TrendMacrolytics

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Fed Cred

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Did the Fed break its promise to the bond market... or is it just that you can't cheat an honest man?

With bond and money markets today not exactly acting reassured by **the FOMC's** reassurances after yesterday's rate-setting meeting -- and in the wake of this summer's massive Treasury market oscillation -- many commentators are talking about whether **the Fed** has lost its credibility. The proper question should be: when will the market lose its credulity?

Those who feel misled by the Fed believe that it broke what they see as a promise to keep the fed funds rate at today's low levels into the indefinite future. But did the Fed really promise that? *Can* it?

Yes, the Fed has gone to great lengths this year to reassure the market that it will do whatever it has to do -- including resorting to "unconventional" monetary policy tools -- to build a firebreak against deflation and to help the economy recover. We have interpreted these reassurances not so much as the promise of any particular fed funds rate -- but rather as a commitment to keep the funds rate as low as humanly possible subject to inflationary risk. With the legacy of past deflationary errors seen as keeping such risk in check, we've said the Fed has what amounts to a "free option" to try to gun the economy with low rates (see "How Much Will These Free Options Cost?" June 25, 2003).

To have interpreted the Fed's statements this year as a promise of any particular *absolute level* of the Fed funds rate for any period of time would have been based on a major misunderstanding about how monetary policy works. In order to deliver on the commitment to gun the economy subject to an inflation constraint, all the Fed has to do is to keep the funds rate *relatively* low in relation to the real interest rate in the economy, which is determined by the economy's growth potential. As the economy recovers and the real rate raises, the Fed would have no choice but to raise the funds rate commensurately -- or risk violating its inflation constraint.

Now, as growth appears to be accelerating, the real rate is rising. If the *absolute* level of the fed funds rate were raised in response, the Fed would then be no less accommodative than it is today: accommodativeness is a product of the fund rate *relative* to the real rate. We could have a very easy Fed at a funds rate of, say, 3% -- provided that the real rate had moved commensurately higher.

But bond traders who put on the so-called "carry trade" -- borrowing overnight at the funds rate to finance long positions in longer term Treasuries -- were making a bet on the *absolute* level of the funds rate, not the *relative* level. To make such a bet was either to misunderstand the Fed's promise, or to bet against an acceleration of economic growth. Either way, the bet hasn't paid off, and it's just going to get worse. Happily, when such bets get worse, that means that everything else in the world is getting better. TM

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