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Fed Uncertainty Means Market Uncertainty

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The new Federal Reserve chairman, Ben Bernanke, is making what cynics would call a serious mistake: he is being honest with the markets. The Fed is uncertain about the future path of U.S. growth and inflation. The most basic tenet of the theory of economic policy is that in circumstances of elevated uncertainty, policymakers should do less. Therefore, in his April 27 testimony to the Joint Economic Committee of Congress, Bernanke suggested that the Fed might start doing less: "Even if in the Committee's judgment the risks to its objectives are not entirely balanced, at some point in the future the Committee may decide to take *no action* at one or more meetings in the interest of allowing more time to receive information relevant to the outlook" [emphasis added].

After its May 10 meeting, the Fed's Open Market Committee reinforced the message of more uncertainty about the direction of the economy, saying: "The Committee judges that some further policy firming *may* yet be needed to address inflation risks but emphasizes that the extent and timing of any such firming will depend importantly on the evolution of the economic outlook as implied by incoming information" [emphasis added].

Chairman Bernanke and virtually all of his colleagues on the Open Market Committee have made it clear, most forcefully in their May 10 statement, that they view the Federal Reserve's most important mandated objective as one of maintaining low and stable inflation. A glance at any long-run chart of U.S. growth and inflation data clearly demonstrates the basis for this view. Since the early 1980s, when inflation was reduced and held to low and stable levels, U.S. economic performance has improved markedly. Growth has been higher and steadier; productivity growth picked up especially after 1995 and has remained higher ever since. Virtually all macroeconomic data have stabilized in a way that has reduced the duration and severity of recessions, so that the last recession (in 2001) was barely detectable. "The Great Moderation" is an often-used term that describes policymakers' pride and satisfaction with the beneficial results of bringing down inflation and holding it at low levels.

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Source of New Uncertainty

Why, one may ask, is the Fed more uncertain about the path of the U.S. economy and requisite policy measures now than it has been since June 2004, when it virtually promised and subsequently delivered fed funds rate increases at a pace of 25 basis points per meeting? The answer is that the Fed has completed the normalization phase of its rate increases, during which time, with ample guidance from former Fed chairman Greenspan, markets became accustomed to the regular delivery of a clear message about the Fed's next step: another 25 basis-point increase of the federal funds rate. Now it is time for the Fed to pause and see if the economy continues at a trend growth rate with stable inflation. The outcome is unclear.

The modest, totally predictable rate increases during the period of normalization were benign, coming especially as they did with a steady rise in inflation that mitigated the rise in the real fed funds rate. As a result of a low-risk policy environment, market players became comfortable

with rate increases, credit remained readily available, and long-term rates actually fell through the first quarter of 2006. It is fair to describe the 375 basis points of Fed rate increases from June 2004 through March 2006 as among the most benign rate boosts of that magnitude ever undertaken. There was a lot of normalizing to do, but it was carefully advertised, had a modest, positive impact on real short-term interest rates, and actually coincided with a modest reduction in real long-term interest rates.

The new chairman has had the good fortune—or the misfortune (only time will tell)—to assume leadership of America's central bank at a time when uncertainty about the path of the economy and about the requisite path of Fed policy had to increase. With the fed funds rate at 5 percent and core inflation around 2 percent, the real fed funds rate at 3 percent is close to neutral, based on most estimates. Neutral would mean a rate consistent with trend growth and stable inflation. In this environment, Chairman Bernanke faces an awkward paradox well identified by *Wall Street Journal* columnist Greg Ip in his May 3 article on the Fed: "[Bernanke] came to the Fed promising to make its policy more transparent, but arrived at the very moment when economic circumstances make it less clear what policy will be."

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The Fed is by no means alone in its expression of uncertainty about the future path of the U.S. economy. Growth has remained robust in the face of major disruptions, including a persistent rise in energy prices and last year's hugely damaging hurricanes. During all of 2005, real growth averaged 3.5 percent while the broad measure of GDP inflation, the implicit price deflator, averaged just below 2.8 percent, resulting in 6.3 percent nominal GDP growth. That robust figure is well above the ten-year average of 5.5 percent for nominal GDP growth. By the first quarter of 2006, after the 375 basis points of increases in the fed funds rate, year-over-year real GDP growth stood at 3.5 percent with the implicit price deflator at 3.2 percent, yielding a 6.7 percent nominal GDP growth rate.

