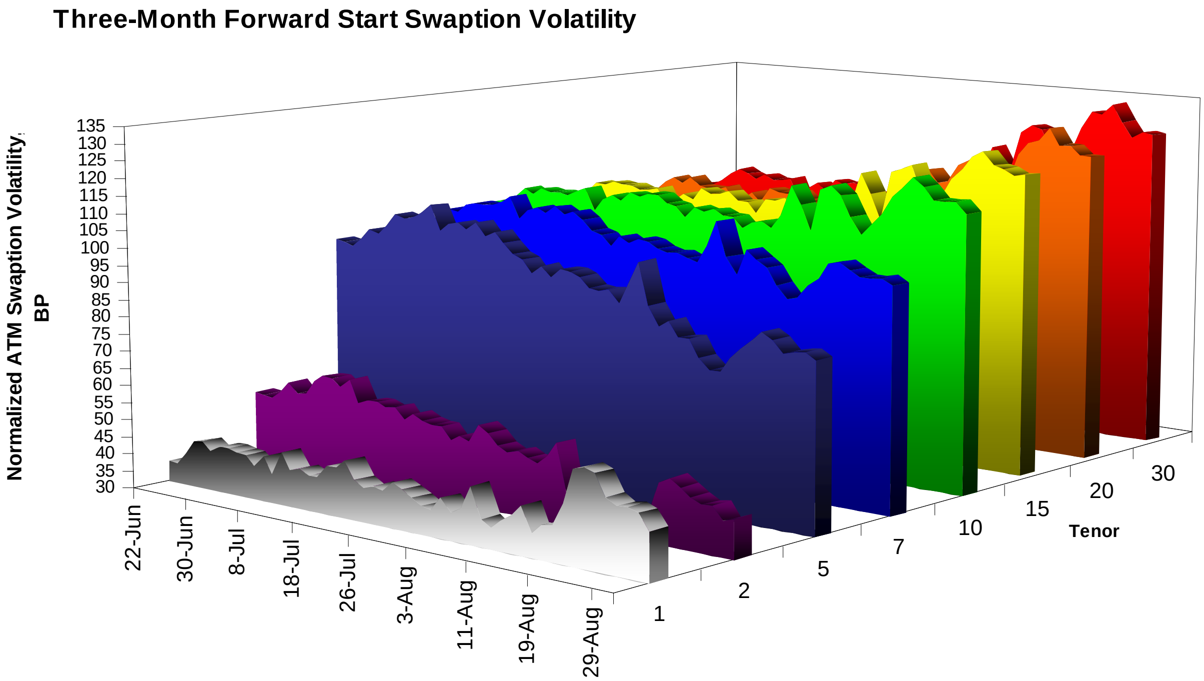
# FOMC's External Credibility Higher Than Internal

I have no way of proving it, but as you have no way of disproving it and this is my column, I will just say it: Most colossal frauds start out with an accident like that moment in Mel Brooks' *The Producers* where someone realizes the rest of the world is willing to believe what the perpetrator does not. In the case of the fictional Max Bialystock, it was Leo Bloom's realization no one would audit the books of a money-losing theatrical production.

What will it be with the FOMC, a group now demonstrating a level of internal cohesion best left in Waziristan? As we shall see below, their level of external credibility for keeping their pledge about short-term interest rates not rising until 2013 is high. This is the first step in what any self-respecting con man would recognize as a golden opportunity: Find yourself a gullible and greedy audience. Everything after that is a footnote.

Let's return to an analysis from April using the path of swaption volatilities to demonstrate just how much the FOMC has convinced the external market despite being unable to convince each other of much. A swaption is an option to enter the fixed-rate payment leg of that swap. Higher swaption volatility reflects a stronger belief rates are going to rise by the time the option expires; lower volatility indicates a greater willingness to stay floating.

The present configuration for three-month forward-start swaptions reflects two things, the continued belief the FOMC will not raise short-term interest rates for either one or two years starting three months from now and the belief long-term interest rates are going to start rising three months from now.




Another way of putting that is the market is perfectly willing to believe not only we are going to stay in this very steep yield curve, but if you come back after Thanksgiving, the yield curve is going to be even steeper. As investment decisions are made not at the overnight federal funds rate or even at one- and two-year rates but rather at the capital market horizon starting at ten years, this belief is equivalent to saying the FOMC's monetary depravity will lead to a higher cost of investment capital.

As I am on record, numerous times, as saying a steep yield curve with low short-term rates does nothing to solve unemployment or increase investment, I will stay consistent in saying it will fail this time, too. What will be most interesting to see, with "interesting" being something of a euphemism, is how the internal dissensions at the FOMC play out over this period.

A better suggestion, one I have made over the years, is we end the pretense you can get deterministic outcomes from monetary policy. You cannot. If low short-term rates and over-reserved banks were effective tools of economic recovery, they would have demonstrated it by now. Milton Friedman had it so right: Replace this failed legacy of central planning, one that has done little but inflate and re-inflate bubbles and produce busts, with a computer trying to make the money supply grow at the long-term growth capacity rate of the economy.

That is change I can believe in, to borrow a phrase.