



The Northern Trust Company
Economic Research Department
Positive Economic Commentary

"The economics of what is, rather than what you might like it to be."

50 South LaSalle Street, Chicago, Illinois 60675

Web Page -- <http://www.northerntrust.com> (See Economic Research)

Paul Kasriel (312)-444-4145

Fax (312)-444-4132

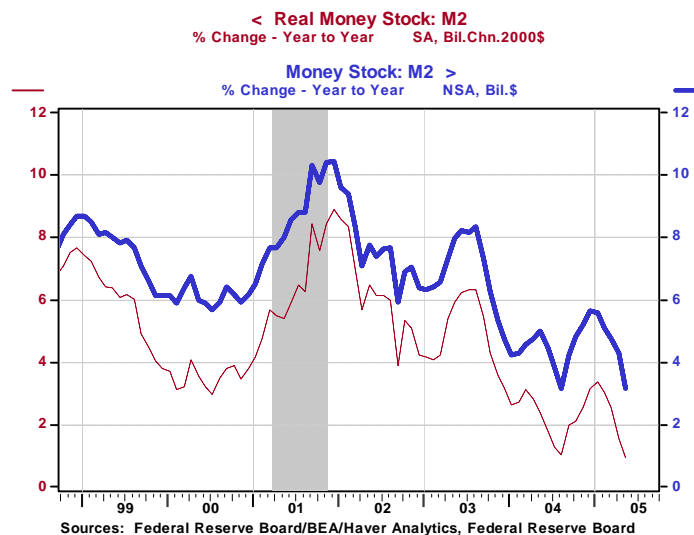
June 29, 2005

Political Economic Reasons Why The Fed Is On The Cusp Of Pausing

Although the consensus thinks it is a slam dunk that the Fed will raise the funds rate another 25 basis points when the FOMC convenes again on August 9, I don't. I am, however, willing to entertain that possibility. But let's not quibble over a quarter of a point. What I *do believe* is a slam dunk is that the Fed will pause in its rate hikes *no later* than right after August 9. Herewith are the reasons why I think the Fed is on the cusp of pausing.

- **The reliable indicators of monetary policy suggest that policy is no longer accommodative.** These indicators are the (real) inflation-adjusted M2 money supply and the spread between the Treasury 10-year note yield and the fed funds rate target. In May, the real M2 money supply was up only 0.93% vs. year ago. As Chart 1 shows, real M2 growth is well below where it was in 2000, the eve of the last recession. Notice, too, that real M2 growth is slowing not only because inflation picked up, but also because *nominal* M2 growth is slowing. The slowdown in nominal M2 growth is a result of Fed interest rate hikes. Real M2 growth is not a perfect leading indicator – to my knowledge, there is none – but more often than not trend reversals in real M2 growth precede with a short lead time trend reversals in the pace of economic activity.

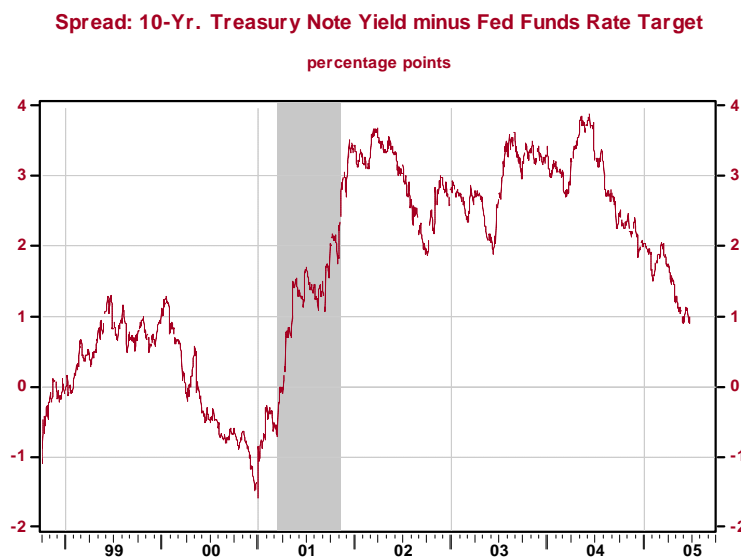
Chart 1



The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.

