ELY'S FED FAX

Bert Ely's Irregular and Highly Irreverent Commentary on the Fed

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WHAT WILL THE FED DO NEXT TUESDAY?

Whatever the FOMC does or does not do next Tuesday will be bad because, as the essay below explains, its action or lack thereof will distort the financial market's setting of interest rates. However, based on the economic data released this week, my bet is that the FOMC will hold the Federal Funds Rate Target (FFRT) at 5 1/2%. While Greenspan craves attention, good or bad, hiking the FFRT will rain more opprobrium on the Fed than I think he wants at this time.

"HOW LONG CAN THIS LAST?" A LONG, LONG TIME, IF THE MARKETS SET ALL INTEREST RATES

"How Long Can This Last?" was the headline on a recent Business Week cover story about the state of the economy. That headline captures the tone of many similar articles recently, most of which reflect substantial disbelief about the sustainability of present economic conditions. That disbelief stems from the not unreasonable supposition, based on historical experience, that periodic recessions are inevitable. (The six recessions since 1960 are shown by the shaded bars on the accompanying chart.) But are recessions inevitable and if so, do they need to be as severe or prolonged as many that we have seen? This issue of Ely's Fed Fax will address this two-part question. Briefly, stable economic growth can continue, thereby avoiding a recession, for as long as growth in the economy's demand for goods and services keeps pace with the economy's ability to produce or import those goods and services.

Recessions occur because aggregate economic demand is less than what an economy can produce at a relatively full employment of the labor and reproducible capital assets (factories, offices, stores, machinery, rental housing, transportation equipment, etc.) used to produce goods and services. Key to avoiding recessions is keeping demand in reasonably close balance with supply. I focus on demand because demand can vary much more quickly and dramatically than supply, or more specifically, the capacity to supply. That is, in the United States today, productive capacity (measured in sufficiently broad terms to include the delivery of services) can and should grow at a fairly steady rate (absent a sudden supply shock comparable to the oil shocks of the 1970s) as the work force grows, production facilities are built (including facilities that produce services), and productivity improvements take hold. Common to all recessions and depressions is an underutilized capacity to supply goods and services; i.e., insufficient demand. An insufficient capacity to supply is a macroeconomic problem only when excess demand occurs, a problem that I will touch on below.

As I noted above, demand is the critical variable in the economic equation. Demand, including the demand for investments goods such as machinery and housing, is a function of both the ability and the willingness of consumers, businesses, and governments to buy goods and services. No matter how great the desire to buy, buying will not occur unless prospective buyers have the ability to buy. Except in highly unusual circumstances (nuclear war has just broken out, a large meteor will soon hit the earth, etc.), the aggregate desire within the economy to buy should exceed the ability to buy. After all, how many of us are truly satiated with goods and services? Keynesianism, of course, recognized the importance of the ability to buy; unfortunately, Keynesianism did not come up with a sustainable mechanism for maintaining that ability.

The ability to buy is a function of one's income plus, for most buyers, the ability to obtain the savings of others to use for purchasing purposes. Businesses boost their buying power beyond the income they generate by selling stock and borrowing money. Individuals cannot sell stock in themselves; therefore, they must borrow to pay for whatever spending they cannot finance from their current income. How much people and businesses are willing to borrow in turn is a function of interest rates. Like any good or service, the willingness to borrow is inversely related to the price of borrowing; that is, the interest rate. If interest rates go up, the amount borrowed will decrease, and vice versa (for the sake of brevity, this discussion glosses over the distinction between real and nominal interest rates). For businesses selling stock, how much they have to pay, in terms of an expected future return, is substantially linked to interest rates. Hence, interest rates are the key to balancing aggregate demand with the economy's capacity to supply. In fact, interest rates play an absolutely key role in preventing recessions, which is the challenge we face today.

Interest rates vary as expectations about the economy's future (short-, medium-, and long-term) vary. Accordingly, rates should respond to real economic events, including shocks such as an oil price spike, a bumper wheat crop, a sudden drop in unemployment, etc., because shocks alter aggregate demand, up or down. Changes in the actual or expected supply of savings relative to the demand for savings also should affect interest rates as should changes in consumer preferences, new technology, the productivity of capital, and foreign exchange rates. A more detailed discussion of what should affect interest rates lies beyond the scope of this essay. What is important to observe, though, is that interest rates should respond fully and immediately to all real events, whatever those events might be, so as to alter the demand for credit and equity capital so that buying will remain in balance with changes in the economy's capacity to supply, as that capacity has been affect by real events. In other words, interest rates should function as a highly sensitive and constantly changing balancing mechanism between aggregate demand and supply.

