



U.S. ECONOMIC & INTEREST RATE OUTLOOK

Northern Trust
Global Economic Research
50 South LaSalle
Chicago, Illinois 60603
northerntrust.com

Paul L. Kasriel
Director of
Economic Research
312.444.4145
312.557.2675 fax
plk1@ntrs.com

Asha Bangalore
Economist
312.444.4146
312.557.2675 fax
agb3@ntrs.com

Why Did the Fed Raise Rates in October 1931?

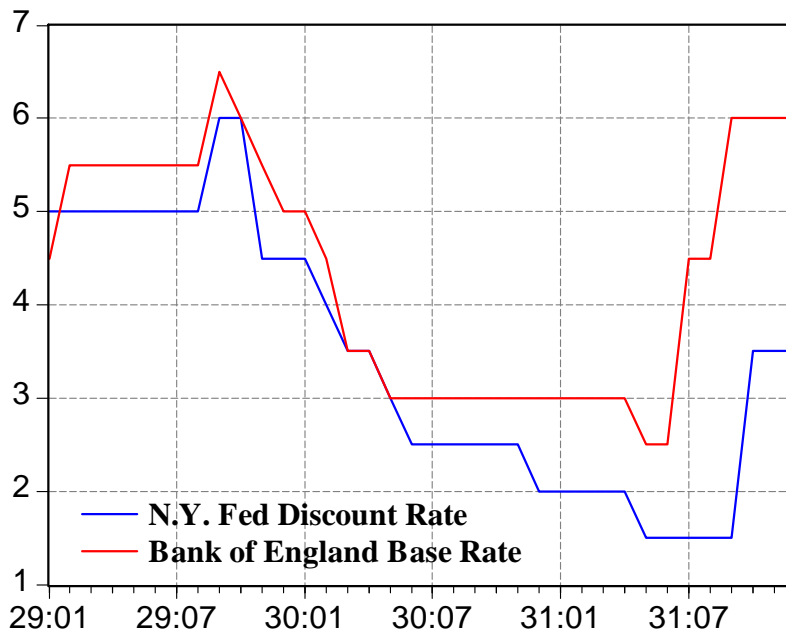
March 13, 2008

Don't get excited. We are *not* predicting another Great Depression, although our prediction of another recession – which we have been hinting at for over a year and “officially” announced last month – is still operative. No, what we want to discuss this month is the possibility that the Fed's rate-cutting program could be constrained by developments in the foreign exchange markets. Something similar to this occurred in October 1931.

Let's review a little history, history that we are sure Fed Chairman Bernanke is familiar with. After the bursting of the U.S. asset price bubble in October 1929, the Federal Reserve engaged in some aggressive reductions in its then-main policy interest rate – the New York Fed discount rate. Chart 1 shows that after raising its discount rate from 5% to 6% in August 1929, the New York Fed starting reducing its discount rate in November 1929, ultimately pushing it down to 1.50% by May 1931. The Bank of England basically shadowed the New York Fed in terms of its policy interest rate actions until the summer of 1931.

Chart 1

Central Bank Policy Interest Rates: Federal Reserve and Bank of England percent, end-of-month

