

ECONOMICS: US PERSPECTIVES—MARCH 5, 2010

Sustained Growth Likely to Force Fed's Hand on Interest Rates

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As the economy continues to recover, policymakers face the question of when to begin raising the federal-funds rate—and by how much. We believe that sustained growth will lead to interest-rate increases well before year-end.

Over the past few weeks, Federal Reserve Chairman Ben Bernanke has staked out a clear path for the Federal Open Market Committee (FOMC), as it prepares an exit strategy from the extraordinary lending and liquidity policies put in place during the recent economic crisis. The committee soon plans to wind down all of the special facilities it created, and end its purchase of \$1.25 trillion in agency mortgage-backed securities by the end of March.

But the Chairman has been somewhat vague—perhaps intentionally so—about when the committee will begin to lift the historically low target for the federal-funds rate. This benchmark rate, which applies to interbank lending of Federal Reserve funds, has been held to an extraordinarily low range between 0% and 0.25% since December 2008.

In his semiannual congressional testimony on monetary policy in late February, Mr. Bernanke indicated that the FOMC remains committed to a low federal-funds rate for an extended period. But he also

hedged, adding that “as the expansion matures, the Federal Reserve will at some point need to begin to tighten monetary conditions to prevent the development of inflationary pressures.”

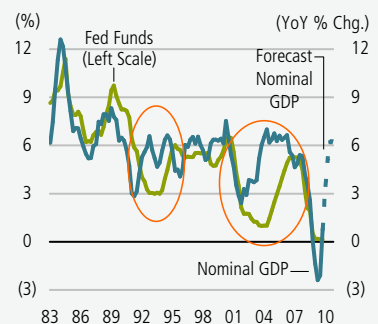
Clearly, the unprecedented circumstances of the credit crisis and recession have dictated a highly unusual path for monetary policy. And since the US economy still faces extreme headwinds, notably an unemployment rate near 10%, it's sensible to maintain stimulative measures well into the recovery. However, policymakers will eventually face a pressing question: as the economy recovers from its deepest downturn in the postwar period, is a federal-funds rate of virtually zero simply too accommodative?

Lessons from 1994 and 2004

Over the past two decades, the FOMC has faced this difficult decision twice, in 1994 and again in 2004. In both periods, headline inflation, as measured by the Consumer Price Index, was roughly the same—ranging between 2.5% and 3.0%. Still, policymakers chose two different

Display 1
Policy Rates Are at Unsustainable Levels

Nominal GDP Growth vs. Federal Funds Rate



Source: Bureau of Economic Analysis, Federal Reserve Board and Haver Analytics

paths for raising interest rates—one fast and the other more gradual.

During 1994, with the overall unemployment rate hovering around 6.5%, policymakers doubled the federal-funds rate from 3% to 6%. In the process, they lifted the real federal-funds rate, which is adjusted for inflation, to a level close to its historical average. They also closed a huge—and highly accommodative—gap between official interest rates and nominal gross domestic product growth (**Display 1**). History shows that if interest rates are set too far below nominal GDP growth, it encourages excess leverage and speculation that could lead to price increases or other

real and financial imbalances that would undermine the economic cycle.

In hindsight, this aggressive action successfully headed off an increase in inflation and other financial-system imbalances that could have derailed the economy. The expansion continued for six years after the 1994 rate increases, and the downturn that followed was the shortest and mildest on record.

In 2004, both the policy path and result were markedly different. With unemployment in the neighborhood of 5.5%, one full percentage point below that of 1994, policymakers chose a much more measured path, nudging the federal-funds rate target up by 25 basis points at each regular FOMC meeting from June 2004 to June 2006.

In all, the target rate rose 4%, from 1.25% to 5.25%, a relatively slow adjustment that left policy rates well below their normal relationship to inflation and nominal GDP growth for an extended period of time. Eventually, real sector and financial imbalances developed, especially in the housing market and financial sector,

triggering the worst economic performance in a generation.

Following the Nominal GDP Rule

Policymakers are certainly well aware of these experiences as they contemplate adjustments of a similar—or even larger—scale.

As 2004–2006 showed, holding short-term rates too low for too long can lead to dangerous imbalances in the real economy, financial markets or asset prices. On the other hand, taking modest corrective steps early in the process may avoid the need for more wrenching adjustments later.

To date, the only voting member of the FOMC that publically agrees with taking early action is Kansas City Federal Reserve Bank President Thomas Hoenig, who opposed February's commitment to keep official rates low for some time. In his opinion, "maintaining short interest rates near zero for an extended period would lay the groundwork for future financial imbalances and risk an increase in inflation expectations."

However, other nonvoting policymakers, including Federal Reserve Bank of Atlanta President Dennis Lockhart and Federal Reserve Bank of Philadelphia President Charles I. Plosser, have recently stated that they're equally uncomfortable with a commitment to low rates for an extended period.

Clearly, as policymakers ponder their interest-rate exit strategy, they'll have to base their decision on the economic forecast—not only for 2010, but for the next few years. We expect the federal-funds target rate to be lifted from near zero today to 2% by the end of 2010, because we forecast nominal GDP growth of 5.5% this year.

While a hike of 200 basis points from today's level doesn't fully close the gap between official rates and nominal GDP, it moves official rates a lot closer to where we—and many policymakers—believe rates need to be in the years ahead. Moreover, history suggests that the sooner policymakers can close the gap, the greater chance the US economy has of enjoying a sustainable recovery. ■

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