Anything that distorts the marketplace process for adjusting interest rates harms the economy, which is why Fed monetary policy is harmful, as the last issue of Ely's Fed Fax explained (#41, dated April 28). Briefly, by announcing a FFRT, the Fed, with surprising effectiveness given the impotence of its open market operations, dampens or smooths short-term interest rates. That is, the Fed knocks the interest rate balancing mechanism out of whack, thereby preventing short-term rates from responding fully and immediately to all real economic shocks and the important news that those shocks convey. As the last issue of EFF explained, that portion of an economic shock not fully reflected in short-term rates is instead reflected in medium- and long-term rates, often with a magnified effect. In effect, an insufficient response in short-term rates to an economic shock usually causes an overresponse in longer term rates.

Sometimes the Fed's distorting effect will drive rates too low, which will cause the excess demand problem noted above, thereby creating a problem of insufficient capacity relative to an artificially stimulated demand. These are times when wage inflation rears its ugly head as excess demand strains the productive capacity of both labor and capital. In effect, wage inflation is a strong indication that interest rates are too low. The Fed traditionally cures the excess demand that it has stimulated by then rapidly hiking the FFRT, usually too fast, too far, and too late, which then dumps the economy into a recession. Consequently, as the accompanying chart shows, the economy swings from one extreme to another, which makes recessions seem inevitable.

The most severe example of this swinging is readily evident from accompanying chart. As part of the Vietnam War effort, the Fed signalled very low real rates of interest, starting in 1967, which the markets foolishly followed. Real rates went even lower, and even into negative territory during much of the 1970s, especially after the Arab oil boycott took hold in 1974. Paul Volcker then pushed real rates up to record levels, starting in late 1979, to neutralize the earlier, highly inflationary effects of excessively low rates. From start to finish, this inflation/disinflation cycle spanned about 20 years, during which time there were four recessions, including the worst two of the entire post-World War II era.

The economic instability caused by the FFRT is not too severe as long as, one, the FFRT is not too far from where an uncontaminated marketplace would set short-term rates and two, the economy is not being hit by any significant shocks that should cause a major adjustment in interest rates. In other words, the Fed has not screwed up too badly in recent years because the real world has been relatively benign. However, the Fed's continued pronouncement of a FFRT is like playing Russian roulette -- some significant event could happen tomorrow that should materially affect interest rates immediately or a subtle trend could develop that should materially affect interest rates over a longer period. But because the Fed, like all central planning agencies, is bureaucratic, slow-moving, and not always sure of itself, it will not respond as fast or as accurately as will the financial markets to this event or trend. While markets often make mistakes, they correct those mistakes much more quickly than do government bureaucrats that are not harmed financially by their mistakes. (Somehow, it seems strange in 1997 to be arguing that markets are superior to central planners, but apparently that argument still has to be made with regard to the setting of interest rates.)

Hence, today's good times (and improving times for many of society's most vulnerable) can last for as long as the Fed does not screw up too badly or if, with the media's help, the financial markets finally wake up to the fact that they, and not the Fed, should set all interest rates and then go about doing so, without any Fed "guidance." If we are lucky, the markets will wake up before the Fed tanks the economy, again. Complete reliance upon market-driven rates will not eliminate the business cycle, but market-determined rates will greatly reduce the amplitude of swings in the economy and the cost of economic slowdowns.

Even if the economy is hit by a severe shock, it still will be better for all concerned to rely upon the financial markets to set interest rates in response to that shock. For example, a supply shock might trigger an immediate, sharp jump in interest rates, which could induce a recession as the economy adjusted to the real effects of that shock. However, a sharp drop in demand due to the impact of the recession on personal income and the effect of higher rates on the demand for credit would trigger a quicker reversal of the underlying cause of the shock than would be the case if interest rates did not spike. Hence, an economy with totally market-determined interest rates should put a severe shock behind it much more quickly and with much less cumulative economic pain (i.e., lost output) than the United States experience in the aftermath of the oil shocks of the 1970s. As we all know, it is much less painful to quickly pull a Band-Aid off of a hairy arm than to slowly pull it off.

You will notice that I have not drawn any link between productivity and inflation. There is no such linkage even though many commentators attribute recent declines in inflation to rising productivity (yet another case where correlation does not identify cause). While higher productivity is good, its effect is to raise the economic growth rate, which means that incomes and the demand for goods and services will rise at a faster rate than they will during times of low productivity growth. In other words, an economy can experience low inflation even during a time of low productivity growth. The reverse, though, is not necessarily true. Whatever the level of productivity, the financial markets can easily adjust interest rates to hold demand in approximate balance with the economy's capacity to supply.

