Long Live The King?

"They told me if I voted for Goldwater we'd be in Vietnam in six months. I did and we were." -- 1960s witticism

American public life virtually mandates change comes from the other side of the spectrum. Who, for example, would have believed fiscal surpluses would have arrived during the Clinton years and massive deficits would return during the Bush years? Nixon famously went to China, and if the looming problems of Social Security and Medicare ever are addressed, it will no doubt be by a liberal Democrat.

The same phenomenon may apply to leadership at the Federal Reserve. Consider the bond market's poor if delayed reaction to the nomination of Ben Bernanke to succeed Alan Greenspan. Parenthetically, much of last week's jump in yields and bearish steepening of the yield curve may owe more to unexpectedly strong sentiment data in Europe, but *RealMoney* contributor David Merkel did not raise a single eyebrow when he said, "The bond market doesn't like Bernanke…"

Thinking About The Federal Reserve

The Federal Reserve and its Chairman occupy a unique and somewhat anti-democratic role in American life. How so? Congress has been very happy to relieve itself over *its* Constitutional responsibility over monetary policy: Article I, Section 8, Paragraph 5 states "The Congress shall have power... To coin Money, regulate the Value thereof, and of foreign coin, and fix the Standard of Weights and Measures."

Given the principle you can delegate authority, but not responsibility, the original and ultimate assignment of monetary policy to elected officials remains. Congress has delegated much to the Federal Reserve over the years, principally in the Full Employment Act of 1946 and in the Full Employment and Balanced Growth Act of 1978, known more commonly as Humphrey-Hawkins.

Under Alan Greenspan, the Federal Reserve moved a long way toward making itself more transparent; this move accelerated after the bond market's bad reaction to a series of rate increases in 1994. The Founders had some thoughts on secrecy and transparency, too: Article I, Section 5, Paragraph 3 states "Each House shall keep a journal of its Proceedings, and from time to time publish the same, excepting such parts as may in their Judgment require Secrecy."

The move toward transparency was difficult, both within the Federal Reserve and the market. We all have become semanticists able to parse "measured," "patient" and "considerable." Several commentators, myself included this past February, noted the unintended consequences of the Federal Reserve's predictability. This is the better of two evils, though: Government operations of all kinds have been kept open to the public through an intricate system of public hearings, testimonies, and a vast amount of publication by all technological means available. Unnecessary secrecy usually is the cloak of the unknowing and the ill-intentioned.

Hail Milton!

One of the few rewarding aspects of getting older is seeing how events move in cycles – see recent proposals for a "windfall profits" tax on oil companies – or how they swing as if on a pendulum. Sometimes, what is perceived as a fringe opinion, such as Milton Friedman's suggestion the monetary policy duties of the Federal Reserve be replaced by a computer, look more and more sensible over time.

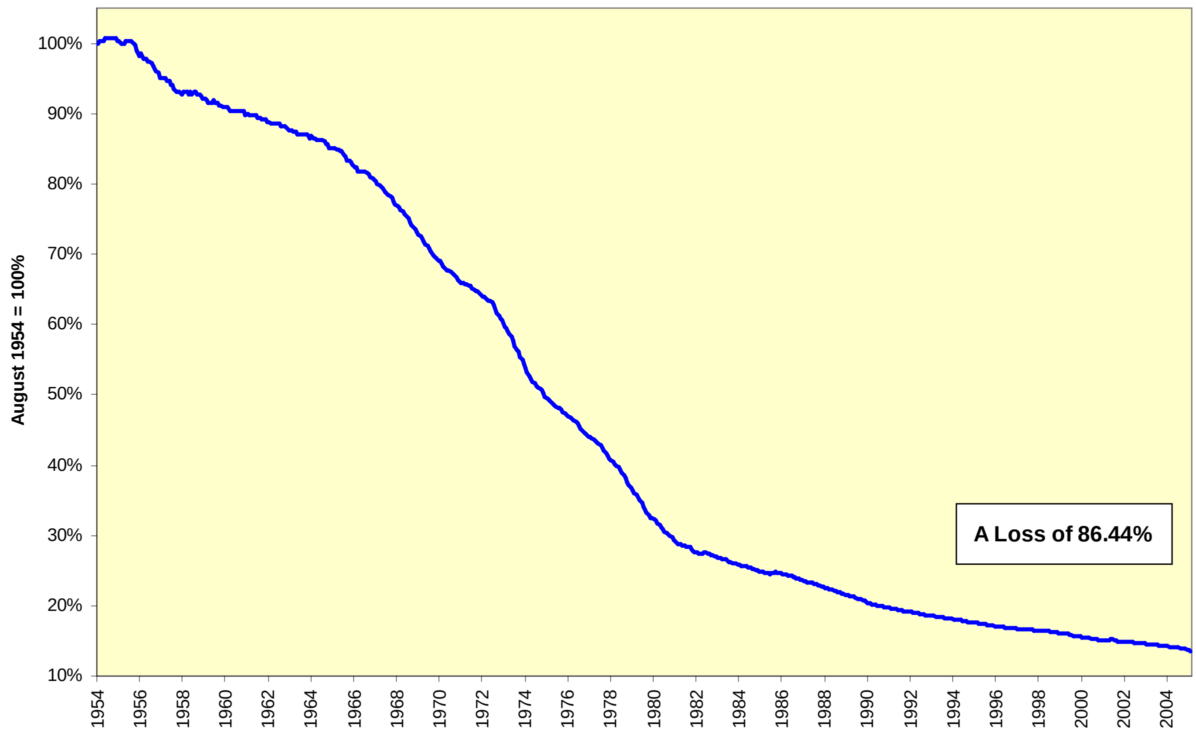
The Federal Reserve has the conflicting goals of promoting output and employment, price stability, the exchange value of the dollar and the integrity of the banking system. Its principal tool is targeting the overnight rate at which member banks in the U.S. can lend each other money. This tool operates with long and variable lags and in an unpredictable manner; witness Greenspan's musings earlier in the year over the Conundrum, the unwillingness of the long end of the yield curve to do his bidding. For that matter, long-term rates and the exchange value of the dollar were slow to decline after the Federal Reserve began cutting rates in January 2001. They both took until May 2002 to begin declining in earnest.

