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Money Cops

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

The Federal Reserve's Open Market Committee (FOMC) announcement on March 21 regarding future monetary policy was met very favorably by the stock market, which saw the Dow average jump 159 points. As widely expected, the Fed did not change its critical federal funds rate, which has been stuck at 5.25% since last June 30. However, the FOMC did (vaguely) suggest (we think) that (perhaps) the next move in monetary policy (most likely) will be to (probably) ease its key rate. Prior to March 21, the Fed (we're quite sure) had a bias (most likely) towards additional monetary tightening…

…whew!!

The following is a discussion of the who, what, how, when, and why regarding the Fed…

The Federal Reserve is easily one of the most powerful—and misunderstood—of all American institutions. The Federal Reserve's steady hand as America's "central banker" has been especially critical to U.S. economic performance during the past 25 years. Why?

The management of fiscal policy (taxation and spending) during the majority of those years by various Administrations and Congresses was less than admirable. As a result, the enormous and irresponsible buildup of Federal debt remains, for now, our collective lasting legacy.

Today's Federal Reserve—under the control of Chair Ben Bernanke—enjoys a very high level of credibility as an inflation fighter. In the world of central banks, there is no loftier objective…nor any greater success.

Inflation Control

The Federal Reserve's number one responsibility is to maintain American price stability. It has been largely successful over the past 15 years in doing so, with consumer prices rising at an average annual rate of 2.7% since 1991. More comprehensive measures of inflation have risen at even lesser rates. In contrast, U.S. consumer prices rose an average of 6.2% annually during the '70s and '80s, with a painful bout of double-digit inflation in 1979 and 1980.

Today's Fed is very concerned that higher energy prices now impacting the economy will contribute to a broad series of price increases for thousands of products and services across the economy. Such a pass-through of energy costs keeps Fed officials awake at night.

Federal Reserve Chair
Ben Bernanke

Add in volatile commodity and gold prices, the fear of further terrorism in the U.S. and abroad, enormous purchases of U.S. Treasury securities by foreign investors, and a handful of other topics, and one gets a feel for the life of a Fed official. It is not for the faint hearted.

In its efforts to maintain price stability, the Fed many times is called upon to…

1) "take the punch bowl away from the party" (to slow the economy) when it gets a bit too rowdy

2) administer preventive "medicine" to its patient (the U.S. economy) when necessary in order to minimize the chance of a more serious "inflation disease" later, which would require even more drastic action (more painful medicine)

Note: Most changes to monetary policy are enacted by the Fed adding reserves to or withdrawing reserves from the banking system through a process called open market operations. The result of such moves is to increase or decrease

the Fed's most critical interest rate, the federal funds rate. The federal funds rate is the rate at which commercial banks and certain other financial institutions invest excess funds with other commercial banks on an overnight unsecured basis.

The federal funds rate is easily the most important of ALL short-term interest rates. Changes in the federal funds rate immediately impact the level of all other short-term interest rates, including the prime lending rate and various short-term investment rates. The discount rate, the other rate controlled by the Fed, is now almost irrelevant in today's conduct of monetary policy.

The "Dog" and the "Tail"

While many of the Federal Reserve's official responsibilities remain unchanged from earlier years, the nature of the Federal Reserve's monetary policy flexibility has changed markedly during the past 25 years. In my opinion, the Federal Reserve is no longer the primary determinant of when monetary policy changes are necessary—the U.S. bond market is.

Since the Federal Reserve's creation in 1913 until perhaps the late 1970s, the Federal Reserve solely determined monetary policy. The nation's bond market—much smaller during those times—then quietly fell in line. During that era, the Federal Reserve was the "dog," while the bond market was the "tail." This relationship has now reversed.

Today's reality is that the Federal Reserve, to a large extent, provides the monetary policy mix that is demanded by a powerful and very inflation-sensitive bond market. The market is now the "dog," while the Federal Reserve is the "tail."

Today's inflation-wary bond market provides the Federal Reserve with less monetary policy flexibility than at any time in its history. Any future Federal Reserve attempt to over-stimulate U.S. economic growth with "easy money" would be met with rising long-term interest rates (to protect lenders/investors from impending higher inflation) and cries of Federal Reserve irresponsibility.

Conducting Monetary Policy

How is proper monetary policy determined by the Federal Reserve? The Fed is clearly concerned about the inflation implications of today's historically tight labor markets and the wage pressures that could result.

In addition (and figuratively speaking), today's Federal Reserve conducts monetary policy using an old-style balancing scale with four trays.

In separate trays, the Fed balances:

1) Criticism from the "hawks," who see inflation under every rock. The hawks are typically critical of the Fed, noting that the institution is not aggressive enough in diffusing inflationary expectations

2) Criticism from the "doves," who constantly argue that monetary policy is too restrictive. The doves argue that the Fed has usually gone too far in monetary tightening or not eased policy enough, and that the Fed frequently threatens the economy with the "r" word…recession

3) Recent price performance of gold and various other commodities. Price movements in these commodities can serve as inflation red flags, as well as signs of monetary policy that is too restrictive

4) The current shape and slope of the U.S. Treasury yield curve, including the most recent direction of 10-year U.S. Treasury Note and 30-year U.S. Treasury Bond yields. Such information provides a clue as to the bond market's collective view of inflation expectations

Only when all trays are in "relative balance" does the Fed consider monetary policy to be appropriate.

The Fed must also consider the inflation implications of U.S. dollar strength or weakness relative to other global currencies. The Fed must also consider the conduct of monetary policy by other major central banks including the European Central Bank, the Bank of England, and the Bank of Japan…

…the job is quite complicated—(I think)

Jeff

"TEA"ser

A housework-challenged husband decided to wash his sweatshirt.

Seconds after stepping into the laundry room, he shouted to his better half, "What setting do I use on the washing machine?"

"It depends," replied the woman. "What does it say on your shirt?"

He responded, "University of Oklahoma."

—from Sharron Horsey

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