



The Bottom Line

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Fed Policy Tighter than Normal at 2% Fed Funds

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While the Fed decided to leave its benchmark interest rate at 2% this week, well below the level suggested by the Taylor Rule, credit conditions in the U.S. are much tighter than this rate would suggest. Named for Stanford University Professor John Taylor, the rule has been cited by both Chairman Bernanke and Fed Vice Chairman Kohn as “essential guidance” to central bankers on how to set interest rates. The so-called Taylor Rule is a short-hand formula that suggests how a central bank should set rates if inflation or growth veers from goals. The rule is used more as a reference than a policy trigger because central banks have difficulty with timely measurements of some of its components, such as potential GDP and the real federal funds rate that would be ideal for an economy producing at its maximum potential. Also, the rule varies depending upon which measure of inflation is used. Federal Reserve policymakers are shown several versions of the Taylor Rule, using different measures of inflation, in the material they receive before each meeting of the Federal Open Market Committee.

Bernanke has said that the rule “embeds a basic principle of sound monetary policy.” According to this principle, when a shock causes a shift in the inflation rate, the central bank must adjust the nominal interest rate by more than one-for-one. But the U.S. economy is far too complex to rely on a small set of summary statistics, some of which are unobservable. Policymakers often base their decisions on risk scenarios that may have little to do with the economy’s current performance.

Currently, the Taylor Rule, using core PCE inflation of 2.3% and an assumed noninflationary rate of unemployment of 5% (the latest unemployment rate is 5.7%), suggests the benchmark fed funds rate should be at roughly 3.75%. So by this standard, one could question the Fed’s decision to leave the rate at 2% (with the exception of serial-dissenter Richard Fisher, President of the Dallas Fed, who is concerned about a wage-price spiral). One clear reason for the Fed’s decision is that credit conditions are much tighter than a 2% fed funds rate would normally suggest. The Fed’s Senior Loan Officer Survey has shown for some time that banks have tightened their credit standards for both business and household lending. The latest survey (in April) showed that a record number of domestic and foreign banks reported further tightening in lending standards on a broad range of loan categories. The July survey will be out soon and evidence in the Beige Book suggests that the survey will indicate even more restrictiveness in the second quarter.

On the mortgage lending side, banks apparently did not restrict lending sufficiently to reduce risk until about one year ago when the subprime mess hit the headlines. According to the FDIC, mortgage delinquency rates are higher for prime mortgages issued in the first half of 2007 than for the same period in 2006, suggesting the housing crisis and its fallout on banks will be deeper and will last longer than the Fed once thought. A reported 0.91% of prime mortgages from 2007 were seriously delinquent after 12 months; this compares to 0.33% in 2006. These borrowers purchased homes at near-peak prices and have suffered massive declines resulting in negative home equity. Freddie Mac (which generally purchases loans made to creditworthy borrowers) reported this week that 1.38% of the 2007-vintage loans it purchased were seriously delinquent after 18 months compared with 0.38% of 2006 loans at the same point in their life. Some large banks have suggested that losses will as much as triple from current levels on prime mortgages, especially jumbo loans, made in the second half of 2007. These loans were not securitized and remain on the books of the banks, putting further pressure on financial institutions in the next year. Until foreclosures slow from record levels, the U.S. housing market and the U.S. economy will remain under dark clouds as banks realize they didn't pull back far enough, and continue to tighten loan standards.

The Bottom Line: Monetary policy in the U.S. remains restrictive—much more so than suggested by the historically low fed funds rate. The Fed is on solid ground in keeping the benchmark rate at 2% because of continued deterioration in the housing market and continued financial stress for the banks. What's more, headline inflation will likely fall before the end of the year and, under current economic conditions, wage-price spiraling is highly unlikely. U.S. workers just don't have the bargaining power to demand wage hikes. Quite the contrary, union power is at a record low and falling, while layoffs are rising. Real wages have fallen this year and there is no reason to assume that nominal wages will catch up with inflation in the foreseeable future.

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