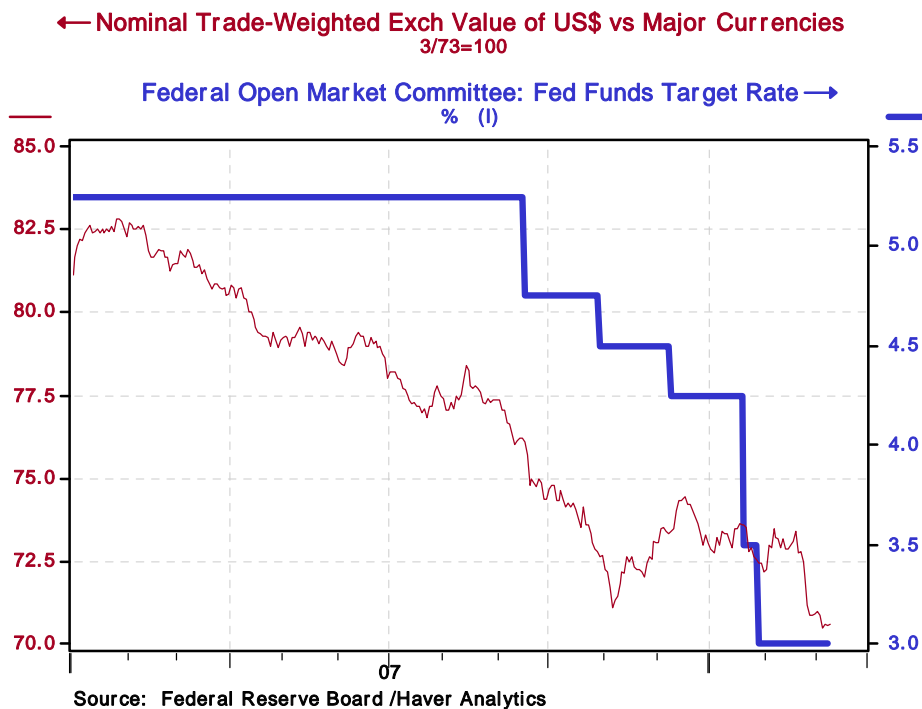


In the summer of 1931, there began to be runs on the British pound. In an effort to combat these currency attacks, the Bank of England began raising its policy interest rate, the so-called base rate. In July 1931, the Bank of England raised its base rate by 200 basis points to a level of 4.50%. This did not stop the run on the pound. On September 21, 1931, the Bank of England abandoned the gold standard but, in an attempt to forestall further raids on the pound, raised its base rate another 150 basis points that month to a level of 6.00%.

Market expectations began to develop that the Fed would follow the Bank of England in abandoning the gold standard. The United States began to experience a gold outflow. In an effort to stop this gold outflow, the New York Fed raised its discount rate a cumulative 200 basis points in two steps in October 1931 to a level of 3.50%.

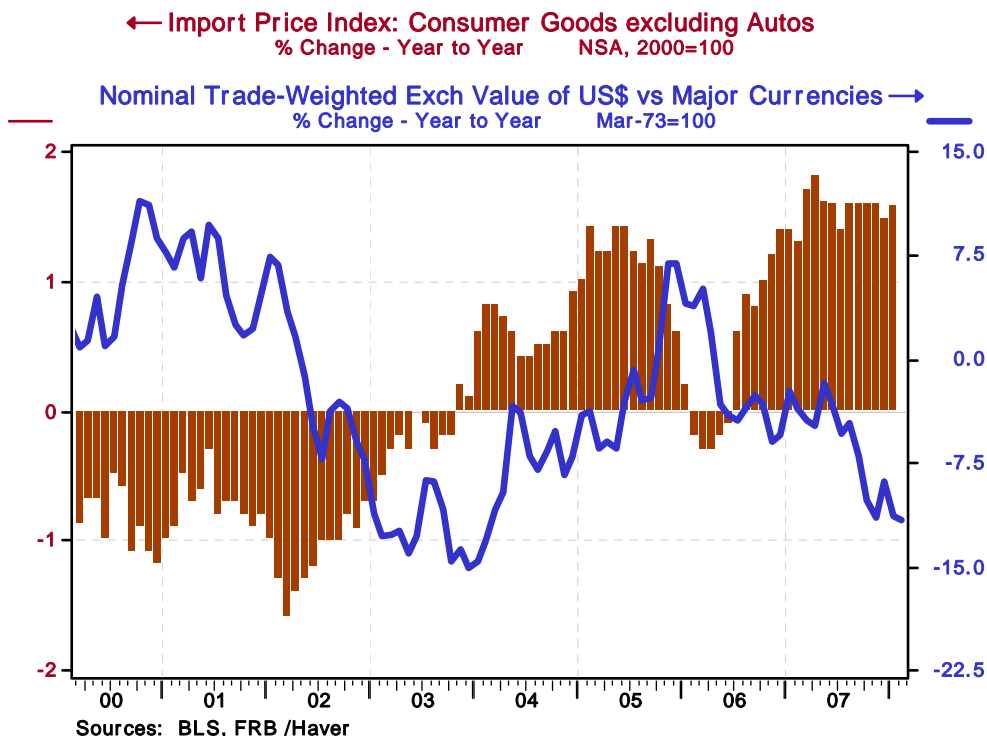
So what does October 1931 have to do with current Fed policy? Well, if not a run, there has been a renewed “walk” on the dollar of late (see Chart 2). Chart 3 shows a general inverse relationship between changes in the value of the trade-weighted dollar and changes in the prices of imported consumer goods. Further declines in the dollar could induce an accelerated rate of increase in the prices of imported consumer goods. With other major central banks, such as the European Central Bank, expressing a reluctance to reduce their policy interest rates, further reductions in the U.S. federal funds rate would seem to put additional downward bias on the foreign exchange value of the dollar.

Chart 2



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Chart 3



But, in our opinion, what could turn a walk on the dollar into a sprint would be a decision by the Chinese and/or Saudi central banks to eliminate the pegs of their currencies to the greenback. Now, what would motivate these central banks to sever the peg? The desire to rein in their domestic inflation. In an environment in which the dollar is under downward pressure, the by-product of pegging one's currency is higher inflation in the economy whose central bank is pegging.

