Kudlow's Commentary

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Is The Fed Still Too Tight?

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Background

What is the goal of monetary policy? Should the Federal Reserve Board attempt to manipulate the economy by raising or lowering interest rates to slow or speed up economic activity or should monetary policy be focused solely on maintaining the value of the dollar? Over the years it appears as though the Fed has vacillated between these two objectives causing uncertainty in financial markets and related swings in levels of economic activity.

During the 1960s and 1970s, Fed policies appeared to favor tinkering with the economy. When President Nixon took the U.S. off the gold standard in 1971 and the U.S. experienced double-digit inflation, the Fed took some of the blame for increasing the money supply to finance the Viet Nam war and the Great Society programs that were linked to a surge in the price level. By the late 1970s, the Fed appeared concerned that the loss in the value of the dollar was the major problem and that a new approach to monetary policy, i.e., a plan to reduce inflation, i.e., stabilize the price level was the direction Fed policy should take.

Supply side economists Arthur B. Laffer and Charles W. Kadlec identified the Fed's commitment to a new monetary policy in an article written in October of 1982 and published in the Wall Street Journal. In this article the authors proposed that the Fed had adopted a "price rule" for monetary policy. This price rule theory reinforced the idea that the Fed was going to eliminate inflation by tying monetary policy to changes in the general price level. In other words, when prices rose above some arbitrary level set by the Fed it would signal coming inflation and the Fed would tighten by raising the Fed funds rate until prices returned to a normal or non-inflationary level.

Similarly, the Fed would ease when prices fell below a predetermined level. In the Laffer/Kadlec hypothesis, a benchmark was established to determine when the Fed would act. While there are many price indicators available that could have been selected as a benchmark, the authors chose the Dow Jones Spot Commodity

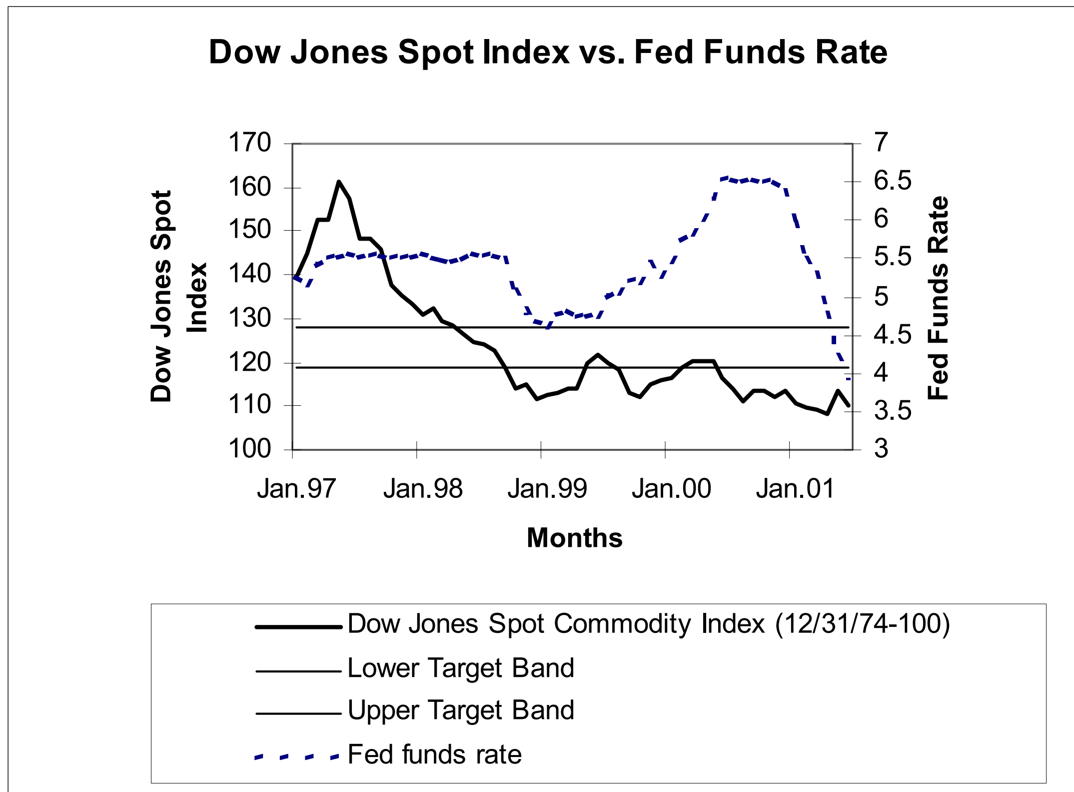
Index as the basic indicator. (The reason for this choice was quite simple: it was published every day on the front page of the Wall Street Journal.) They also established two bands, one at an index level of 119 and one at an index level of 128. The idea was that, if the spot index went above 128, the Fed would tighten and if went below 119, the Fed would ease. In order to determine whether or not the Fed was maintaining this price rule policy, the authors suggested monitoring changes in the Fed funds rate when prices moved outside of this band.

