



**The Northern Trust Company**  
**Economic Research Department**  
**Positive Economic Commentary**

*"The economics of what is, rather than what you might like it to be."*

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### **Why The Change In The FOMC's Reaction Function?**

Pipeline inflationary pressures are greater and the economy is stronger today than they were ten years ago when the FOMC began raising the fed funds rate. Why is the FOMC reluctant to raise the funds rate now? Could it be that the FOMC is concerned that the financial health of the household sector could deteriorate quickly if interest rates were to rise and that deterioration could adversely affect the safety and soundness of the U.S. financial sector?

In September of 1992, the FOMC lowered its fed funds target to, at that time, an unusually low level of 3%, holding it there through January 1994. In February 1994, the FOMC commenced raising its fed funds target. In June of last year, the FOMC lowered its fed funds target to 1%, its lowest level since 1958. At its most recent meeting on March 16, the FOMC stated that its current monetary policy stance was accommodative, but chose not to raise its fed funds target. At the January 27-28, 2004 FOMC meeting, FOMC "members commented that the information that had become available since the December meeting had tended to validate their earlier assessment that the expansion was firmly established and that robust economic growth, under way since about mid 2003, was likely to continue as the year progressed." I doubt that the FOMC's assessment of the 2004 economic growth outlook was materially different at the March 16 meeting.

Inquiring minds want to know: why was the FOMC willing to start hiking the fed funds rate in February 1994 but remains reluctant to do so in March 2004? Are the pipeline inflationary pressures weaker today than they were ten years ago? Are economic growth and the FOMC's forecast of growth weaker today than ten years ago? Is the "real" fed funds rate today higher than it was ten years ago? The data in the table below suggest that the FOMC's reaction function must have changed in the past ten years.

| <b>Economic Environment</b>                                      |               |                         |
|--|---------------|-------------------------|
|  | <b>Jan-94</b> | <b>Most Recent 2004</b> |
| Core Intermediate PPI (6-mo. annualized % chg.)                  | 1.62          | 3.21*                   |
| Core Finished Goods PPI (6-mo. annualized % chg.)                | -0.44         | 1.47*                   |
| PMI-Mfg. Price Index (6-mo. moving average)                      | 53.3          | 66.9**                  |
| PMI-Mfg. Supplier Deliveries Index (6-mo. moving average)        | 52            | 57.2**                  |
| JoC Industrial Metals Price Index (6-mo. annualized % chg.)      | 10.1          | 83.6**                  |
| London PM Fix \$Gold Price (6-mo. annualized % chg.)             | -2.7          | 26.6**                  |
| Trade-Weighted \$ vs. Major Currencies (6-mo. annualized % chg.) | 4.74          | -18.5**                 |
| Real GDP (latest 2-qtr. annualized % chg.)                       | 3.8           | 6.1                     |
| FOMC's Central Tendency Real GDP Growth Forecast (Q4/Q4)         | 3 - 3¼        | 4½ - 5                  |
| PMI-Mfg. New Orders Index (6-mo. moving average)                 | 58.9          | 67.9**                  |
| Unemployment Rate - HH Survey                                    | 6.6           | 5.6**                   |
| Insured Unemployment Rate - State Programs                       | 2.6           | 2.4**                   |
| Fed Funds Target less Y/Y % Chg. In Core PCE                     | 0.88          | 0.16*                   |
|  |               | * Jan. 2004             |
|  |               | ** Feb. 2004            |

Although consumer inflation is lower today than it was ten years ago, pipeline inflationary pressures appear to be considerably greater today. Both intermediate and finished goods core wholesale inflation are running at higher trend rates. Non-energy industrial commodity prices are rising at faster rates today than ten years ago. More purchasing managers are reporting higher input prices and more production bottlenecks today than they were ten years ago. The U.S. dollar is depreciating today, whereas it was appreciating ten years ago. A depreciating dollar adds to inflationary pressures via two avenues. Firstly, the prices of imported goods tend to rise faster. Secondly, domestic producers have greater leeway to raise their prices faster because of lessened foreign price competition. And finally, that age-old barometer of price inflation, the price of gold, is advancing today, whereas it was falling ten years ago.

