to AIG executives under contracts approved by Geithner. When the Democrats upped the ante by introducing on the floor of the House of Representatives a bill calling for a 90% tax on any bonus received by any employee of a bank that took more than $5 billion in TARP capital, it passed with 85 Republicans voting for it, over minority leader John Boehner's embarrassed objections.

Recommended reading

The Fed's Anti-Inflation Exit Strategy Will Fail by Allan H. Meltzer, *Wall Street Journal* January 27, 2010

Housing, depressions and credit collapses by Vernon L. Smith and Steven Gjerstad, *Financial Times* Economists Forum. January 24, 2010

Analysing the impact of the Fed’s mortgage-backed securities purchase by Johannes Stroebel and John Taylor, VoxEu, January 27, 2010

[Recommended Reading home]

These political attacks are a potent subtext to yesterday's FOMC statement. So if it had any hawkish tone at all, that would likely be the Fed's attempt to camouflage the reality that, in this election year, it is not in a political position do anything but go full-throttle to stimulate the economy as much as possible (see "Redoubling Down" January 25, 2010). It would probably do the same thing even without the political pressure, actually. The Fed sincerely believes that it can support the struggling labor market by staying extremely easy without courting any significant inflation risk, precisely because the labor market itself has so much "slack" (again, see "Sucker Trade: Inflation for Jobs"). What's more, the Fed likely sees that it's going to have to do it alone. After last week's Massachusetts upset, one might have hoped for a genuine pro-growth job-creating turn from the Obama administration. But when the president's idea of pro-growth job-creating policy is, as he said in his first State of the Union address last night, to cut the deficit with a purely cosmetic "spending freeze," by enacting budget-busting health care policies and the House's version of cap-and-trade, and trying to emulate China's success by subsidizing clean energy -- then monetary stimulus is about all we've got.

BOTTOM LINE: Yesterday's FOMC statement was not a hawkish surprise, and Thomas Hoenig's dissent should not be taken as a harbinger of the committee's changing sentiment. The Fed is hostage to the deeply stagnant jobs market, and to the volatile political environment, which together will work to keep the funds rate on hold near zero all this year.