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It Doesn't Follow

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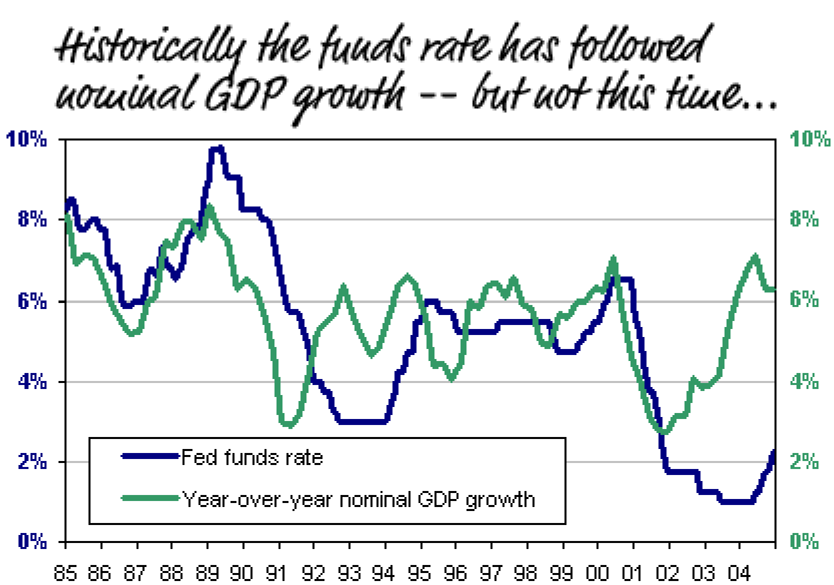
If Wall Street doves have their way, even higher inflation will be the result.

Among scenarios breeding anxiety in the equity markets, the notion that **Fed** rate hikes pose a growing threat to continued economic expansion is gaining prominence. Wall Street strategists and economists in increasing numbers are warning of ominous consequences for growth and earnings if this rate-hiking cycle is not soon brought to a conclusion. The sentiment appears to be having at least a marginal effect within the Fed itself, with some policy makers broaching the prospect of a pause in raising the funds rate target in recent comments. At this point, however, the concern appears entirely misplaced. It ignores that by any relevant standard the Fed remains in a highly accommodative posture, and policy is unlikely to become what could objectively be considered "tight" even if it maintains its current course through this year.

The thinking guiding this line of analysis holds that since the Fed was a major source of economic "stimulus" in cutting the funds rate to its rock-bottom low of 1% in mid-2003, any reversal of the rate cuts must necessarily remove an impetus to expansion. With resource use continuing to show signs of "slack," excess demand is not an issue, and higher rates are simply a penalty on growth. In this archaic **neo-Keynesian** conception, the nominal rate target is the be-all controlling aggregate demand. The relation of the target both to current and expected inflation, and to economy-wide rates of return and opportunity costs, is at best an after-thought. It is the context of these variables, however, which determines the appropriateness of the rate target, and how it is functioning to affect the supply and demand for dollar liquidity. Just as in life, in monetary policy there is no such thing as a free lunch. As should have been learned from hard experience in decades past, any Fed attempt to artificially boost growth by maintaining below-equilibrium overnight rates will only bear bitter inflationary fruit, inevitably torpedoing any short-lived monetarily induced boom.



Even after 125 basis points in hikes since mid-2004, with a 2.25% rate target the Fed's stance still can only be characterized as easy. Indeed, the extent to which the Fed remains behind the curve is brought into bold relief by viewing the Fed's policy normalization effort thus far against the most widely used measure of underlying inflation, core CPI. As a result of the Fed remaining too easy for too long, the year-on-year core inflation rate has more than doubled since year-end 2003, from 1.09% to 2.27%. In other words, the Fed has barely kept pace with the rise in core inflation, and for all practical purposes the real inflation-adjusted funds rate remains at zero. If, as is nearly universally expected, the Fed next week lifts the funds rate again to 2.5%, it will put the real rate in positive territory for the first time in this exercise. However, we see the trend higher in core inflation as likely to continue apace until the year-on-year rate approaches -- or perhaps exceeds -- the 3% level, probably within the next year. If the Fed, as expectations now suggest, moves the funds rate to no higher than 3.25% by year end, it likely will leave the target barely in positive territory. Over the past 20 years, by contrast, the real funds rate -- using core CPI as the deflator -- has averaged just below 2%. The Fed's failure thus far to evince a commitment to restore that level of inflation protection in the overnight rate undoubtedly has contributed to reduced dollar demand.

Another perspective on the scope of the Fed's accommodative posture relative to historic norms is illustrated by the chart on the previous page, plotting the fed funds rate target against the rate of nominal GDP growth. As can be seen, whether intentionally or not, the Fed's rate-setting over the past 20 years has closely followed the path of nominal GDP growth. To a degree, this can be seen as a natural consequence of the Fed's growth-regulation mindset, which has been a source of significant error over the years. One should not lose sight of the fact, for example, that the central bank's current predicament is a consequence of it having over-corrected for the deflationary liquidity squeeze it engineered in 1997-2001.

It's also the case, however, that nominal GDP growth can be considered a proxy for an aggregate rate of return, influencing the opportunity costs that are reflected in rates across the maturity spectrum. In this sense, keeping the funds rate in line with market-wide opportunity costs should see adjustments in the target corresponding broadly to nominal GDP growth. The Fed's current error lies in continuing to peg rates below opportunity-cost equilibrium, forcing it into a surplus liquidity posture to maintain the target. Since 1985, the funds rate target has averaged just 50 basis points less than nominal GDP. Today, it is 400 bps below the nominal GDP growth rate.

Bottom line: The real risk to growth and markets arises not from the current pace of Fed action choking off the expansion. Rather, should the Fed continue to lag behind the curve in quelling incipient inflationary impulses, higher-than-expected inflation is inevitable, sharply raising market-wide risk premia and forcing a much more harsh policy response than is currently envisioned. TM