Since that revelation almost twenty years ago, the tracking of the relationship between the Fed funds rate and the Dow Jones Spot Commodity Index has, more often than not, indicated that the Fed led first by Paul Volcker and then under Alan Greenspan was committed to conducting monetary policy with the objective of stabilizing prices. Dr. Laffer's firm, A.B. Laffer Associates, has diligently tracked this relationship since 1989 and has provided extensive evidence that the Fed's commitment to a price rule has contributed to a dramatic decline in inflation and interest rates, a fall in the price of gold, a rise in the value of the dollar and the greatest bull market in stock market history.

Monitoring Recent Developments

Fed policy has been quite active since the global financial market calamity in 1998 and the related Long Term Capital Management crisis that occurred in the U.S. As a result of these financial disturbances, the Fed eased monetary policy in late 1998. As the U.S. economy avoided the Asian contagion, as it was called, growth spurted ahead in 1999 led by the increasing concerns about Y2K and related spending on remedial computer hardware and software. The emergence of the dot-com gold rush also contributed to a booming U.S. economy.

By mid 1999, it appeared as though the Fed was becoming concerned about unsustainable growth in the U.S. and, with it, a prospective surge in inflation. As a result of this inflationary concern, the Fed began raising the Fed funds rate to preempt an inflationary bubble. The following exhibit reflects the rise in the Fed funds rate in 1999 and 2000 when the economy was growing at an above average rate.



The Fed Goes Off the Price Rule

During 1999, there was no indication of building inflationary pressures as measured by the Dow Jones Spot Commodity Index. As reflected in the exhibit, the Index remained below the lower band established by the Laffer/Kadlec hypothesis. If the Fed were committed to a price rule, then they would have held their ground and not raised interest rates until such a time as the Dow Jones Spot Commodity Index went above the upper band of 128. In fact, based on this index, the Fed might have eased a little in 1999.

The Fed continued to tighten through the end of 2000 and the Spot Commodity Index remained below the lower band indicating that the Fed should have been easing rather than tightening. By the end of 2000, the continued tight monetary policy, falling prices and the dramatic slowdown in tech spending signaled that a recession was a possibility.

The quick reversal in Fed policy in January 2001—almost a panic reaction to a weakening economy—was reflected in six cuts in the Fed funds rate during the first half. As the second half of 2001 got underway, there was a growing chorus of economists who called for an end to Fed ease. Should the Fed stop easing?

If we give any credence to the historic record of the price rule as interpreted by Laffer and Kadlec, the Fed must continue to ease. The reason is simple. The Dow Jones Spot Commodity Index has continued to fall throughout 2001 reaching a low of 104 recently, a level that is substantially below the 119 lower target band. Until there is a recovery in prices, at least as measured by this index, falling prices are a sign that money is too tight. The continued increase in the value of the dollar since last October is an indicator that there is a shortage of dollars worldwide. The risk is deflation, not inflation.

Conclusion

The Federal Reserve's abandonment of the price rule in 1999 by maintaining a policy of tight money has contributed to a slowing economy, falling prices and a global shortage of dollars. If the Fed shifts to a neutral stance now, in the face of indicators that mandate continued ease, the economic recovery that is forecasted for later this year or early next year may be postponed indefinitely accompanied by further financial market turbulence. Fortunately, Chairman Greenspan's latest remarks indicate a commitment to further easing if the economy does not show imminent signs of recovery. Let's keep our fingers crossed.

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