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Several Gauges Point To Aggressive Easing

By MIKE COSGROVE

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According to many, the Bernanke Federal Reserve places weight on behavior of the core personal consumption deflator for one of its inflation measures. That was 1.8% on a year-to-year basis in August. We don't know precisely their target for core inflation, but it is probably in the 1% to 2% range.

In comparison, growth in the economy is subpar. Economic growth is expected to be about 2% or slightly above in both 2007 and 2008, according to some surveys of economists.

But the U.S. economy has a potential growth of 3% per year, according to the Congressional Budget Office. That estimate may be low by 25 or 50 basis points.

According to research by the Dallas Federal Reserve on the Taylor Rule (named for Stanford economist John B. Taylor, it models Fed interest-rate changes by comparing where GDP growth is vs. its potential, and where inflation is vs. the Fed's target rate), the FOMC should lower the federal funds rate by 0.7 percentage point if GDP growth is expected to fall by one percentage point. This ignores any impact of deflation in housing prices on consumer spending or other factors depressing economic growth.

Clearly a substantial lowering of the funds rate is implied by the Taylor rule, since actual GDP growth is running approximately one full percentage point below potential while core inflation appears to be in the Fed's approximate range.

Additionally, a target federal funds rate of 4.75% is about 75 basis points above the three-month Treasury yield. This signals that the cost of money to banks is far above what the market suggests.

Over the past 20 years, the federal funds rate has averaged 22 basis points above the three-month yield. In June 1989, the fed funds rate was one full percentage point above the three-month yield. A recession followed in 1990.

In September 1998, the gap was about 75 basis. That closed with the federal funds rate declining more quickly than the three-month to help resolve that credit market issue. As recently as February 2007, the federal funds rate was only 10 basis points above the short-term Treasury yield.

The market is providing a clear signal that the Fed is substantially behind where it needs to be to help resolve the credit market problem.

Another market signal is the difference between the 10-year Treasury note yield and the federal funds rate, a gap that has averaged 130 basis points over the past 20 years. Currently, the federal funds rate is above the Treasury bond yield. It was last negative during the year 2000 — prior to the mild 2001 recession. In July 1989 the difference was also negative — prior to the 1990 recession.

The Bernanke-led Fed has an opportunity to follow the advice of the Taylor rule and other market indicators and swiftly move the federal funds rate to the 4% level or lower. The slowdown in output is already here. Impact of the housing recession and deflation on consumer spending is uncertain at this time, as we don't know the degree of housing deflation that we face over the next few years.

A rule of thumb is that each dollar decline in home equity may cut consumer spending by up to 5 cents. Several years of housing deflation, which could occur, would imply more subpar years of economic growth ahead or recession.

Unemployment is a lagging indicator, and the current unemployment rate is of little significance for prudent Fed policy. Monetary policy has substantial lag time, so the Fed needs to act in advance of major housing deflation.

Housing value in the recent Federal Reserve Flow-of-Funds was estimated at about $20 trillion. The Fed doesn't want to find itself replicating the Japanese multiyear period of real estate deflation, which occurred because the Bank of Japan wouldn't take aggressive action.

Credit markets are telling the Federal Reserve to reduce the funds rate in an aggressive manner to help buoy the economy at the margin.

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