# Economic Commentary

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## The Fed Funds Rate to Rise for Ninth Time to 3.25%: "Measured" or "Hurried" Pace of Rate Increases?

The Federal Reserve Board's FOMC is holding its fourth meeting of the year and is expected to raise the key policy setting inter-bank lending rate to 3.25%, up another quarter point, the ninth straight hike in short-term interest rates. The futures market is fully pricing in a 3.5% rate for August maturities and a 3.75% rate for December maturities. Obviously, as explained in previous Commentaries, the Fed had to unwind the monetary stimulus it put in place from January, 2001 through the first half of 2004, which brought the fed funds rate down to a generation low of 1.0%, the lowest since 1958. It has announced that it will proceed at a "measured" pace so as to give time to markets and the economy to adjust to higher rates.

But in harping that it is raising rates at a "measured" pace it is also inadvertently lolling markets in to a false sense of security. The term has become a misnomer for what the Fed is doing. Rather, the term "*hurried*" pace of rate increases should be substituted instead. The Fed has **tripled** the level of short-term interest rates in less than year from 1% to 3%; it has gone on raising them in each successive meeting without a pause, and is on course to quadrupling them by the end of this year. What is so "measured" about this schedule? Last time the Fed did the same in 1994 it slowed down the economy dangerously to near recession and equity markets lost nearly 20% of their value. In my opinion, this is no longer a modest rise in rates, as the word "measured" implies, but a dramatic rate hike over a very short period of time. They haven't missed a chance to raise them at each meeting. Has anyone considered the consequences for the economy of such a massive swing in monetary policy? If the structure of the global economy has changed, if inflation is no longer the biggest risk, if the bond market is satisfied with a 3.8% – 4.0% yield on ten year US treasuries, if the global economy outside China is slowing down, and if the Fed Chairman Alan Greenspan acknowledges all of the above, then why is there such a hurry to return to pre-2001 rate levels? Is it because he is retiring at the end of the year and he feels that he should complete the job he started before stepping down from the helm? Why not space out the rate increases over time by pausing every other meeting? To me this would be more measured, than the hurried pace the Fed is currently on.

Someone must make the case for a slower pace of rate increases. Here is why; every one knows that monetary policy acts with a lag of nine to eighteen months. We have yet to see what the impact of the recent rate increases has been on the economy, because there has not been enough time for the economy to react to them. Caution would suggest that the Fed go more slowly and to wait and see what the economy's reaction is to higher rates first, before piling up more rate increases. The challenge when monetary policy authorities tighten is that they never know how far they have gone because the economy responds with a lag. The danger is that they might raise rates more than they need to and precipitate a recession. This happened in Canada in the early 1990s under John Crow and in 2000 in the United States under Greenspan! Why repeat the same mistake?

If there is cause for concern under normal conditions, there are more reasons to be concerned this time around. One of these reasons is the high and rising price of crude oil. Today, the price of crude reached $60.95 US. Bond markets reacted by pushing yields lower rather than higher. What this means is that fixed income markets view the rising price of oil more as a deflationary force in the medium to long-term than as an inflationary force. Indeed, this is the case. As oil prices rise, they siphon spending power out of oil consuming economies like the United States and they reduce the buying power of consumers and therefore slow down production in the economy. Another way of putting it is that high oil prices act like a tax hike or an interest rate hike. When added to the interest rate increases of the Fed, this only reinforces the contractionary effect of monetary policy.

A second reason is the flattening yield curve. With 10-year treasuries trading at 3.9%, and the spot fed funds rate at 3.31%, the gap between long and short rates has narrowed to 59 basis points from over 400 basis points a year ago. Clearly, this is a massive swing in the stance of US monetary policy in the span of less than a year! If the Fed maintains its "measured" pace of rate increases over the next few months we will be looking at a perfectly flat yield curve which implies a reduction in the rate of growth in the economy to around 1.0%, the population growth rate. If they raise them even more to the 4%-4.5% level, as many analysts suggest should be the "neutral" setting for monetary policy, we are talking of an inverted yield curve, which in every single previous episode has resulted in a full-fledged recession. Greenspan in a recent speech raised this issue, but much to my surprise, he downplayed it, stating instead that this time the underlying fundamentals have changed and that it should not result in a recession. I totally disagree.

A third reason, one related to the above, is what Greenspan has called the "conundrum" of why bond yields have stayed so low and actually have fallen during the year instead of rising, what should have been the normal response in an expanding economy experiencing short-term inflationary pressures and rising short-term rates. The answer, it appears, as it slowly emerges from the facts of the situation, is that the bond market is expecting a slowdown in the growth rate of the economy and a slow-down in inflation and is accordingly pricing them in the bond yield. If the bond market doesn't see inflation then what is the hurry to raise rates so fast?

A fourth reason to be concerned over the hurried pace of rate increases is the recent recovery in the exchange value of the US dollar. A stronger dollar also carries contractionary implications for the US economy and is equivalent to a rate hike.

The fifth, and perhaps the most important reason to be concerned is the increased fragility of the household and government sector in the US economy, the result of increased financial leverage that flowed from a protracted period of low interest rates. With consumer indebtedness at a record high and with the US budget deficit also at a record high, what is going to be the asset/liability impact of such a massive and sudden run-up in interest rates on the economy? At low rates, the interest service burden is small, but as rates rise higher it gets bigger and consumers will find it harder to service their debts. So will the government. If at the same time the economy slows and/or the housing bubble bursts, and real estate values start to fall, you have a very explosive mix of factors that might result in a Japan-style protracted recession over the next few years, not to mention the possibility of a depression.

In other words, the Fed is tightening monetary policy at a time when other factors are also tightening demand and production in the United States. Although it clearly needed to tighten monetary policy, it has been doing so at a “hurried” rather than a “measured” pace. My point is that a less hurried and more cautious and pragmatic approach is in order here. The Fed may be under-estimating the power of its rate hiking actions while over-estimating the strength of the US and global economy, and in so doing is risking tightening monetary conditions much more than they are warranted under present circumstances. They should pause for now and raise rates more gradually later, based on actual evidence of how the economy is adjusting to the previous rate hikes. It is never too late to raise rates to calm inflationary fears, but if they go too far in raising them, it will be too late to prevent the economy from falling into recession.

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