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Economic Outlook

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The Fed's Dilemma

By John H. Makin

The Fed is in a bind, pulled toward easier monetary policy by a weak economy and fragile credit markets, while simultaneously needing to resist higher inflation. On Monday, June 9, after a weekend of headlines regarding a half-percentage-point rise in the unemployment rate, Federal Reserve chairman Ben Bernanke gave a pathbreaking speech entitled "Outstanding Issues in the Analysis of Inflation" at the Federal Reserve Bank of Boston's fifty-third Annual Economic Conference. In that speech, after suggesting that the risks of a substantial economic downturn had diminished over the past month and citing further progress in the repair of financial and credit markets, he proceeded to address the problem of rising inflation. In two sentences, he contributed to a sharp, fifty-basis-point rise in two-year bond yields and boosted the market's assessment of the chance of a fifty-basis-point rise in the federal-funds target rate at the September 16 meeting of the Federal Open Market Committee (FOMC) from virtually zero to nearly 70 percent. Shifting the focus of monetary policy to fighting inflation, Bernanke said:

> [T]he latest round of increases in energy prices has added to the upside risks to inflation and inflation expectations. The Federal Open Market Committee will strongly resist an erosion of longer-term inflation expectations, as an unanchoring of those expectations would be destabilizing for growth as well as for inflation.[1]

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With those two sentences, Bernanke embarked on a path that may lead to removal of the famous "Greenspan put," whereby the Fed avoids policy measures that could cause systemic risk in financial markets.

Rethinking Monetary Policy

Bernanke's statements, and statements by other FOMC members consistent with the views he expressed, are the occasion for a thoughtful reappraisal of what to expect from U.S. monetary policy. This opportunity comes at a time when inflation risks and the need for the Fed to resist higher inflation have been added to the risks attached to an ongoing credit crisis, as well as to the substantial uncertainty about the future paths of the American and global economies. Two major changes are noteworthy. First, the Fed and Bernanke have decided to lay out a policy reaction function that can be clearly understood by markets. Persistently rising food and energy prices and attendant rising import prices that boost inflation expectations either directly or through pass-through to core inflation will lead to tighter monetary policy. The Fed is not promising to raise the fed funds rate at any particular point in time, but it is articulating the conditions under which it would do so irrespective of the state of credit markets or the economy.

Second, by including higher food and energy prices in the trigger for tightening, the Fed is moving toward targeting headline inflation rather than core inflation. The persistent and rising divergence between headline and core inflation since 2002, a mirror of the persistent rise in food and energy prices

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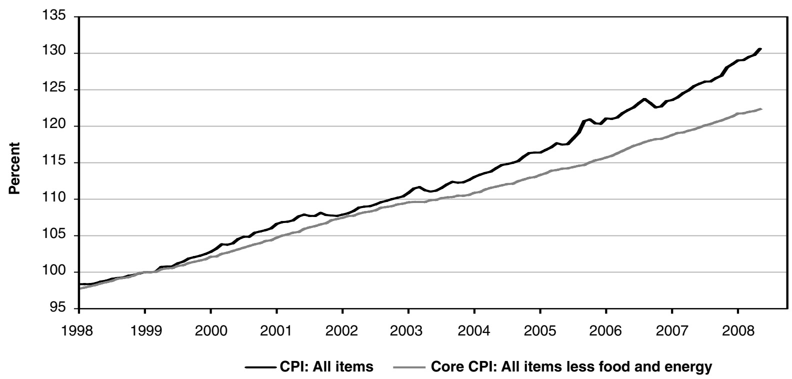
FIGURE 1
CPI VERSUS CORE CPI INDEX LEVELS
January 1998–May 2008
(monthly; January 1999 = 100)



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

since then, has forced the Fed to this position (see figure 1). While many measures of inflation expectations (even long-run ones) have been well-behaved, even during the last run-up in oil prices, the Fed is—wisely, in my view—warning markets that its reaction to higher inflation expectations or to passing higher food and energy prices through to higher core inflation will be prompt and not conditional on the state of credit markets and the economy.

Longer-run inflation expectations, like the implied inflation rate derived from a comparison of inflation-indexed Treasury securities with regular securities, have been well anchored in the 2.3–2.6 percent range since mid-2004. Inflation expectations among households, however, have risen sharply, tied to the highly visible, accelerating rise in gasoline and food prices this year. The University of Michigan's survey of consumer sentiment released on June 8 put twelve-month inflation expectations at 5.1 percent versus an average of 3.2 percent in 2006 and 2007. Ominously, in the same report, consumer sentiment dropped to its lowest reading since 1980 in the face of deteriorating labor market conditions, worries over inflation, persistently falling home prices, and tightening credit conditions facing most households.

