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The Fed Out of Silver Bullets? Not yet.

When the Fed lowered the funds rate to 1.25% early last month, many believed the economy was ripe for an economic rebound. But with the consumer ending the year on a soft note, some fear the Fed is running out of silver bullets, those delightful reductions in short-term interest rates that have always pulled the market and the economy out of past doldrums. Is it possible that the U.S. could head into a Japanese style economic slump with the Fed running out of fire power to spur the economy?

Chairman Greenspan seems unconcerned. He has recently reaffirmed that the central bank has more tools in its policy kit than just setting the Federal funds rate. Greenspan fondly recalled the Fed's policy of "pegging" the interest rate on long-term government bonds just after the Second World War, when the Fed supported long-term bond rates at an extremely low level of 2.5%.

But I believe it would be much harder to set long-term interest rates than the Chairman implies. In today's markets, it may take the help of both the Treasury and the foreign exchange markets to revitalize the economy if reductions in the funds rate don't do the trick.

To understand why this is true, one needs understand the nature of the Federal funds market. The Federal Reserve can easily peg the Federal funds rate because this rate is determined by the supply and demand for bank reserves and the Fed is the sole supplier of these reserves. Reserve balances at the Fed are small – less than \$15 billion – so the central bank, through buying and selling just a few billion dollars of government bonds, has a huge impact on the interest rates in this market. Furthermore, since Fed funds mature in only one day, expectations of what will happen months or years down the road have little bearing on the funds rate. The Fed funds rate, which anchors the short end of the "yield curve", becomes an interest rate that can be easily manipulated by the central bank.

But once you travel up this yield curve into longer maturities, circumstances change radically. Not only does the actual supply of government securities become much greater but the yield on these securities is dominated by expectations of inflation, real economic growth, and Fed policy in the future.

When Greenspan referenced the ability of the Fed to peg long-term interest rates after World War II, he was referring to a time when there were nowhere near as many bond traders with huge resources at their disposal. Today hedge funds use highly leveraged interest rate futures, options, swaps, and other derivatives that can inundate the market with trillions of dollars of those securities, overwhelming the size of the Fed's entire bond portfolio. One need only recall how George Soros broke the Bank of England ten years ago by shorting the British pound in the face of massive purchases by the central bank.

If the Fed buys long term bonds, trying to force their interest rates down, but traders believe that this action will stimulate the economy or cause inflation, long-term rates will rise, not fall. "Bond vigilantes" have often sent long term interest rates in the opposite direction to the movement of the Federal Funds rate in anticipation of the effect of the Fed's action. For evidence of this, note that the rates on long bonds initially moved higher after the Fed's latest rate cut on November 6.

If the bond traders are right and the economy picks up, then all is well and good. But what if they are wrong? What if the Fed rate cut does not stimulate growth as bond traders expect? How can the Fed push the long rate down in spite of bond traders sending rates in the opposite direction?

One solution is to enlist the help of the US Treasury to change the maturity structure of federal government bonds, reducing the supply of long-term debt by selling a like amount of short-term bonds. Short interest rates would not rise because they are closely linked to the fed funds rate, which is controlled by the Fed, but long rates would drop because the supply of long-term government bonds would fall.

Bond traders always take note of significant maturity changes announced by the Treasury. We saw one manifestation of how this strategy would work two years ago when the Treasury announced it would no longer issue the 30-year bond and long-term bond rates fell dramatically. Certainly the Federal Reserve can shift the maturity structure of the bonds held by the public by selling short-term and buying long-term bonds from its vast portfolio of government securities. But the market would take the shift by the Treasury as far more definitive and significant.

But this isn't all that can be done. It is possible that even lower long term rates will not stimulate the economy. After all, Japanese long term bonds are currently below two percent and Japan is still in an economic slump.

Here is where the change in markets between the 1950s and 2000s can help,

instead of hinder, the Fed. A half century ago the US dollar was rigidly pegged to all other world currencies. In fact, monetary policy had to be mindful of international capital flows in order to maintain those fixed parities. But under today's floating exchange rates, there are no such restrictions. The Fed can continue to expand the money supply, even as interest rates are driven towards zero. This policy, called "quantitative easing," and will likely induce foreign exchange traders to sell these excess dollars, pushing down the dollar exchange rate.

Recently, newly-appointed Fed Governor Ben Bernanke questioned the usefulness of these actions and commented that the Treasury, and not the Fed, is responsible for dollar policy. But foreign exchange traders understand that the central banks are the ultimate arbiters of exchange rates because they control the money supply.

A falling dollar, although not a positive development for US consumers in the long run, would serve to boost aggregate demand in the short run. Not only would US exports become cheaper on world markets, but import prices would rise. This would go a long way towards mitigating the "imported deflation" from such low-cost countries as China and other developing countries.

A little inflation in an economy where many corporations and individuals are saddled with debt would be an encouraging development. In fact, there is a strikingly positive correlation between producer prices and profits in the short run, as pricing power is a key driver of corporate earnings. I think today that a softer dollar is a positive development for both the economy and the stock market.

Nevertheless, I do not believe that the Fed will have to reach into its tool box of extra tricks, as the current short-term rates are likely to work their magic next year. But if the Fed needs to stimulate the economy further, it should not hesitate to continue to cut rates for fear that it is running out of silver bullets. It won't be quite as easy as Greenspan indicates, but the Fed in conjunction with the Treasury and the foreign exchange markets can get the economy on the road to recovery.