Returning to the two-part question in the first paragraph, severe or prolonged recessions are not inevitable and in fact should not occur if we encourage the financial markets to set all interest rates. At the worst, what we should see in an era of market-determined interest rates are slight economic slowdowns in response to economic shocks from which the economy should easily recover. Over time, therefore, the economy should grow at a faster, more equitable, and more easily sustained pace than we have seen in recent decades.

Please call if you have any questions regarding how long these reasonably good times can last or if you wish to challenge this admittedly free-market analysis of how the financial markets work. Also, if you have time, visit our website, http://www.cais.com/ely.

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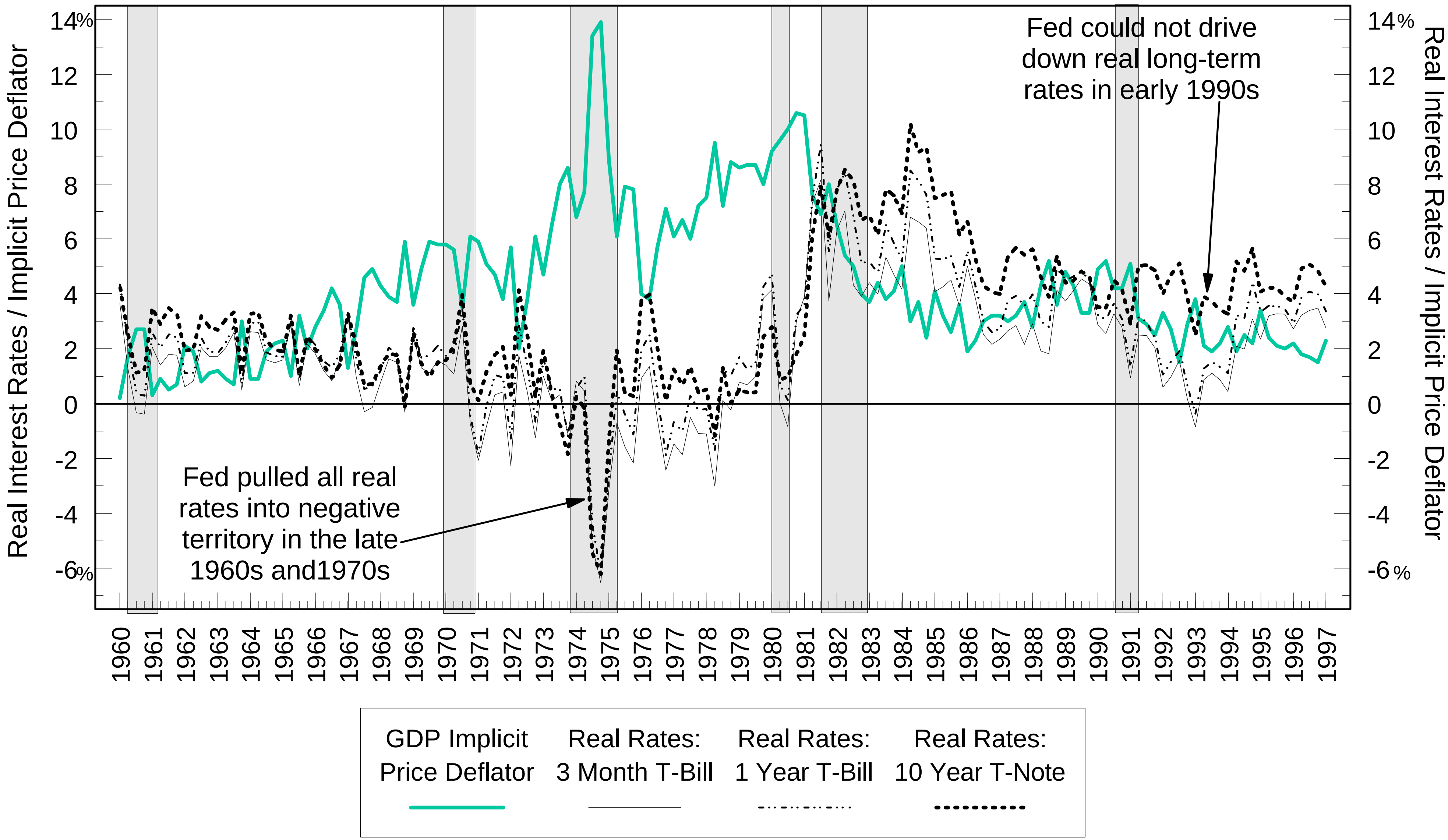
Real Interest Rates in the United States have been Quite Volatile Since the Late 1960's



Notes: Implicit price deflator has not been lagged so that graph reflects actual ex post rates.
Long hash marks indicate the first quarter of each calendar year. Shaded areas represent recessions.