TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

FED SHADOW

BoJ On the Potomac

Friday, November 2, 2001

David Gitlitz

Futures markets now priced odds-on for another 50 basis point cut in the overnight rate will in all likelihood be confirmed when Fed policymakers meet next Tuesday, putting the fed funds rate at a 40-year low of 2%. Given the still-volatile exogenous risk environment, and amid the total absence of anything that could conceivably indicate inflation risk, Alan Greenspan will not choose this moment to chance disappointing market expectations, especially after today's half-point jump to 5.4% in the unemployment rate. The Fed's policy rate will thus have been slashed by 450 basis points since early January, ranking among the central bank's more aggressive easing campaigns – at least as defined by the convention gauging monetary "ease" by the size of the reduction in the rate target.

A different picture emerges, however, when policy is assessed using objective indicators of dollar strength which are transmitted on a moment-to-moment basis in global auction markets. Here we see that the series of funds rate reductions has produced little if any measurable relief from a long-running policy bias maintaining an excessive scarcity of dollar liquidity relative to demand. In the 10 months since the Fed initiated this rate-cutting cycle, the dollar has appreciated about 5%, on net, relative to major foreign currencies on a trade-weighted basis, and by more than 14% against the commodities represented by the broad-based Dow Jones spot index. At just below $280 per ounce, the price of gold, the most monetary of all commodities, is up about 2.5% from the levels extant just prior to the first rate cut. Up until the Sept. 11 attacks, however, gold had shown little inclination to sustain any move above its low-$270s/oz. ranges of early January. Although the yellow metal has retraced about half the increase it tacked on in the wake of 9/11, the remaining gains appear largely to be a function of gold's status as a shelter during periods of high uncertainty.

At this juncture, then, it's not premature to pose several questions that might otherwise be considered impertinent. If cutting the overnight borrowing rate – the banking system's marginal cost of funds – from 6.5% to 2% has not resulted in any discernible softening in dollar purchasing power, what level of confidence can there be that further cuts will meet with better results? When does an ever-lower rate lose its potency as a spur to monetary stimulus and simply become symptomatic of a deflationary, low-return reality? To what degree, in other words, does the Fed risk following in the footsteps of the Bank of Japan, which parlayed a seemingly accommodative interest rate policy, with overnight rates set at zero, into a chronic monetary deflation that has devastated the Japanese financial system.

There is, to an extent, a plausible rationale for offering reassurance on these issues. Since early in this rate-cutting exercise, the thinking here has been that the Fed would eventually find a level for short rates that would cease to provide a competitive real return to essentially risk-free cash instruments. At the margin, incentives would then shift, encouraging a faster pace of asset creation and enhancing the risk exposure of the financial system. That would bring in train an increased demand for reserves, which the Fed would accommodate to keep funds from trading above target, while diminishing risk-averse demand for interest-bearing cash balances. On net, liquidity would become more abundant relative to demand, relieving the deflationary pressures.

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com

325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 335 8016

Within the rigidities and distortions imposed by the rate-targeting paradigm, bringing the funds rate down to a point that no longer offers a premium relative to a market-wide rate of return is key to restoring incentives for lending activity, allowing the requisite liquidity creation. We noted preliminary indications suggesting that the Fed might have reached that level with its move to 2.5% early last month ("Looking Up," Oct. 4, 2001). In the intervening weeks, however, support for that supposition has admittedly been scarce. The Fed's balance sheet gives only the barest hint of a more generous stance. Since early October, by which time the post-9/11 emergency liquidity operations were drained off, growth of Fed balance sheet assets has shown a slight upward tilt relative to pre-attack rates, growing year-on-year in a range around 9%, versus 7.5-8% previously. The non-response of sensitive market price indicators, however, suggests that even this small acceleration is still being driven largely by risk-averse cash demand. Certainly, it cannot be traced to growth in new lending; commercial and industrial loans are now showing a year-to-year decline of about 3%, the worst contraction of commercial lending in more than eight years.

Until now, we have resisted drawing parallels between the Fed's rate-cutting program and Japan's disastrous experience. Japan's decade of gloom grew out of a confluence of fiscal and monetary policy errors that may be without historical precedent, making easy comparisons suspect. The downdraft began with a punitive change in the tax treatment of real estate, the backbone of the Japanese financial system. As the value of real estate portfolio holdings began their long and precipitous decline, borrowing came to a standstill and nonperforming loans began to mount. The so-called "bubble" was popped, and the BoJ's attempts to ease with repeated rate cuts could get no traction because the mechanism transmitting central bank stimulus through the bank lending channel was incapacitated. Basically, expected returns to capital were falling even faster than the BoJ could bring rates down.

That can be considered the initial policy error. The effects, however, were greatly exacerbated by a long series of calamitous operational blunders fostered by the BoJ's rate-targeting procedures. In essence, the collapse in bank lending left the banking system with little need to bid for new reserves even as the BoJ was cutting rates. At the same time, though, the mounting fragilities of the banking system were increasing safe-haven money demand. Nevertheless, the dictates of its rate-targeting doctrine compelled the bank to actually drain liquidity as it was cutting rates due to the slack demand for reserves from the banking system. The result is the deflationary nightmare we see today, with the banking system on the precipice of insolvency, unemployment at record levels and bankruptcies spreading like wildfire. Thus, Japan's zero overnight rate actually exemplifies the deflationary economic straits produced in large measure by the BoJ's own staggering incompetence.

Can't happen here? Perhaps not to the same extent, but in a rate-targeting regime that remains for all practical purposes blind to the real-world signals of market prices, repetition of the same sort or errors is by no means impossible. For example, the depression in real capital investment -- itself a demonstration of the plunge in expected returns produced by an overly tight Fed – has been a major factor contributing to the contraction in new lending. In this environment, though, it's not clear at what point a lower overnight rate can provide the incentive to restore investment activity, boost lending and thereby generate new supplies of liquidity. As evidence of deflation pressures mount all around it, the Fed could well remain incapable of responding if the customary signals are not delivered through the reserve-demand channel. At some point, we'd imagine, Greenspan would find it within himself to recall the principles by which he once operated and construct a rationale for action outside the rate-pegging convention. That, though, would probably only emerge from the kind of crisis we'd be better off not having to witness.