Giving the Right Signals

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Watch What You Say and Do

The Federal Reserve realizes that its statements are scrutinized and analyzed to the fullest. Every board member's statements will have ripple effects throughout the markets and economy. The FOMC's decisions on the fed funds rate not only affect interest rates, the Fed's moves send signals to everyone from investors to consumers.

Some of the members' statements over the past couple of months have sent mixed signals to frustrated market participants. Dallas' Federal Reserve Bank president, Richard Fisher previously came out suggesting to CNBC viewers that the interest rate hikes were coming to an end. He then recently suggested otherwise. So which is it, more or less?

Greenspan probably understands that sending mixed signals will have negative effects. This is revealed in the FOMC minutes when the Chairman stated that the Fed should raise fed funds rate to 3.75 percent in its September meeting, despite the Hurricane Katrina aftermath. Most members agreed that halting their moves because of Katrina would have sent wrong signals. A review of the recent FOMC minutes and statements may show some indications as to where interest rates are headed.

FOMC Minutes

The FOMC minutes summarize some of the key economic issues Fed members consider when deciding what to do about rates. The biggest concern during the recent meeting was inflation. Before the decision makers rush to put out the fire, they must consider how the economy may handle rate hikes. Let's review some of these economic issues.

- Employment (pre-Katrina) seemed to have increased across all industries except manufacturing. Manufacturing jobs will continue to move overseas where labor costs remain low.
- Real personal consumption rose in primarily due to the first half of 2005, however falling in August. This was primarily due to large increases in motor vehicle purchases. We can thank employee-discount programs for that. However, other purchases showed moderate levels.
- Real income growth remained bleak, which put downward pressures on the already low savings rate. Gas price increases have caused a reduction in real disposable income and will likely hurt the retail industry.
- Housing continued its elevated levels, supported by the low mortgage rates. However, there are concerns to methods of how some people have purchased their homes. People who have financed through interest-only and adjustable rate mortgages (ARMs) will see that their decisions were ere mistaken. Most of those who have recently jumped into their purchases deluded themselves that housing prices would continue to rise and completely ignored that prices can actually fall.
- Trade deficits narrowed, which corresponds to the trade-weighted foreign exchange value of the dollar depreciating slightly.

- Overall CPI rose due to drastically increasing energy prices. However, core CPI remained benign in July and August. The Fed however acknowledges that the surging energy prices would probably pass through for a time into core prices. Core CPI for September stayed rather subdued.
- Business fixed investments came softer than expected, despite high sales and profitability. The FOMC believes that this is because CEOs have been anticipating a downward trend.

The Federal Reserve lowered projections for economic growth over the remainder of 2005 because of the impact from Hurricanes Katrina and Rita. However, the rebuilding efforts are expected to increase growth rates in 2006. The Fed anticipates return to normalcy by 2007.

Conclusion

The U.S. economy has taken many punches, and yet it still remains in reasonably good shape. Greenspan attributes this amazing feat to our economic flexibility. This flexibility comes from careful decisions on economic monetary and fiscal policies. Information technology enhancing cost savings also contributes to economic flexibility. Complex financial instruments such as derivatives also allow our markets to be efficient, spreading risks to those who are willing and able to handle them. The Fed Chairman suggested in his recent speech that this flexibility allows our economy and our markets to self-correct after disturbances. He also noted that this leads to less dependence on macroeconomic policymakers. Perhaps this was his way of saying that the Fed will continue to fight the inflation fire with further rate hikes. He seems to be suggesting that markets and consumer habits will adjusts without too many negative effects. I suppose we'll see how this will all play out.