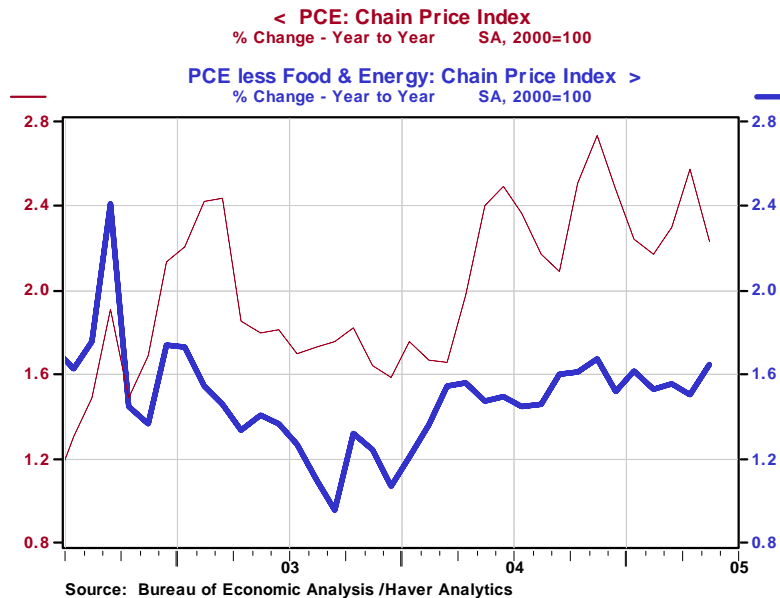
Chart 2 shows that the spread between the yield on the Treasury 10-year note and fed funds rate target has narrowed to about 100 basis points as of Wednesday. With the 25 basis point increase in the fed funds rate target today, this spread has narrowed to about 75 basis points. The spread, unlike real M2 growth, is *not* currently signaling that a recession is imminent. It is, however, signaling that economic growth will be slowing *going further*. Although the Fed has pooh-poohed the reliability of the spread as a leading indicator, would the Fed want to tempt fate by pushing the funds rate above the Treasury 10-year yield? Wouldn't that open the Fed up to a lot of criticism inasmuch as it has been warned in recent months that the narrowing spread was conveying information that monetary policy was becoming restrictive?

Chart 2



- **Economic growth already has slowed.** On a year-over-year basis, real GDP growth peaked in the Q1:2004 at 5.0%. In Q1:2005, year-over-year real GDP growth moderated to 3.7%. There is every indication that real GDP growth will moderate more. For example, real consumption growth is slowing as is real business fixed investment growth.
- **Inflation is a lagging economic process.** Overall consumer inflation already appears to have peaked and core consumer inflation has settled in to a flat trend under 1-3/4% (see Chart 3). With real economic growth in a moderating trend, with core inflation low in absolute terms and inflation being a lagging phenomenon, why would the Fed feel the need to continue raising the funds rate, risking a recession in 2006?

Chart 3



- **The conventional wisdom, to which I do *not* subscribe but the Fed does, is that the rise in energy prices in the past year will act to retard aggregate demand.** With energy prices showing no signs of significant retreat, in fact, just the opposite, high energy prices would seem to be a reason, in the Fed's way of thinking, for the FOMC not to have raise the funds rate as much as otherwise would be the case.
- **The dollar is trending higher.** This relieves some of the upward pressure on inflation and is a marginal negative for real GDP growth due to the potential for slower export growth. Another negative for export growth is the slowdown in western European economic growth, including U.K. growth. The potential for policy interest rate cuts from the Bank of England and/or the ECB would put even more upward pressure on the dollar if the Fed continued to raise the funds rate.
- **The Fed does not want to risk a rapid deflation of the housing bubble at this juncture.** If the housing bubble were to burst in the next year, it would have the potential of precipitating a serious recession. As my colleague, Asha Bangalore, reported, housing-related employment has accounted for 43% of the increase in private nonfarm payrolls since this recovery/expansion got started (http://www.northerntrust.com/library/econ_research/daily/us/dd052305.pdf). So, a sharp fall off in housing activity could have a significant negative impact on employment growth. Because households have been extracting large amounts of equity from their homes -- \$324 billion in 2004 -- to maintain their high levels of consumer spending relative to their after-tax incomes, a bursting of the housing bubble would also have an indirect negative impact on consumer spending inasmuch as "tappable" home equity would rise more slowly. Last, but by no means least, the bursting of the housing bubble could cripple the banking system in that over 60% of commercial bank loans and investments are mortgage related -- mortgages, mortgage backed securities, home equity loans and the liabilities of government

sponsored enterprises such as Fannie Mae and Freddie Mac. The banking system is the vital transmission mechanism between the central bank and the economy. History tells us that if this transmission system is broken, monetary policy is less effective in reviving the economy once a recession sets in. The Fed is in the process of applying “regulatory suasion” to mortgage lenders in order to gently “blow some of the froth” off the housing market. This is a substitute for raising interest rates.

- **The Fed does not want to risk a recession in the next year because there are not that many arrows left in policy quivers to promote a quick recovery.** If interest rates had to be cut to fight a recession, the starting point would likely be considerably lower than the 6.5% level of January 2001. Moreover, how many more tax cuts can Congress pass what with the current deficit still relatively high and much larger future deficits lurking on the horizon?
- **The Fed does not want to risk a recession now in that a recession in conjunction with a large current account deficit would increase the odds of Congress passing protectionist legislation.** This could plunge the global economy into a deep recession.
- **Greenspan does not want to end his concert on a sour note.** Why not let his successor deal with the housing bubble and any inflation flare ups?

Paul L. Kasriel, Director of Economic Research (plk1@ntrs.com)