TrendMacrolytics

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The Price of the Pause

Friday, October 20, 2006
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With the Fed on pause, the equilibrium funds rate is now arguably above 6%.

Update to strategic view

FED FUNDS: No change at the October FOMC meeting. But by the December meeting, core CPI will likely have printed above 3%, and the sharp growth moderation the Fed is expecting is unlikely to have materialized. There is a better than 50/50 chance that the funds rate will be hiked at the December meeting.

[see Investment Strategy Dashboard]

The fed funds rate is still below equilibrium, and inflation pressures will continue to compound so long as that is so. We measure such things with tools very different than those used by the Fed, but we believe that the Fed has arrived at a similar conclusion. For now, the central bank is content to stay on pause while acknowledging inflation as the "dominant" risk. The Fed wants to tread lightly for a while as it assesses the impacts to the economy of the cooling housing market (see "The Frustrated Fed" September 28, 2006). At the same time, it expects that moderating growth will act to relieve inflation pressures. But over the coming months, greater economic vitality than the Fed expects will both put its housing concerns to rest *and* fail to provide expected inflation relief. At that time we expect the Fed to start hiking rates again. If the Fed had raised the funds rate just one more time at the August FOMC meeting, we think they probably could have stopped permanently at 5.5%, without any real risk to growth. But having paused, and having allowed inflation pressures to compound, the funds rate will now have to go to higher and more risky levels than if there had never been a pause in the first place (see "Judgment Day" August 3, 2006).

By the Fed's own historic norms, the funds rate today should already be considerably higher. Harvard economist and former Council of Economic Advisors chair Greg Mankiw developed in a 2001 paper a simple formula that explains the funds rate during the Greenspan years, with a very robust r-squared of 0.85. By this reckoning, the funds rate today should be 6.12%.

$$\text{FED FUNDS} = 8.5 - 1.4 * (\text{UNEMPLOYMENT} - \text{CORE CPI})$$

$$8.5 - 1.4 * (4.6 - 2.9) = 6.12$$

We don't think that macroeconomic variables such as the unemployment rate, or backward-looking aggregates like the core CPI, should have any bearing on setting monetary policy. But thinking of them purely as *instrumental* variables, and recognizing that the Greenspan regime one way or another ended up converging the inflation rate to near zero, it's not entirely untenable to think of Mankiw's formula as producing something like an equilibrium rate -- and, sadly, now we're quite far from that rate.

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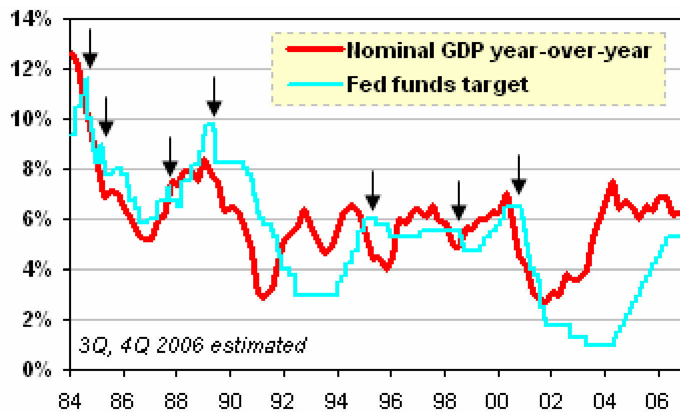
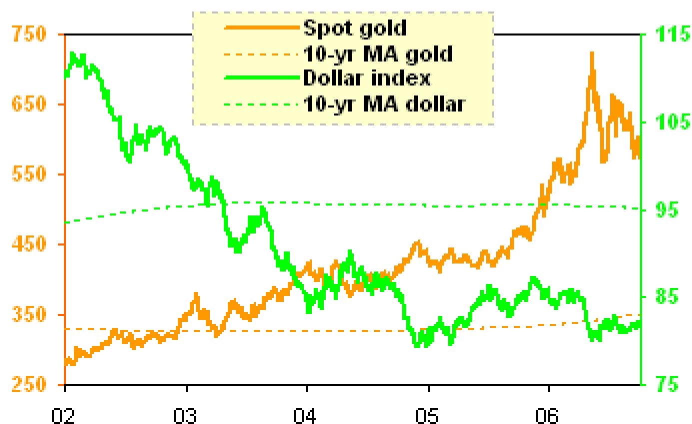
A more fundamental way to think about the equilibrium rate is to compare the funds rate to nominal GDP. Historically -- excluding the anomalous post-2002 period -- the funds rate has averaged 11 basis points above trailing 4-quarter nominal GDP growth. This suggests that the equilibrium funds rate is one that roughly equates bank funding costs with investment opportunities across the economy. The Fed has *never* started easing unless the funds rate is above nominal GDP (as indicated by the black arrows in the chart at right). Today's funds rate is far *below* nominal GDP, so unless the economy were to fall into recession immediately, the equilibrium funds rate has to be higher than today's rate. If we assume for the third quarter only 4.5% nominal growth -- down sharply from 5.8% in the already slow second quarter -- that will put trailing 4-quarter growth at 6.1%. Thus, by historical standards, the equilibrium funds rate should now be 6.21% -- almost the same result as Mankiw's model.



THE FED HAS NEVER STARTED EASING UNLESS THE FUNDS RATE ABOVE NOMINAL GDP



GOLD STILL TOO STRONG, DOLLAR STILL TOO WEAK

These two estimates of the equilibrium rate are useful as simple demonstrations of how low the funds rate is -- standing in stark opposition to the consensus in the bond market the that Fed's next move will be to lower rates. But the true test of whether any given fed funds rate is at equilibrium will be the response of sensitive market-price indicators. We know that the funds rate today is too low because the gold price is still so strong, and the dollar exchange rate is still so weak. Gold is 70% *above* its long-term moving average. And the dollar is 16% *below* its long-term moving average. Both indicate that the present funds rate is too low to sop up a considerable remaining excess of dollar liquidity in the world economy. While that excess remains, inflation pressures build. Yes, it's a good thing that these two indicators have both corrected back toward their long-term averages from their early May extremes. That suggests that rates are closer to equilibrium today than they were in May. Why, even though the Fed has paused, have gold and the dollar corrected from their May extremes? It is because, in the face of those extremes, Fed chair Ben Bernanke gave several tough-talk speeches in which he aggressively reaffirmed the primacy of price stability among the Fed's policy objectives (see "Bernanke Arrives" June 6, 2006). This seems to have had the effect of drawing a line in the sand against the worst-case inflation threat. For the moment, gold, the dollar and other sensitive market-price indicators of inflation have chosen to take Bernanke at his word. But all these indicators remain highly elevated, and unless the Fed ultimately follows through by moving the funds rate up to equilibrium, that line in the sand will be challenged and potentially breached.

BOTTOM LINE: If gold, the dollar and other market-price indicators were still at their May extremes, the Fed would have far further to go -- and would have to risk far more damage to the economy -- than it does today. When the inevitable move toward equilibrium finally begins, we'll be watching these indicators to determine whether the higher funds rate will merely slow the economy, or throw it into recession. But it's only a question of when and how much -- not if. With core CPI now just 7 basis points away from our long-standing prediction of 3% (see "Surprises in Store" May 27, 2004) -- and with an economy strong enough to sustain an unemployment rate nearly identical to that of the "irrational exuberance" years -- for the Fed the pressures are becoming too great and the potential for relief too remote. We reiterate our strong conviction that the next rate move will be higher. TM