The inflation mechanics are as follows. The pegging central bank has to buy U.S. dollars in the foreign exchange market in order to prevent the dollar from falling against its currency. The dollar-buying central bank purchases dollar with its own currency. The dollar-buying central bank gets its own currency the same way all central banks get their own currency – it figuratively “prints” it. The dollar-purchasing central bank therefore floods its economy with its own base money, resulting in inflation – inflation in the prices of goods/services and inflation in the prices of assets.

Chart 4 shows the growth rate in the annual average total assets of the Saudi Arabian Monetary Authority (SAMA) and the People's Bank of China (PBoC). In the five years ended 2007, the compound annual growth rate in SAMA's balance sheet has been 43%; 27% in PBoC's balance sheet. Chart 5 shows the behavior of consumer price inflation in China and Saudi Arabia in recent years. Given the high growth in monetary base money in each economy, is it any wonder that their consumer inflation rates also are high?

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Chart 4

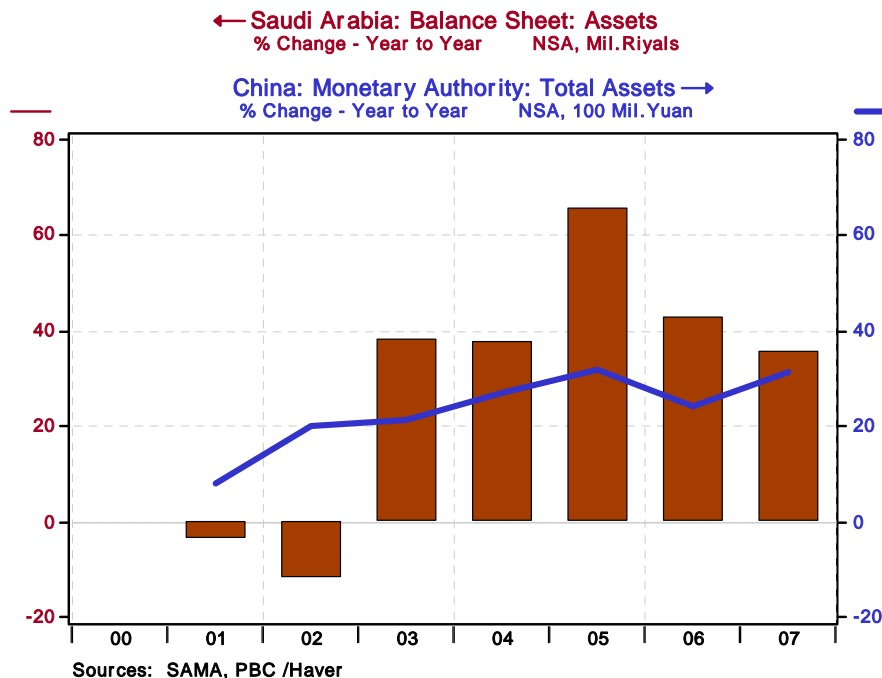
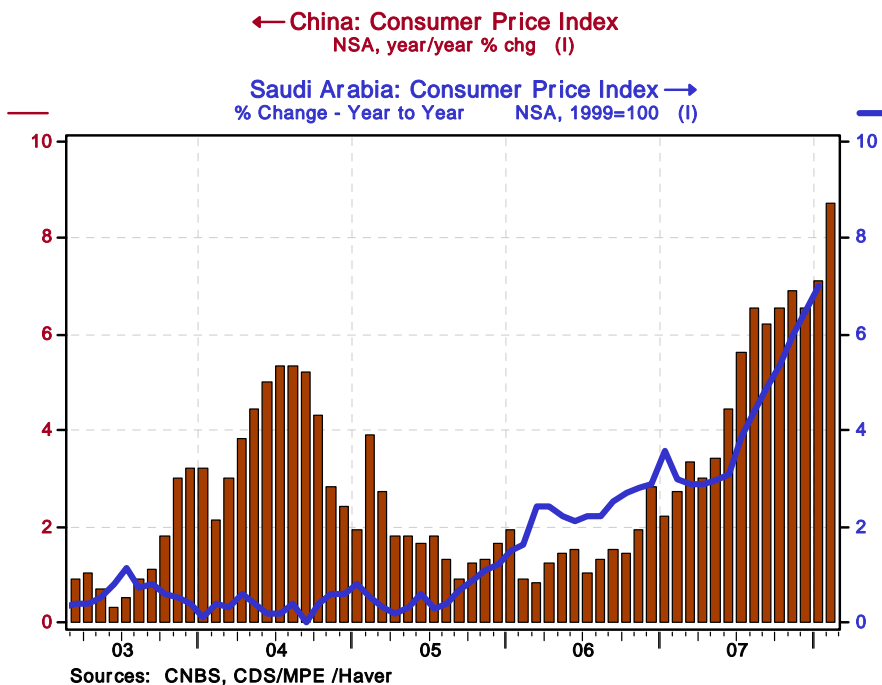


Chart 5



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After World War II, major central banks opted to peg their currencies to the U.S. dollar. The United States agreed to peg the dollar to gold at \$35 an ounce. This was called the Bretton Woods Agreement. By the late 1960s, the United States was flooding the world with more dollars than were desired at the pegged exchange rates. The only way that the French and German central banks could maintain their currency pegs versus the dollar was to inflate their own economies. The demise of the Bretton Woods Agreement occurred in August 1971 when the peg between the U.S. dollar and gold was severed and an era of floating exchange rates was ushered in.

