PARSING THE CHAIRMAN II

Alan Greenspan, Chairman of the US Federal Reserve, is always difficult to interpret, but the effort is always worthwhile. In April, 2000, (see Parsing the Chairman), he expressed his concerns about the potential for “disengagement”. This was Central Bank-speak for falling prices that might lead to a market panic. He mused about how and when the Fed might respond, and concluded: “that choice may be the essence of central banking.” While the Fed could/would not act preemptively against a presumed bubble, they would certainly respond to the subsequent collapse.

In the event, the stock market plunge had just begun, and within the year, the Federal Reserve had moved to a fully stimulative policy stance, with the substantial aid of the mortgage credit granting quasi-government organizations. Since the economy did not collapse with the stock market, and inflation was well in hand, Fed officials have been happy to pat themselves on the back.

However, by early October, 2002, it appeared that Mr. Greenspan’s worst fears might be realized. “Disengagement” (precipitous declines in stocks) had reached extreme levels, and were threatening to disrupt consumer spending – the only economic cylinder that was firing. The Fed had used all its ammunition, having pushed their administered interest rate from 7% down to 1%. Their preoccupation had become the possibility that unmanageable deflationary forces were at hand, similar to those which have strangled Japan for more than a decade.

Fed Governor Bernanke spoke to the National Economists Club in Washington, on November 21. His topic: Deflation: Making Sure “It” Doesn’t Happen Here. In the event that deflation does become a problem, the Fed has “a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost”.
He was careful to note: “Of course, the U.S. government is not going to print money and distribute it willy-nilly.”

If this proves inadequate, “there have been times when exchange rate policy has been an effective weapon against deflation. A striking example from U.S. history is Franklin Roosevelt’s 40 percent devaluation of the dollar against gold in 1933-34, enforced by a program of gold purchases and domestic money creation. The devaluation and the rapid increase in money supply it permitted ended the U.S. deflation remarkably quickly.”

Mr. Greenspan revisited the topic on December 19 . “The recent experience of Japan has certainly refocused attention on the possibility that an unanticipated fall in the general price level would convert the otherwise relatively manageable level of nominal debt held by households and businesses into a corrosive rising level of real debt and real debt service costs”. Fortunately, this remains a low probability outcome, “but if deflation were to develop, options for an aggressive monetary policy response are available.”

What are we to make of these statements? One conclusion is clear. If they had no concerns, they would not be raising the issues. Thus, in their opinion there is a meaningful probability of a deflation scenario developing. We should worry, but how much and about what?

Second conclusion: they will do everything in their power to counteract the pernicious effects of deflation should it develop. Will strong doses of medicine cure the patient? Will they be able to manage a smooth transition back to moderate inflation and economic progress? Or will the monetary stimulation swing the US economy to a regime of persistent high or runaway inflationary pressures? Or will the Japanese deflation model play out again?

Our bias is that the US economy and financial system became inherently unstable during the twenty year period during which financial excess was rewarded and, until recently, seldom punished. This led to much naïve acceptance of unappreciated risk by many people who should have known better. Many bad decisions about where to invest financial assets and more importantly, productive investment capital, were made. The process of purging the system of these extravagances has begun, but probably has not run its course.

We have been around long enough to know that financial forecasting is a very uncertain task, and that our bias may well be wrong, and the deflation issue may be supplanted by another, much more benign. Central Bankers are strong and insightful.

We will continue to watch what the Chairman says and does. His is the best market intelligence we can have. Until he tells us differently, our strategies will remain biased towards caution and identifiable cash flows; and we will execute our disciplines.