Consumers who expect inflation above 5 percent in the coming twelve months are a threat to price stability, particularly insofar as they become willing to pay higher prices on discretionary purchases and demand higher wages from their employers. So far, the evidence of willingness to pay higher prices on items outside of the food and energy categories is absent. Year-over-year core CPI inflation through May was 2.3 percent versus an average of 2.4 percent during 2007. The other major measure of core inflation—the Personal Consumption Expenditures index—rose year-over-year by 2.1 percent through April, down slightly from the 2.2 percent rate in 2007.

The absence of an inflationary spillover from higher food and energy prices to other goods and services—the "core"—is testimony to the lack of pricing power in most sectors of the economy. That lack of pricing power, which includes an inability to demand higher wages, is testimony to the weakness of the economy and suggests that higher food and energy prices are, so far at least, acting as a tax on U.S. households. As newspapers and television commentators are suggesting, households are being squeezed by higher food and energy prices. So too are firms, meaning that the outlook for profits is deteriorating in proportion to a sharp rise in input costs tied to higher energy costs. Still, firms are responding to higher energy costs by attempting to boost prices: Dow Chemical announced a 20 percent rise in the cost of many of its petroleum-based products in May. Everyone is familiar with the effort on the part of airlines to pass on higher fuel costs to their customers.

Beyond reclaiming an unconditional option to tighten in the face of rising inflation expectations, the Bernanke Fed has, in effect, indicated that it believes the systemic risks emanating from a crisis in the credit market, while not absent, have been contained. Former Fed chairman Paul Volcker, in an April speech to the Economic Club of New York, suggested that the Fed had tested the limits of its legal authority in undertaking containment of the Bear Stearns crisis. Opening the discount window to investment banks was an extraordinary step undertaken (probably necessarily so) to contain a run by counterparties on them. The Fed's willingness to take on to its own balance sheet $30 billion of largely unmarketable Bear Stearns assets was also problematic.

FOMC members, specifically Jeffrey Lacker, president of the Richmond Fed, and Charles Plosser, president of the Philadelphia Fed, have articulated the "moral hazard" concerns arising from the Fed's role in the Bear Stearns intervention. The Fed's effort to contain systemic risk conflicted with the need to constrain the risk-taking by institutions that played a large role in creating a housing bubble while underestimating the risks associated with a large class of loans and derivative securities tied to the notion that house prices never fall.

The Primary-Dealer Credit Facility (PDCF), whereby the Fed made discount-window borrowing available to investment banks, was a temporary measure scheduled to be either extended or allowed in September to expire. The decision concerning the PDCF is highly conditional on the health of credit markets and the economy. If, as the Fed seems to have suggested, the economy is recovering in the second half of the year, while the credit crisis is largely contained, then the moral hazard problem—too much risk-taking by banks and investment banks—could be contained by undertaking a well-advertised closure of the PDCF, either in September or later. Alternatively, if credit markets are still too fragile and the economy is still too weak, with the risk of an adverse feedback loop from a credit crisis to a still-weaker economy present, removal of the PDCF could precipitate another financial crisis.

Under a condition of higher inflation and lower growth, the Fed has signaled strongly that it would tighten monetary policy.

Risks of New Monetary Stance

By reclaiming the option to tighten monetary policy under predetermined conditions, the Fed is risking pursuit of a procyclical—in this case, slowdown enhancing—monetary policy, should stagflation intensify. Under a condition of higher inflation and lower growth, the Fed has signaled strongly that it would tighten monetary policy. It is important to recognize that the Fed is not taking these risks without good reason. There is a substantial body of research that supports the notion that higher and more volatile inflation depresses long-term growth. Beyond that, once inflation expectations rise, they tend to be sticky and difficult to reverse, having the opposite effects of the stable inflation expectations of the past two decades. The Fed is taking preemptive steps to minimize the chance of substantial damage to the real economy that can follow from higher inflation. That is why Bernanke said that the FOMC would strongly resist “an erosion of longer-term inflation expectations, as an unanchoring of those expectations would be destabilizing *for growth* as well as for inflation.”[2]

The drama and market volatility tied to the Bernanke Fed’s promise to resist higher inflation is enhanced by the uncertainty surrounding the state of credit markets and the economy. The intensity of the mid-March Bear Stearns crisis is behind us, but credit markets and financial markets remain fragile. Large segments of the credit market are virtually closed, with no transactions taking place. Stocks in the Standard & Poor’s financial index, a good overall measure of the health of the financial sector, recovered somewhat after relief from the Bear Stearns crisis but have fallen from early May to mid-June more than 20 percent, to levels below those prevailing just before that crisis. Even with the support of the PDCF, investment banks like Lehman Brothers have struggled to obtain financing. Like most financials, Lehman’s shares rallied after the Bear Stearns crisis to a high of about $48 per share, then fell to an average of half that in mid-June. Buyers of Lehman’s common stock offering at $28 a share on June 10 had lost 20 percent on their investment by the end of that week.

