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The Fed's Complacency

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Now that the gentlemen at the Federal Reserve have used the "D" word, it's time for them to do something about it. You can't ward off deflation -- witness Japan -- by gradually ratcheting down interest rates. With key inflation rates flat-lining, the best way to beat deflation is to aggressively increase liquidity by pumping up high-powered money. The Federal Open Market Committee did this in 1998 and 1999 for reasons other than deflation. It can do so again.

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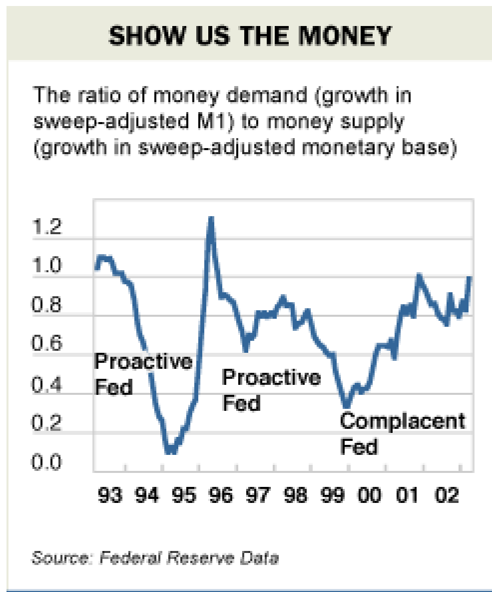
Meanwhile, the Fed's monetary policy remains stuck in neutral -- that is, monetary forces pushing the price level lower are roughly balanced by monetary forces pushing the price level higher. The Fed is doing what the Bank of Japan did in the wake of the 1990 bursting of the "bubble economy." Japan's discount rate was 6% in 1990; now it's near zero at 0.1%. The Fed is using the same game plan. The federal-funds rate was 6.5% in 2000; now it's 1.25%. Retail stores usually lower selling prices when consumers do not buy their merchandise. The BOJ and Federal Reserve are dropping the price of money as their economies languish, unemployment increases and the expected return on capital falls.

One method to assess Fed policy is to compare growth in money demand to growth in money supply. Growing money supply faster than money demand is a method to encourage real economic growth and put upward monetary pressure on prices. The best measure of money supply is growth in the sweep-adjusted monetary base (currency plus bank reserves), also known as high-powered money, since it's the one the Fed has the most control over. The proxy for money demand is growth in sweep-adjusted M1 (currency plus total checkable deposits).



The nearby graph illustrates the ratio of growth in money demand to growth in money supply. Recent numbers are about 1:1, which says that growth rates in money demand and money supply are approximately the same. Result: Central bank monetary pressures on inflation are neutral.

In the current economic environment, however, neutrality equals complacency -- and that's not good enough. The Fed should be increasing money supply much faster than money demand if their objective is to place upward pressure on the price level. In the graph, the downward sloping line in 1993 illustrates a period in which the Fed grew money supply faster than money demand. That was after President Clinton took office and the Fed ramped up growth of high-powered money.

The Fed also gunned growth in high-powered money in excess of money-demand growth during the latter '90s period of "irrational exuberance."

The FOMC follows an interest-rate target that reflects supply of, and demand for, money. However, interest rates eventually reflect the expected real return on capital plus an expected rate of inflation. A recessionary or sputtering global economy doesn't generate much of an expected return so the FOMC continues reducing the federal-funds rate. But when the real economy doesn't respond to lower interest rates in a reasonable time frame, as in Japan in the '90s and in the U.S. right now, central bankers doggedly focus on their interest-rate target -- which they keep lowering -- and pump in only enough high-powered money to hold the federal funds rate at its new lower rate.

It might appear that central bankers are doing their job as interest rates keep sliding. But following a slowing economy by lowering interest rates isn't working. The global economy continues to meander toward deflation. Japan is in deflation; Germany if not in deflation is very close; and odds of deflation in the U.S. increase as pricing power weakens on the goods side of the global economy. Falling interest rates reflect a sputtering global economy and absence of pricing power as the expected real return on capital investments sinks in a weak global economy. Falling interest rates reflect lack of investment opportunities, not easy money. In other words, the FOMC process of targeting interest rates isn't working. It didn't work for the BOJ and it won't work for the European Central Bank.

The FOMC as well as the BOJ and ECB need to become proactive and create an environment of excess money-supply growth relative to money-demand growth. The Federal Reserve doesn't know a priori where excess money-supply growth might go when it increases money supply faster than money demand. It could go into: a) economic growth; b) upward price pressure; c) increases in the equity market; d) placing downward pressure on the currency; or some combination of all of the above.

The dollar is down 8% from its recent peak in February 2002. Much of that decline reflects the apparent shift in the Bush administration position on the dollar, with a weaker dollar seen as a way to regain pricing power for U.S. business. Plus a weaker dollar reflects weakness in the U.S. economy. In a weak global economy investors want diversification.

The FOMC was very proactive in 1998 and 1999 and pumped in excess high-powered money. In September 1998 the Federal Reserve engineered a rescue of Long Term Capital Management, which was near the brink of failure. American and European entities bailed out that hedge fund. In addition more liquidity appears to have been pumped into the economy by the FOMC at about that time. In 1999 it was the Y2K concern that resulted in the FOMC adding incremental liquidity, which further pushed up growth of high-powered money relative to money demand. The point being that the FOMC has been very proactive in the not-so-distant past.

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Former Fed Governor Wayne Angell wrote on these pages last fall that complacency is deflation's friend. Unfortunately, deflation has plenty of friends on the FOMC, BOJ and ECB -- plus it has pals in Congress. Friends of deflation in Congress are fighting efforts by President Bush to cut tax rates. Slicing tax rates on personal income, as the president proposed, and eliminating taxes on dividends, would have a very positive impact on enhancing returns to capital and can be expected to add half a percentage point

per year to growth of real economic activity.

One might expect FOMC members to realize that the weakened state of the U.S. and global economy carries at least as much risk to the U.S. economy as LTCM and Y2K did in 1998 and 1999 and implement a very proactive monetary policy. As tax-rate cuts go to work, the FOMC needs to aggressively increase liquidity to ensure that the U.S. economy can grow and to ward off deflation. Complacency will not do the job.

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