The Fed Is Growing More Confident In Recovery

Contact:
Thomas D. Higgins, PhD
Chief Economist
ph: 213 830-4302
email: thiggins@payden-rygel.com

Highlights

- The Federal Reserve left its benchmark interest rate unchanged in a range between 0% and 0.25% and acknowledged that US economic activity has “continued to pick up”.
- Bank reserves are only inflationary if they are being lent out. Only then does Milton Friedman’s old adage about *too many dollars chasing too few goods* hold true.

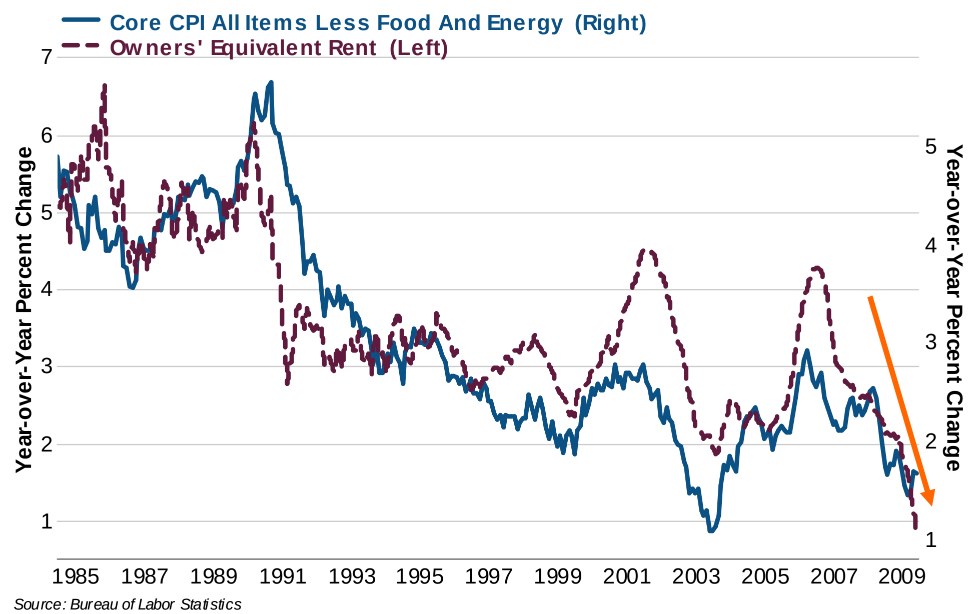
The Federal Reserve left its benchmark interest rate unchanged in a range between 0% and 0.25% and acknowledged that US economic activity has “continued to pick up” at the conclusion of its December policy meeting. Although an entire year has passed since the Fed first adopted its zero interest rate policy, and its confidence in the US recovery is increasing, the central bank reiterated that economic conditions are likely to warrant an exceptionally low level of the federal funds rate for an “extended period.”

The central bank is wise to be cautious about tightening monetary policy at this stage since much of the economic activity that was achieved during the second half of 2009 was driven by government incentives in the form of the new home buyers’ tax credit or the cash for clunkers program. The Fed needs to wait for more signs of a self-sustaining recovery in private demand before ending its credit easing and raising short-term interest rates. Fed Chairman Ben Bernanke is well aware of this fact. In a recent speech he stated, “Though we have begun to see some improvement in economic activity, we still have some way to go before we can be assured that the recovery will be self-sustaining.” From our perspective, the biggest risk facing the US economy in the short-term remains a premature tightening of fiscal or monetary policy.

Inflation Fears Are Overblown

Yet some commentators disagree, fearing that the quantity of reserves in the banking system is simply too great for the Fed to mop up liquidity in a timely fashion. As a consequence, they say that a resurgence in inflation is likely in the near future. Similar rumblings about the inflationary impact of excess bank reserves were heard after the Great Depression. The Fed responded by doubling the reserve requirement for banks in 1937, which caused them to rein in lending and tip the economy back into recession. What the Fed failed to realize at that point was that bank reserves are only inflationary if they are being lent out. Only then does Milton Friedman’s old adage about *too many dollars chasing too few goods* hold true. If they are simply sitting in bank vaults, there is no way for reserves to fuel inflation.

Shelter Costs Are Likely to Drive the Inflation Rate Lower



Source: Bureau of Labor Statistics

Contact:
Thomas D. Higgins, PhD
Chief Economist
ph: 213 830-4302
email: thiggins@payden-rygel.com

Highlights

- Our main concern is not the technical means of unwinding monetary stimulus, but rather the timing of this unwinding.
- Though we are concerned about a premature exit from easy fiscal and monetary policy in the short-term, this will change over time as the US recovery gathers momentum.

The latest data on inflation seem to support this viewpoint. The consumer price index (CPI) rose just 1.8% from year ago levels in December, much of which was a byproduct of an increase in oil prices over the past year. The core CPI, which excludes food and energy costs and encompasses nearly 78% of consumer expenditures, remains well anchored at 1.7%. In fact, the downward drift in shelter costs, which make up one-third of the core CPI, suggests that a further easing in core inflation is likely in the coming months. Add in the tremendous slack in product and labor markets and it is hard to picture how a virulent inflation could take hold in the current environment.

Gradually Making Its Way Toward the Exit

Nevertheless, the Fed is preparing investors for the day when it does have to end its ultra-easy monetary policy. It has done so by communicating its exit strategy through its policy statements, speeches, and testimony. In its December policy statement, for example, the Fed formally announced that it will allow most of its special liquidity facilities to expire on February 1, 2010 and that it will complete its mortgage purchase plan by the end of the first quarter of next year.

Operationally, the most important tool for adjusting the stance of monetary policy will be the Fed's ability to pay interest on commercial bank reserves held at the central bank. Banks will be unwilling to make overnight loans to each other at a rate lower than the rate that they can earn risk-free from the Fed, and so the interest rate the Fed pays on banks' balances will tend to set a floor for short-term interest rates. The Fed has also recently tested the use of reverse repurchase agreements as a means of quickly draining reserves from the banking system. If necessary, the Fed has the option of reducing the size its balance sheet by selling some of the securities it acquired during the financial crisis, including its mortgage portfolio, on the open market.

Our main concern is not the technical means of unwinding monetary stimulus, but rather the timing of this unwinding. The Fed needs to base its decision on when to raise interest rates on forecasts for how the recovery will unfold in the future since monetary policy operates with long and variable lags. Though we are concerned about a premature exit from easy fiscal and monetary policy in the short-term, this will change over time as the US recovery gathers momentum. At that point, the risks will shift to keeping rates too low for too long and either fueling another asset bubble or inflation. However, such a scenario seems unlikely before 2011.