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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

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Is Ben Bernanke The "Reincarnation" Of Manley Johnson?

Do you remember Manley Johnson? He was a Fed governor from February 7, 1986 to August 3, 1990. Johnson was the "leader of the pack" of FOMC members – all of whom were governors – who advocated that monetary policy decisions be guided by the behavior of "auction-market" indicators. Auction-market indicators is just fancy terminology for prices of goods and financial instruments determined in relatively free markets. (For two excellent books on auction-market indicators – well, one excellent book anyway, see *Monetary Policy, A Market Price Approach*, by Manuel H. Johnson and Robert E. Keleher, and *Seven Indicators That Move Markets*, by Paul Kasriel and Keith Schap.) One of these auction-market indicators that Johnson placed a lot of faith in was the behavior of the shape of the yield curve. A steepening in the yield curve was a signal that monetary policy might be getting more accommodative. A flattening in the yield curve was a signal that monetary policy might be getting more restrictive.

What does all this have to do with current Fed Governor Bernanke? On Tuesday, March 8, in a speech in Chicago, Bernanke made the following comments:

The funds rate will have reached an appropriate and sustainable level when, first, the outlook is consistent with the Committee's economic goals and, second, *the slope of the term structure of interest rates is approximately normal*, as best as can be determined. With this definition in mind, one can search for indications of where the "neutral" funds rate is likely to be at a given point in time. [emphasis added]

Is Ben Bernanke picking up where Manley Johnson left off? It sure looks that way from these prepared comments. And it looks as though Bernanke was a member of the "few" who, at the December 14, 2004 FOMC meeting, expressed the following interpretation of the flattening in the yield curve at that time:

A few participants commented that the generally low level of interest rates across a wide range of maturities and the recent flattening of the slope of the yield curve (measured as the spread between ten- and two-year Treasury yields) might signal that expectations of longer-term growth had been marked down.

Unfortunately for us, Governor Bernanke did not reveal at his March 8 speech what exactly is the *normal* slope of the term structure of interest rates. Under a gold standard, the normal slope probably would be flat to inverted. Why? Because under a gold standard, investors would have great certainty that money supply growth would be restricted. Therefore, price increases of goods, services, and assets would also be restricted. Under a fiat money standard, however, there would normally be some positive slope to the yield curve because investors have no guarantees of restricted monetary growth. But how much of a positive slope to the yield curve would be considered normal. If history is any guide to normality, then a normal spread between the Treasury 10-year yield and the Treasury 2-year yield would be about 73 basis points – the median monthly value of this spread between June 1976, when the Treasury first started issuing 2-year notes, and February 2005. As this is being written, the Treasury 10-year – Treasury 2-year spread is trading at 83 basis points – not far from its historical median spread. Thus, if the historical median spread is Bernanke's notion of the normal slope of the yield curve, and this spread continues to narrow after the expected March 22 funds rate increase of 25 basis points, we might expect to hear Bernanke start arguing for a pause in the FOMC's measured pace of rate hikes.

Chart 1 shows the behavior of this spread throughout its history with economic recessionary periods indicated by the shaded areas and with the median value of the spread indicated by the horizontal line at the 0.73 level. Notice that the spread has dipped below the zero level – that is, the yield curve has inverted – prior to the onset of recessions. The regularity of yield curve inversions prior to recessions might have something to do with the reason a similar yield spread is included as a component of the Leading Economic Indicators (LEI) index. In the LEI, the yield spread used is the difference between the Treasury 10-year yield and the fed funds interest rate level. The longer history of this yield spread is shown in Chart 2, along with its median value of 103 basis points. As this is being written, the spread between the Treasury 10-year and the FOMC's fed funds target rate is 196 basis points – suggesting more "measured" funds rate hikes to reach normality than is the case with the current 10-year – 2-year spread.