Lehman’s experience with the PDCF window has been mixed. During the first week in June, rumors that Lehman had borrowed from the Fed’s facility to accommodate investment banks led to a sharp sell-off in its shares, which was partially reversed when Lehman’s spokesman vehemently denied having used the PDCF facility. Whatever one concludes from that episode, it does not suggest a robust investment banking sector.

Prospects for the U.S. Economy

Bernanke characterized the state of the U.S. economy by saying, “The risk that the economy has entered a substantial downturn appears to have diminished over the past month or so.”[3] He did add that, because of the ongoing contraction in housing and the continued increases in energy prices, “growth risks remained to the downside.” Perhaps he was hoping to put the adverse feedback loop—whereby worsening credit conditions lead to a worsening economy that, in turn, worsens credit conditions—behind him. That would be a necessary condition to support the articulation of a possible tightening of monetary policy.

With all that said, the outlook for the U.S. economy remains highly uncertain and may be contrary to the Fed’s expectation of a modest pickup in the second half of the year. The major positive factors, at least for second-quarter U.S. economic growth, have been stronger net exports, some evidence of possible stronger capital spending, and stronger than expected retail sales during April and May.

The stronger retail sales probably reflected the positive impact on spending of the anticipation and distribution of federal tax rebate checks. About $50 billion in rebates was distributed in May with another $50 billion to come in June. The rebate checks, relative to past stimulus packages, were widely advertised and skewed more toward low-income households. The premise was that American households living from paycheck to paycheck will spend most, if not all, of any windfall gains, such as rebate checks.

The rise in the May unemployment rate largely reflected an 11 percent jump in the number of unemployed workers during that month, the largest increase since 1974. Indeed, a percentage increase of that size in the number of workers unemployed has always occurred during a recession.

Taken together, stronger exports, retail sales, and capital spending have boosted pessimists' estimates of second-quarter growth from about –1 percent at an annual rate to about 1 percent, with a wide distribution still in place from zero to 2 percent. More problematic is the outlook for growth in the second half of the year. The sources of modest strength in the first half of the year all look set to atrophy moving into the second half, while tightening credit conditions have spread from the subprime sector to the economy at large; house prices have continued to drop rapidly; and, with the Fed's promise to tighten, interest rates and the dollar have risen, thereby placing an additional drag on the economy.

The only question with respect to the drag on growth tied to the aftermath of rebates is timing. The larger the growth in spending that results from distribution of rebate checks during the second quarter, the larger the drop in spending that will follow their removal. The prompt and aggressive spending of rebate checks suggested by April and May retail sales data, and no doubt forthcoming with June retail sales data, means that households have not used rebate checks to pay down debt and, even in the face of higher outlays on food and energy, have not cut back on purchases in other areas. If food and energy prices continue to absorb larger than usual portions of household budgets, the absence of rebate checks and limitations on available credit will force a reduction in spending outside the areas of food and energy, thereby depressing consumption growth during the second half of the year.

Durable goods numbers have suggested some revival in capital spending, but it is difficult to imagine that firms that have begun to lay off workers (as evidenced by the higher unemployment rate in May) will be adding to productive capacity by spending more on capital. Beyond that, a high level of uncertainty about the outlook for the economy and a low capacity utilization rate—below 80 percent—argue for continued weakness in capital spending. U.S. net exports have been highly supportive of growth, contributing 0.8 percentage points of growth in the first quarter, and probably will contribute a percentage point to growth during the second quarter as dollar weakness and sustained growth in emerging markets have helped to boost U.S. exports. That said, the modest appreciation of the dollar that has accompanied the Fed's lean toward inflation-fighting probably means that the biggest boost from exports will have been witnessed by the end of the first half of this year.

Other parts of the U.S. economy are very weak and appear likely to remain so. As already mentioned, consumer confidence is at a twenty-eight-year low. Auto sales fell at a 25 percent annual rate in the three months ending in May. Sales of new and existing homes remain very weak, and house prices, having dropped by 16 percent since 2006—thereby erasing $4 trillion worth of real household net worth—are on track to drop by another 16 percent by the end of 2009. Foreclosures are rising rapidly, and vacant housing units continue to rise as well, providing the basis for continued downward pressure on housing prices. Needless to say, higher interest rates would not be supportive of the outlook for housing.