The economy has maintained growth at or above its long-run 3.5 percent trend while inflation has increased slightly as the Fed has raised the fed funds rate. It is little wonder—with the real fed funds rate at a neutral level, real growth holding just over trend, and inflation accelerating slightly—that the Fed is a little unsure about what to do next. The uncertainty is compounded by signs of weakness in the housing sector that have, as yet, had little negative impact on consumption. Meanwhile, investment spending remains robust, and the contribution to growth from net exports and government spending remains on trend.

Rising Long-Term Rates

Recently, the "conundrum" of long-term interest rates remaining low, even as short-term rates have risen considerably, has begun to unwind. The Fed's indication of elevated uncertainty about the future path of growth and inflation, coupled with a modest but steady upward creep in core inflation rates, has combined to boost U.S. long-term interest rates by 70 basis points over the past two months. Real rates have risen by about 50 basis points as economic growth has remained stronger than expected, while elevated policy uncertainty may have boosted risk premiums on longer-term financial instruments.

Over the last month, 0.3 percent increases have boosted year-over-year inflation rates to 2 percent for the core Personal Consumption Expenditures (PCE) and 2.3 percent for the core Consumer Price Index (CPI), pushing both of these inflation gauges to the top of the Fed's desired ranges. The result has been an increase of long-term inflation expectations by about 20 basis points, thereby compounding the upward pressure on longer-term interest rates. Bernanke's hint in his April 27 testimony to Congress that the Fed's rate increases may pause even if "risks to its objectives are not entirely balanced" (that is, with target inflation measures close to the top of their desired ranges rather than near the middle) has coincided with higher inflation expectations and a weaker dollar. Ironically, the Fed's uncertainty and the resultant upward move in long-term interest rates may weaken the housing sector further and thereby contribute to holding growth at sustainable trend levels.

Stepping back and viewing the path of U.S. monetary policy in a broader context suggests that markets may need to make substantial adjustments regarding the outlook for Fed policy over the coming year. Clearly, the spring of 2006 has coincided with the removal of a highly accommodative Fed policy that had been represented by the 1 percent fed funds target through June 2004. Removal of

accommodation is intrinsically a straightforward process to communicate to markets, and so investors have benefited from a highly predictable path of normalization of U.S. monetary policy.

The next stage, calibration of real interest rates to achieve trend growth with stable inflation, is intrinsically more difficult and involves more uncertainty, both on the part of the policymaker and for the path of the economy. The Fed, and the households and firms affected by the path of the economy, hope that the calibration will result in a smooth, asymptotic approach to a neutral level of interest rates that permits the simple continuation of trend growth. Such an accomplishment would provide a further boost to asset markets while underscoring a benign outlook for the global economy. It would also boost aggregate demand and, ultimately, inflation as wealthier households sustain higher spending growth.

Inflation Risks Must Be Minimized

The major risks to the benign outlook lie with the possibility that the critical measures of core inflation monitored by the Fed will creep steadily higher, above the upper end of their desired ranges, where they now stand. The sustained rise in prices of commodities, including oil and gold, suggests a buildup of incipient inflation pressure. Should the inflation gauges push above their desired levels, the Fed will have to move past the calibration phase and on to an actual tightening of monetary policy aimed at pushing growth below trend to relieve inflation pressure. That phase would probably require another 100 basis points of tightening to a fed funds rate above 6 percent.

Therefore, the possibility of a fed funds rate of 6 percent or 6.25 percent should not be viewed as unthinkable in a context of the usual path of tighter monetary policy from removal of accommodation to calibration to actual tightening. The possibility is enhanced by the continued strength of the economy through the normalization phase of tightening coupled with ample supplies of liquidity still present. The ultimate effect on asset markets and the economy would be considerably less pronounced if just a few market players and policymakers would suggest that such an outcome, while perhaps not the most probable scenario, is still possible. The total absence of such consideration and the market gyrations that could result from actual tightening beyond normalization is probably another factor troubling Ben Bernanke and his colleagues on the Open Market Committee.

If inflation does keep rising, it will be important to remember another basic policy rule: the number of policy targets must be equaled by the number of policy instruments, and where a single instrument confronts multiple targets, it must be aimed at the target it can best attain. Monetary policy alone cannot produce both price stability and growth, and it works best when aimed at price stability. If the Fed has to choose between maintaining stable prices and maintaining growth, it will choose price stability. That is the lesson of the post-Volcker era "Great Moderation" of inflation and volatility, and Ben Bernanke knows it well. He literally wrote the books on the policy lessons of that era and on the policy lessons of the Great Depression. The former said keep inflation low and stable, in a range of 1 to 2 percent, while the latter said, avoid deflation. Not always easy, but worth the effort.