Some commentators have referred to the Chinese and Saudi pegging of their currencies to the U.S. dollar as “Bretton Woods II.” We wonder if the demise of Bretton Woods II is not close at hand. If it is, the greenback could plunge, U.S. consumer inflation could spike, and the Fed would have little choice but to stop cutting its policy interest rate, and, perhaps, even have to raise it, as it did in October 1931. As Mark Twain said, “History does not repeat itself, but it does rhyme.” We are not yet predicting this outcome, but we are listening carefully for any rhyming.

**Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy*

**THE NORTHERN TRUST COMPANY
ECONOMIC RESEARCH DEPARTMENT
March 2008
SELECTED BUSINESS INDICATORS**

Table 1 US GDP, Inflation, and Unemployment Rate

	2007				2008				Q4-t-Q4 change			Annual change		
	07:1a	07:2a	07:3a	07:4a	08:1f	08:2f	08:3f	08:4f	2006a	2007a	2008f	2006a	2007a	2008f
REAL GROSS DOMESTIC PRODUCT (% change from prior quarter)	0.6	3.8	4.9	0.6	-0.5	-0.6	0.3	0.4	2.6	2.5	-0.1	2.9	2.2	0.8
CONSUMPTION EXPENDITURES	3.7	1.4	2.8	1.9	-0.2	-0.2	0.3	-0.1	3.4	2.5	-0.1	3.1	2.9	0.7
BUSINESS INVESTMENT	2.1	11.0	9.3	6.9	0.9	-1.2	-1.5	0.5	5.2	7.3	-0.4	6.6	4.8	2.8
RESIDENTIAL INVESTMENT	-16.3	-11.8	-20.5	-25.2	-20.0	-12.0	-5.0	0.0	-12.8	-18.6	-9.6	-4.6	-16.9	-16.5
CHANGE IN INVENTORIES ('00 dlrs, bill)	0.1	5.8	30.6	-10.1	-12.7	-18.7	-13.7	-9.7				40.3*	8.3*	-13.7*
GOVERNMENT	-0.5	4.1	3.8	2.2	1.9	1.4	1.5	1.5	2.5	2.4	1.5	1.8	2.1	2.1
NET EXPORTS ('00 dlrs, bill.)	-612.1	-573.9	-533.1	-506.8	-493.8	-482.4	-477.5	-476.7				-624.5*	-560.0*	-482.6*
FINAL SALES	1.3	3.6	4.0	2.1	-0.4	-0.4	0.2	0.2	3.0	2.7	0.0	2.8	2.5	1.0
NOMINAL GROSS DOMESTIC PRODUCT	4.9	6.6	6.0	3.3	4.1	1.6	1.9	1.7	5.4	5.2	2.3	6.1	4.9	3.4
GDP DEFLATOR - IMPLICIT (% change)	4.2	2.6	1.0	2.7	4.6	2.1	1.6	1.4	2.7	2.6	2.4	3.2	2.7	2.6
CPI (% Change, 1982-84 = 100)	3.7	4.6	2.8	5.0	4.9	2.4	1.9	1.7	2.0	4.0	2.7	3.2	2.9	3.6
CIVILIAN UNEMPLOYMENT RATE (avg.)	4.5	4.5	4.7	4.8	4.9	5.3	5.8	6.1				4.6*	4.6*	5.5*

a=actual
f=forecast
*=annual average

Table 2 Outlook for Interest Rates

SPECIFIC INTEREST RATES	Quarterly Average										Annual Average		
	06:3a	06:4a	07:1a	07:2a	07:3a	07:4a	08:1f	08:2f	08:3f	08:4f	2006a	2007a	2008f
Federal Funds	5.25	5.25	5.26	5.25	5.07	4.50	3.25	2.30	2.00	2.00	4.96	5.02	2.39
3-mo.LIBOR	5.43	5.37	5.36	5.36	5.45	5.03	3.25	2.20	2.05	2.05	5.19	5.30	2.39
2-yr. Treasury Note	4.93	4.74	4.77	4.81	4.38	3.48	2.00	1.70	1.90	2.15	4.82	4.36	1.94
10-yr. Treasury Note	4.90	4.63	4.68	4.85	4.73	4.26	3.65	3.40	3.30	3.35	4.79	4.63	3.43

a = actual
f = forecast

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