Can Alan Greenspan move the American economy smoothly towards higher interest rates?

THE chairman of the Federal Reserve may no longer have the aura of infallibility that he enjoyed in the go-go years of the 1990s, but he is still credited by many with a magic touch when it comes to monetary policy. Alan Greenspan's most recent wizardry--a willingness to slash short-term interest rates to 1% and keep them there--helped America stave off a sharp recession and bolstered a shaky recovery. Soon he must pull off another, possibly tougher, trick: raising interest rates back to more normal levels without either undercutting the recovery (by moving too soon or fast) or letting inflation or asset bubbles get out of hand (by waiting too long).

Listen to Wall Street, and Gandalf is about to swing into action. Over the past couple of weeks a slew of strong economic statistics (especially the creation of 308,000 new jobs in March) followed by news that inflation jumped unexpectedly, has sent financial markets into a frenzy of speculation that the central bank will tighten soon--and aggressively.

Only weeks ago, it was conventional wisdom that the Federal Reserve would keep short-term interest rates unchanged until next year. After the inflation and jobs numbers were published, futures markets began to price in the near certainty of a rate hike in August. Some economists even expect the Fed to move in June, with more raises possible before Americans go the polls in November. By the end of next year many in the markets expect short-term rates to be at 3.5%.

This week the magician himself spoke, in two testimonies to Congress. Not surprisingly, his message was both more balanced and nuanced than the thunder from Wall Street. Mr Greenspan was clearly preparing the ground for tighter policy but without suggesting that a move was imminent. He noted--as he has done before--that interest rates "must rise at some point" to prevent inflation from taking off, but suggested that "as yet" the long period of low rates had not "fostered an environment in which broad-based inflation pressures appear to be building".

Nonetheless, compared to the Fed's last official statement on interest rates in March, Mr Greenspan was noticeably more upbeat. In March, the central bank still saw the risks of lower inflation as slightly higher than those of inflation. This week, Mr Greenspan suggested that the
disinflation trend had "come to an end" and that the threats of deflation were "no longer an issue". He described the outlook for America's economy as "good". Significantly, he did not use the word "patient" when discussing how long the central bank could keep rates low. Though much of the testimony dwelt on why there was scant risk of inflation getting out of control, Mr Greenspan was clear that the Fed would "act, as necessary" to maintain price stability.

While Wall Street is fretting about out-of-control inflation, Mr Greenspan and his colleagues in Washington, DC, are relieved that inflation has stopped falling. Despite its recent acceleration, America's inflation rate is extremely low. Excluding the volatile categories of food and energy, the consumer-price index rose 1.6% over the past year. Other measures preferred by the Fed are hardly thrusting skywards. Given the worries about deflation, many central bankers see a small acceleration in consumer prices as a sign of success.

One question looms: is the inflation uptick due largely to one-off factors, such as higher commodity prices, or is it the beginning of a pernicious wage-price spiral? Many Fed governors play down the risk of the latter, pointing out that the labour market is still relatively slack. Despite the March employment figures, the current recovery looks anaemic in terms of job creation; until that changes, they argue, there is scant risk of price pressure being translated into higher wages.

But the central bankers' view of the job market seems to be changing--at least a little. A few weeks ago, when the March jobs figures came out, Roger Ferguson, the Fed's vice-chairman, played down their significance: it would, he said, take "some time" to see whether the improvement in the labour market was "fundamental and durable". By contrast, Mr Greenspan's tone this week was much more upbeat. He expects the pace of hiring to stay strong.

Yet even with faster job growth, Mr Greenspan seems sanguine about inflationary pressure. There is still, he points out, a "sizeable margin" of slack in the economy; productivity growth remains strong. Fat profits also give firms room to absorb higher wages without raising prices. All those factors allow the central bank wiggle-room before rates must rise.

This analysis is not shared by all of Mr Greenspan's colleagues on the Fed's interest-rate-setting committee. The presidents of district central banks, in particular, tend to be more hawkish about inflation. For instance, Bill Poole, president of the St Louis Fed, is concerned about falling behind the inflation curve. He reckons that the Fed must act "aggressively" when inflation risks change. Bob McTeer, president
of the Dallas Fed, said this week that the March rise in consumer prices was "disturbing".

In practice, however, it is Mr Greenspan's views that count most--and his goals seem to be to prepare the markets for higher rates, but not necessarily to rush to action. The reason is partly tactical: if you spend enough time preparing Wall Street for higher rates, the eventual move may not roil the highly leveraged markets.

America's rock-bottom interest rates have not just supported spending; they have also coaxed investors into gambling on borrowed money. Raise rates unexpectedly, or too quickly, and the unwinding of these investment bets could cause chaos in financial markets. Given consumers' dependence on housing wealth, a meltdown in the mortgage market alone could be enough to snuff out the recovery. Memories of 1994, when the Fed began a sharp tightening cycle, are still fresh. Then bond markets collapsed as investors appeared surprised by the central bank's moves. It is an experience Mr Greenspan will not want to repeat.

In all likelihood, the Fed will send a bevy of signals before it actually raises rates. This week's testimony is best seen as the opening salvo. But signalling is not a simple business. In June 2003, Mr Greenspan's efforts to convey his concern about deflation backfired when the central bank failed to cut interest rates by as much as the market expected. And investors can often refuse to take the hint. Fed officials reckon that they sent clear signals about tighter policy in 1993: Wall Street ignored them.

Judging by Wall Street's jitters, that looks unlikely to happen this time around. After Mr Greenspan's comments this week, no one can be surprised if rates rise later this year. But there are still enormous uncertainties about how to get from today's rock-bottom interest rates to more neutral levels. It is not just a question of when the central bank starts to raise rates, but how far they are raised and how fast. If he is to pull off his monetary magic once again, Mr Greenspan will have to become clearer on both counts.