Chart 1

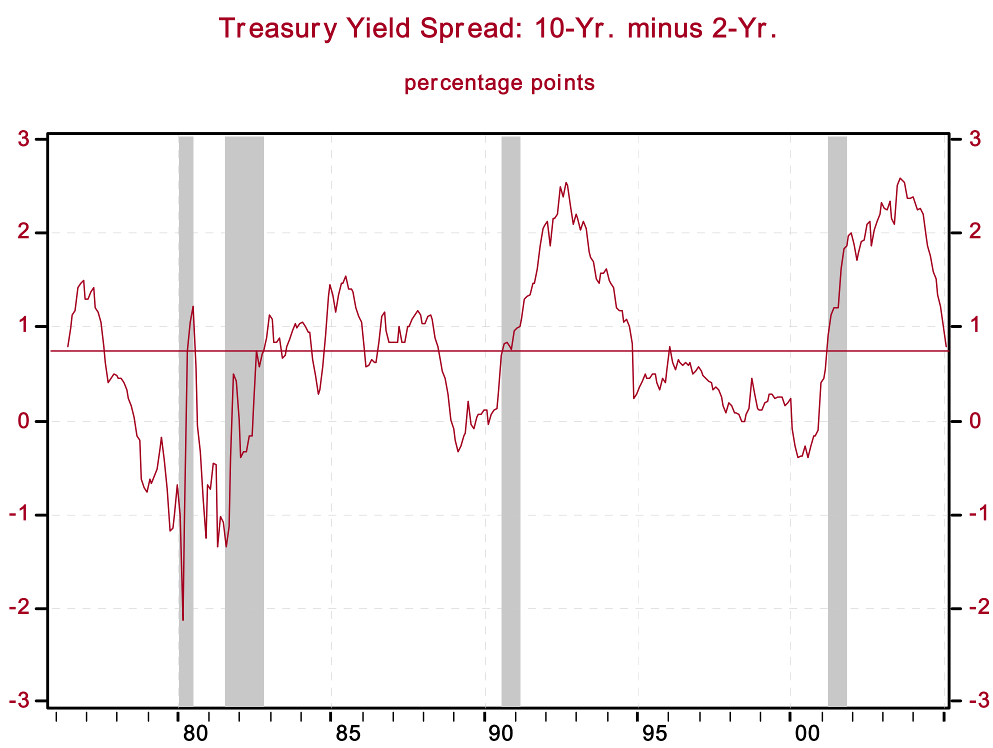
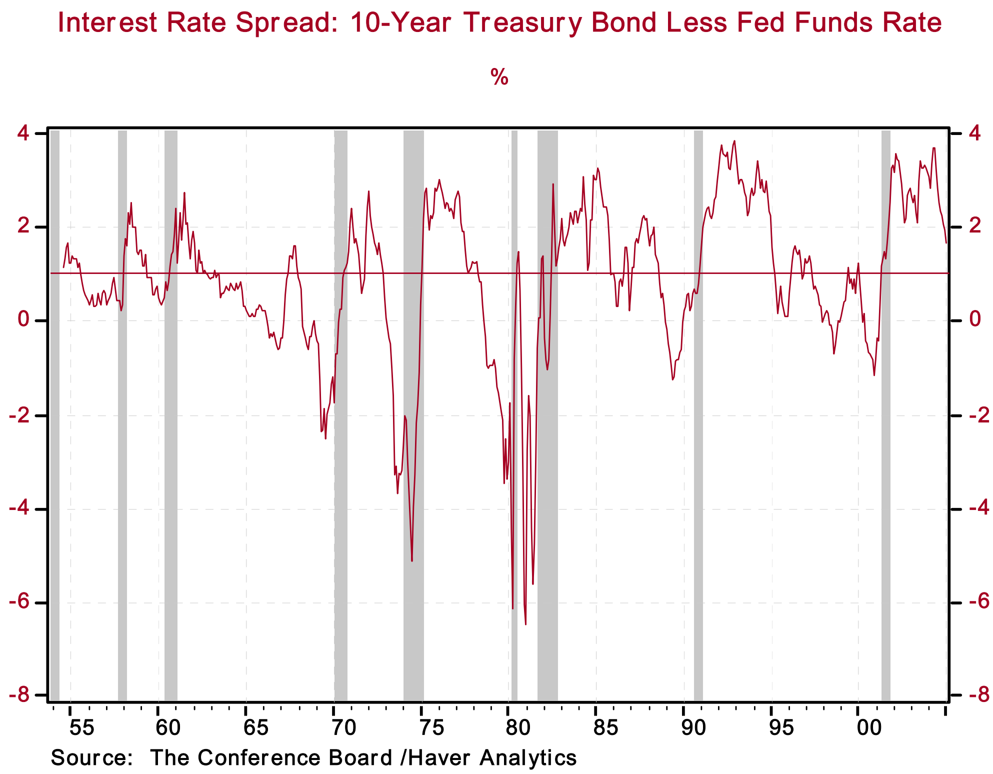


Chart 2



Why might the spread between longer-term and shorter-term interest rates be a reliable leading indicator of economic growth? The behavior of long-term interest rates might represent a proxy for the market-clearing interest rate of the net demand for credit from the nonbank sector. Suppose that there were no banks – commercial or central. There would be demanders of credit – businesses, individuals, and governments. And there would be suppliers of credit – primarily individuals. An interest rate would be determined by the interaction of the demand for and supply of credit. Now, let's introduce a central bank – an entity that can print money, which, in effect, would be tantamount to creating credit out of thin air. If the net demand for credit in the economy were rising, this would put upward pressure on the long-term interest rate. If there were no central bank controlling the short-term interest rate, this rate, too, would rise with an increase in the net demand for credit. But the Fed, a central bank, does target the level of the short-term interest rate. If the net demand for credit is rising, putting upward pressure on the long-term interest rate, but the Fed is not adjusting upward its short-term interest rate target, then the Fed will have to print more money – create more credit out of thin air – to prevent the short-term interest rate from rising. This Fed-created credit will accommodate faster growth in nominal economic activity. Thus, a steepening in the yield curve – the long-term interest rate rising relative to the short-term rate – will be indicative of a more accommodative monetary policy. In contrast, suppose the net demand for credit falls, putting downward pressure on the long-term interest rate. In order for the Fed to prevent a fall in the short-term interest rate, it would have to extinguish some credit it had previously created. This would lead to a slowdown in the growth of money and nominal economic activity. In this case, a flattening in the yield curve would be indicative of more restrictive monetary policy.

The net demand for credit is always changing – changing in ways that are impossible for mere mortals to divine. Entrepreneurs' animal spirits ebb and flow. So, too, therefore do their demands for credit. Households' spending versus their saving decisions change for myriad reasons, too. About the only constant is the government's ever increasing demand for credit. Thus, the equilibrium levels of interest rates do not remain static through time. A fed funds rate of 4% might represent an accommodative monetary policy at one moment and a restrictive policy at another moment. One clue as to whether a 4% policy is accommodative or restrictive is to observe the behavior of the yield curve. If the curve is steepening, then the 4% funds rate is becoming more accommodative. If the curve is flattening, then the 4% funds rate is becoming more restrictive.

If Ben Bernanke were to become Greenspan's successor and were to move toward funds-rate-decision rule based on the changing shape of the yield curve, this would be a giant leap forward for U.S. monetary policy. Don't hold your breath.

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