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**Viewpoint**

# Fed Chases Its Tail In Buy-Now Economy

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During the past year the Federal Reserve has been very clear about its intentions to remove monetary accommodation at a pace that is likely to be "measured." The incentive for the private sector on hearing the Fed mantra is to load up on debt before the Fed takes cheap credit away. Implication: a faster pace of debt-creation.

This explains why growth of private-sector debt additions in excess of real economic growth has slowly picked up speed over the past year and is above its average differential of nearly 4%.

It stands to reason that if someone repeatedly tells you that he plans to increase the price -- in this case the price of credit -- that one would buy more now rather than waiting to buy at a higher price. It should be no surprise that additions to both household mortgages and corporate debt are occurring at a slightly faster pace.

If someone plans to buy a house in the next couple of years and the Federal Reserve announces to the world its intention to hike the cost of credit, one buys now. Housing starts in 2005 are on pace to reach their highest level since 1973 as households buy before the Fed pushes up the price of credit more.

The Fed, so far, has hiked the funds rate 11 times since June 30, 2004. The Fed created this perverse situation in which private debt additions occur at a faster pace due to the clear signals the Fed has given about its intentions. In turn, the Fed sees the buying in-advance private debt additions, so the Federal Reserve increases rates more. The Federal Reserve is chasing its own private-sector debt-generated tail in this series of Fed hikes.

There has been a major debate for years as to how clear the Federal Reserve needs to be regarding its intended policy moves. By moving toward more clarity with its intended policy, the Fed wants to avoid creating disruptions in the financial markets -- in other words reduce the risk that some financial market segment gets caught on the wrong side of unexpected Fed moves.

A good idea, but the idea is aimed primarily at the financial portion of the U.S. economy, not the nonfinancial segment, since the inherent risk in financial markets is sizable without the Federal Reserve adding to that risk by making unexpected policy moves.

It hasn't always been that way. Chairman Greenspan in an Oct. 11, 2001, speech reminisced about monetary policy transparency:

"We need to remember that in decades past it was believed that monetary policy was most effective when it was least transparent. The argument back in the 1950s, as I remember it, was that market uncertainty created significant differences of opinion in the direction of the prices of short-term debt instruments . . . that increased the degree of liquidity."

Greenspan goes on to say, "more recently, in the 1980s, policymakers, myself included, were concerned that being too explicit about short-run targets would make such targets more difficult to change . . . ."

"Not too many years ago, the world learned of decisions of the Federal Open Market Committee through minor variations in the minutia of daily open market operations. . . . True, over time, those signals became increasingly clear, so that in the end, market participants never missed a policy decision . . . Simply put, financial markets work more efficiently when their participants do not have to waste effort inferring the stance of monetary policy," Greenspan said.

The law of unintended consequences, however, is working as households and the nonfinancial corporate debt additions are pulling economic growth ahead of Fed tightening, leading a number of analysts to elevate their economic forecasts.

Since June 30, 2004, when the Federal Reserve made its initial move from 1% to 1 1/4%, it has said that "accommodation can be removed at a pace that is likely to be measured."

The Federal Reserve has essentially kept that phrase in front of the public through its 11 quarter-point hikes so far. This clarity of Fed intentions has set the economy in a buy-now mode even in the face of $65-a-barrel oil so that the Fed responds to its own moves. Everyone is watching to see what entity is tripped up first in this tightening cycle.

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