If anyone believes a series of 25 basis point changes in the overnight rate can alter the course of an $11.2 trillion dollar economy, one in which both the shape of the yield curve and the value of the dollar can trump the central bank's intentions, in a predictable manner, please let me know. The real power of the Federal Reserve lies in its aura, the belief it creates *and in which too many acquiesce* of its own omniscience.

Deification
The Supreme Court always finds itself in the news, and it certainly did last year with its various rulings on public display of The Ten Commandments. Number One, loosely translated, says "I am the Lord thy God, thou shalt have no other gods before me." There is no footnote to this Commandment saying, "except for whoever is the chairman of the Federal Reserve," but we seem to overlook that. Every single occupant of that seat in my lifetime – Martin, Burns, Miller, Volcker and Greenspan – has been treated as if he supped on nectar and ambrosia. Bernanke, a considerable fellow whom I respect greatly, will be accorded the same treatment. Soon he will be dragged up on Capitol Hill to answer all manner of questions beyond his direct portfolio to provide political cover for Congress.

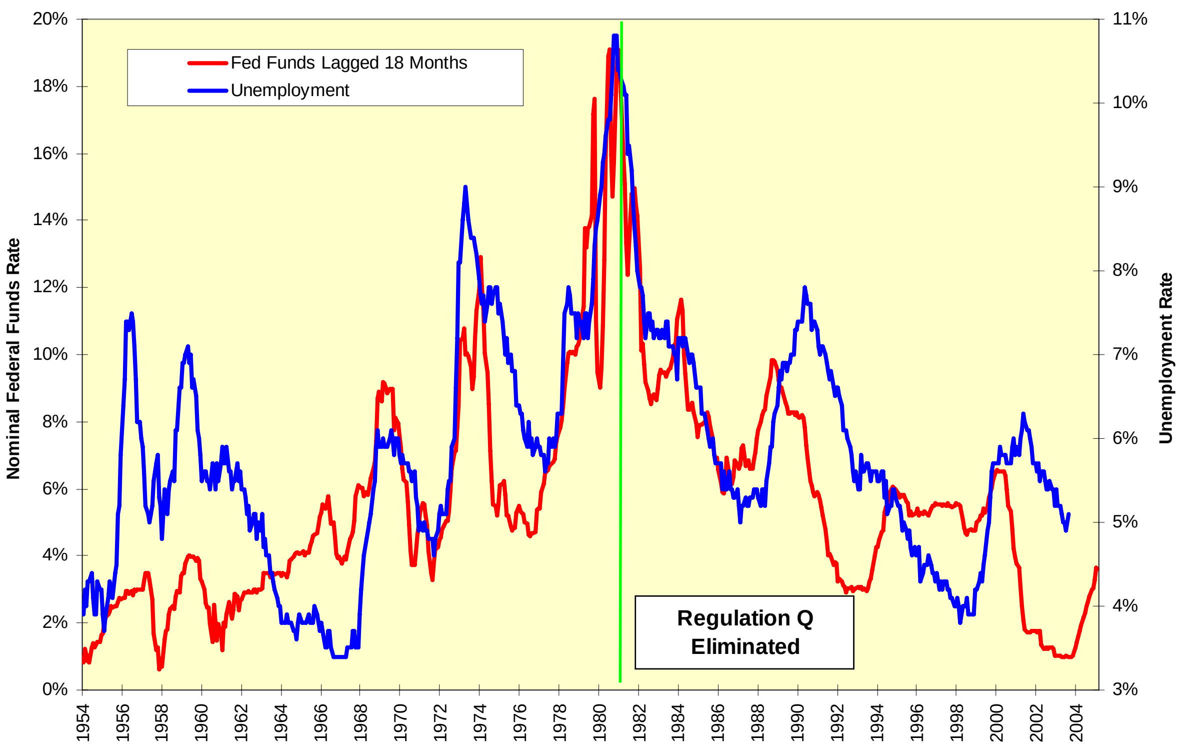
Why this should be so is beyond comprehension. If the Federal Reserve's primary market role is price stability – its primary mission is the integrity of the banking system – it has failed miserably and without pause during my lifetime. A dollar when I was born would be worth less than 14 cents today; only the rate of inflation has changed.

Value Of An August 1954 Dollar



How has the Federal Reserve helped manage its additional mandate of promoting full employment? Prior to the Depository Institution Deregulation Act of 1980 and the elimination of Regulation Q interest rate ceilings on time deposits, we could argue changes in the federal funds rate led changes in unemployment by 18 months or so. Over the past 25 years, however, any sort of leading relationship has disappeared. The growth of the secondary mortgage market and other financial derivatives has allowed credit to keep flowing into the interest rate-sensitive housing and automobile sectors. Quite simply, the Federal Reserve can no longer control economic growth by crushing and resuscitating sectors at will. As the Munchkins sang, "Ding-dong, the witch is dead."

The Federal Reserve And Unemployment



So do not worry about Ben Bernanke. His reputation will force him into hawkish behavior for some time to come. Do ask yourself why, in an open democratic system replete with checks and balances, we allow so much purported power to be conferred upon the FOMC without the slightest bit of evidence they are able to produce the results they desire.