While Bernanke characterized the sharp 0.5 percent rise in the unemployment rate as unwelcome, he opined that together with recent incoming data on the U.S. economy, the higher unemployment rate affected the outlook for economic activity and employment "only modestly." Arguably, that remains to be seen. The rise in the May unemployment rate largely reflected an 11 percent jump in the number of unemployed workers during that month, the largest increase since 1974. Indeed, a percentage increase of that size in the number of workers unemployed has always occurred during a recession. Some observers contended that a large part of the increase was due to an unusual rise in teenage unemployment. In fact, of the half-percentage-point rise in the unemployment rate in May, only a tenth of a percentage point was attributable to a rise in teenage unemployment. Meanwhile, the year-over-year growth in employment slipped sharply, from 0.33 percent in April to 0.17 percent in May. The behavior of high frequency data on the employment picture (initial and continuing claims) is consistent with the payroll data, which heretofore have suggested that, while no hiring is occurring, layoffs have been limited. The 11 percent jump in the number of unemployed workers during May suggests that layoffs may be beginning, which would, in turn, further encumber consumer confidence and spending power.

> My estimate of second-half growth is –1 percent, below the current consensus of about 1–2 percent.

Taken together, the crosscurrents in the economic outlook have taken estimates of growth in the first half to about 1 percent from zero percent previously. My own estimate of second-half growth is –1 percent, below the current consensus of about 1–2 percent. The outlook is complicated by the need to consider whether or not the Fed will raise interest rates over the balance of the year. Markets are currently expecting a twenty-five-basis-point increase in September followed by another fifty-basis-point increase by year-end. If those moves occur, my estimate of second-half growth would be –1.5 percent with substantial downside risk in the fourth quarter.

Complications from the Global Economy

The Fed's dilemma—facing a combination of weaker growth and higher inflation—reflects the uncomfortable fact that the Fed remains the central bank not only for the United States, but for the economies in the Middle East and Asia whose currencies are pegged to the dollar. The sharp easing of Fed policy directed at containing the U.S. credit crisis and thwarting a possible adverse feedback loop to the economy has simultaneously boosted inflation pressures in the Middle East and Asia, particularly in China, whose currency is pegged to the dollar. In effect, with the Fed easing, China and other countries that are subsidizing energy consumption by keeping retail energy costs well below world levels are compounding the impact of the Fed's easy money policies with highly stimulative fiscal policies. China, which is growing at a 17 percent annual rate in nominal terms due to high growth and inflation, is spending 2 percent of GDP to subsidize energy consumption. The Chinese are anxious and able to cushion their consumers from higher global energy prices while simultaneously wishing to encourage the rapid expansion of a domestic automobile industry. Other Asian and Middle Eastern countries have followed similar policies, thereby accelerating the demand growth for energy products and causing a record rise in crude oil prices to nearly $140 per barrel as this is being written. Simultaneously, as incomes rise in emerging markets, the higher demand for protein is pushing up grain and food prices.

The transmission of the Fed's easy money policy to China and emerging markets where currencies are pegged to the dollar has contributed to the Fed's substantial dilemma with respect to monetary policy as it applies to the United States. The best outcome would be for emerging market countries to allow their currencies to float upward in order to cushion them from the capital inflows tied to undervalued currency levels while simultaneously allowing energy prices to rise in order to moderate consumption. In effect, they would be cutting the link between themselves and the Fed's accommodative monetary policy while helping to slow the rise in energy prices. By refusing to act, emerging markets have essentially put the burden of adjustment to rapidly rising food and energy prices back onto the United States, Europe, the United Kingdom, and—more recently—Japan. Because of the threat running from higher food and energy prices to higher inflation, central banks in industrial countries have been forced to put more emphasis on containment of a persistent inflationary threat tied to the highly expansionary policies (both monetary and fiscal) in emerging markets. The Fed may be concerned, in passing, with the additional fiscal stimulus being applied to the U.S. economy, but that threat likely will pass quickly during the second half of 2008, once the temporary boost in spending tied to distribution of the rebate checks is over.

Looking Ahead

The trio of uncertainties tied to credit markets, the economy, and the path of central bank policies in most of the industrial world makes predicting the outlook for the economy and financial markets considerably more difficult than usual. A look at the volatile path of global equity prices and interest rates since the initial wave of relief from containment of the Bear Stearns crisis reinforces this notion. A best guess at the start of what may turn out to be another volatile summer is that the higher interest rates and the stronger dollar resulting from the Fed threat to tighten, coupled with continued problems in the credit markets and a sharp slowdown in growth during the second half of the year, will combine to keep any Fed increases either at zero or twenty-five basis points simply because the U.S. economy and U.S. credit markets could not stand more tightening.

Notes

1. Ben S. Bernanke, "Outstanding Issues in the Analysis of Inflation" (speech, Federal Reserve Bank of Boston, Annual Economic Conference, Chatham, MA, June 9, 2008), available at www.federalreserve.gov/newsevents/speech/bernanke2008 0609a.htm (accessed June 23, 2008).
2. Ibid. Emphasis added.
3. Ibid.