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Déjà Vu: The Fed's Interest Rate Dilemma

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Despite record passenger traffic, airlines are bleeding cash and going bankrupt. Food riots have cropped up around the world, Canada is paying farmers to kill pigs because feed costs too much, and rice, it seems, is in very short supply.

While ethanol subsidies have created havoc, they don't explain everything – like huge increases in precious metals prices, the sharp decline in the value of the dollar, or record-high fuel prices.

What's missing in most analysis is the impact of inflationary monetary policy. Since 2001, and especially since September 2007 – when the Fed started cutting rates in response to credit market issues – excessively easy monetary policy has driven oil and other commodity prices through the roof.

The good news is we've been here before, and we know – well, at least 1980s Fed Chairman Paul Volcker knows – how to get out of this mess. Loose money in the 1960s and 1970s drove up the price of everything. A barrel of oil, which sold for \$2.92 in 1965, rose to \$40 in 1980. Most people believed that rising commodity prices indicated that the world was running out of resources. The Club of Rome predicted global ruin, and then President Jimmy Carter said that "peak oil" was right around the corner.

Oklahoma-based Penn Square Bank handed out oil loans freely, and sold off pieces of its loans in packages called "participations." Seafirst Bank in Seattle and Continental Bank in Chicago were two good customers. These banks thought oil prices would remain elevated and paid a huge price for their mistake.

Today, Bear Stearns, Countrywide and subprime lending are a repeat of Penn Square, Continental and oil loans. Bad decision making, based on a money-induced mirage, is the culprit. We are not running out of food or natural resources; this is an entirely man-made disaster caused by the Fed opening wide the monetary floodgates.

Money is the ultimate commodity because all prices have only money in common. And it is the only thing that a central bank directly controls. Unfortunately, because of globalization and financial-market innovation, money itself has become hard to measure and useless as a forecasting tool. So analysts use interest rates.

The "natural rate of interest" is the theoretical interest rate at which monetary policy does not artificially boost the economy, nor hold it back. It is also the rate at which money is neutral on inflation. There have been many attempts at measuring this. Some economists look at real interest rates. Others use the Taylor Rule,

which includes a target rate for inflation and real growth.

And while these methods are helpful, they rely on estimates. I devised a much simpler system back in 1993, based on actual economic data, that has proven extremely useful. It predicted the sharp increase in long-term interest rates in 1994; it also predicted the recession of 2001, the deflation of the early 2000s, and the inflation of recent years.

This model shows that a neutral federal funds rate should be roughly equal to nominal GDP growth. Nominal GDP growth (real growth plus inflation) measures total spending in the economy, or to put it another way, it reflects the average growth rate for all companies in the economy.

If interest rates are pushed well below nominal GDP growth, money is too easy and it encourages leverage. If interest rates are pulled above nominal GDP, money is too tight, and average companies cannot overcome borrowing costs.

Between 1960 and 1979, the federal funds rate averaged 5.6% and nominal GDP growth averaged 8.4%. With the funds rate 280 basis points below GDP growth, monetary policy was highly accommodative. The result: a falling dollar, rising

commodity prices and fears that resources were being used up.

In 1980, then Fed Chairman Volcker lifted the fed funds rate significantly above GDP growth and held it there long enough to end inflation. This policy instigated a steep decline in oil prices, and drove a stake through the heart of stagflation.

Oil and inflation stayed low in the 1980s and '90s, when the Fed held the fed funds rate 74 basis points above GDP growth on average. By 1999, with oil prices still low, the Economist magazine wrote that the world was "drowning in oil."

Low inflation turned to deflation in 1999 and 2000, when the Fed mistakenly pushed the funds rate above nominal GDP growth again. This deflation spooked the Fed and led to a radical reduction in interest rates. Since then, the fed funds rate has been well below GDP growth – an average of 210 basis points – the most accommodative six years of monetary policy since the 1970s. No wonder inflation is on the rise and commodity prices are setting new records.

The Fed lifted the funds rate from 1% to 5.25% between 2004 and 2006, but monetary policy was never tight because the rate never went above nominal GDP. This suggests that housing market problems were not caused by tight money in 2006-07, but by excessive investment during the

super-easy money of the years before.

Nonetheless, the Fed opened up the old playbook and cut rates aggressively when subprime loans blew up. This cemented higher inflation into place, crushed the dollar, pushed commodity prices up sharply, and created major problems in the energy, airline and agricultural marketplaces. And just like the 1970s, it is now popular to argue that the world is running out of resources again.

The answer to all of this is for the Fed to lift rates back to their natural rate, which is somewhere north of 5%. Tax-rate reductions and interest-rate hikes cured the world of its ills in the early 1980s. They can do so again.

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