What about the strength of the economy? Is it less today than ten years ago? No, quite the contrary. Real GDP has been growing faster of late versus ten years ago. More purchasing managers in manufacturing are reporting higher new orders today than ten years ago. The FOMC, itself, is forecasting stronger economic growth going forward than it was ten years ago. The unemployment rate is lower today than ten years ago.

Despite more underlying inflationary pressures today versus ten years ago and despite an apparently stronger economy today versus ten years ago, the FOMC is holding its definition of the real fed funds rate at a lower level today than it did on the eve of the 1994 rate

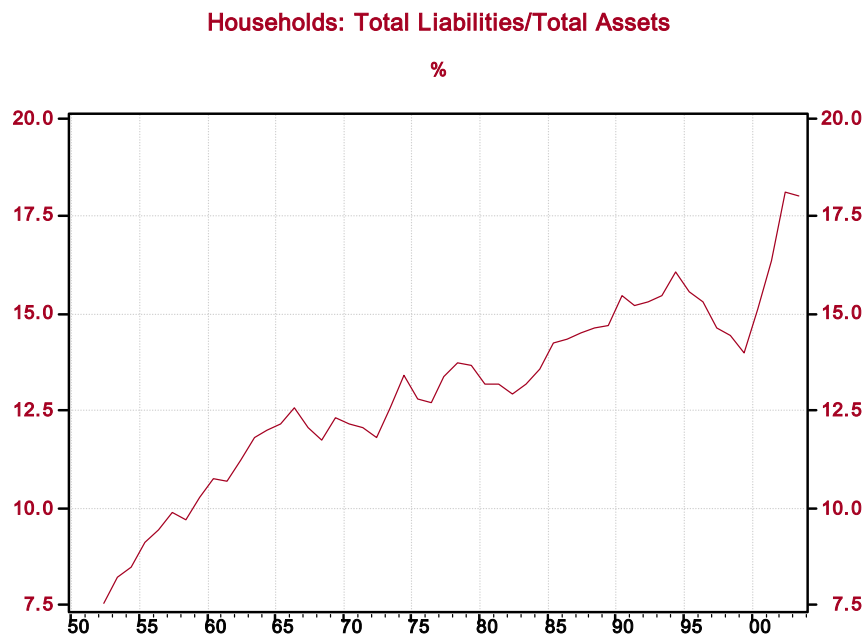
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hikes. Why is the FOMC so reluctant to raise the fed funds rate now? Could it be that, despite all the rhetoric for public consumption about households being in such good shape, the FOMC really suspects that a rise in interest rates would bring down the U.S. house of credit cards?

Could it be that the FOMC is concerned about a household sector that has in recent years increased its leverage to unprecedented levels in the postwar era (see Chart 1)? Could it be that the FOMC is concerned about how households could continue to buy SUVs and McMansions in an environment of rising interest rates when their monthly payment obligations relative to their take-home pay has remained at elevated levels despite the lowest interest rates in over 30 years (see Chart 2)? Could it be that the FOMC is aware that the bulk of the much-heralded increase in household net worth last year was the result of asset price appreciation induced by ultra-low interest rates rather than genuine saving on the part of households (see Chart 3)? Could it be that the FOMC is aware that without ultra-low interest rates, homeowners would not have been able to maintain their consumer spending without extracting a record net \$277 billion of equity from their houses last year, which reduced their relative equity in their houses to a postwar low (see Chart 4)? Could it be that the FOMC realizes that because the value of residential real estate relative to households' take-home pay is at a record level, the only way folks can continue to bid up the price of housing is to keep interest rates at ultra-low levels (see Chart 5)? Could it be that the FOMC is concerned about the safety and soundness of the financial system if interest rates were to rise given that home mortgages now account for a record 32% of total nonfinancial U.S. debt (see Chart 6)? Does the FOMC feel as though it is riding on the back of a tiger? Afraid to stay on, but afraid to jump off? It would appear that the FOMC is willing to trade off some higher inflation for some lower personal bankruptcies. I wonder if this is just delaying the reckoning rather than eliminating it.

Chart 1



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Chart 2

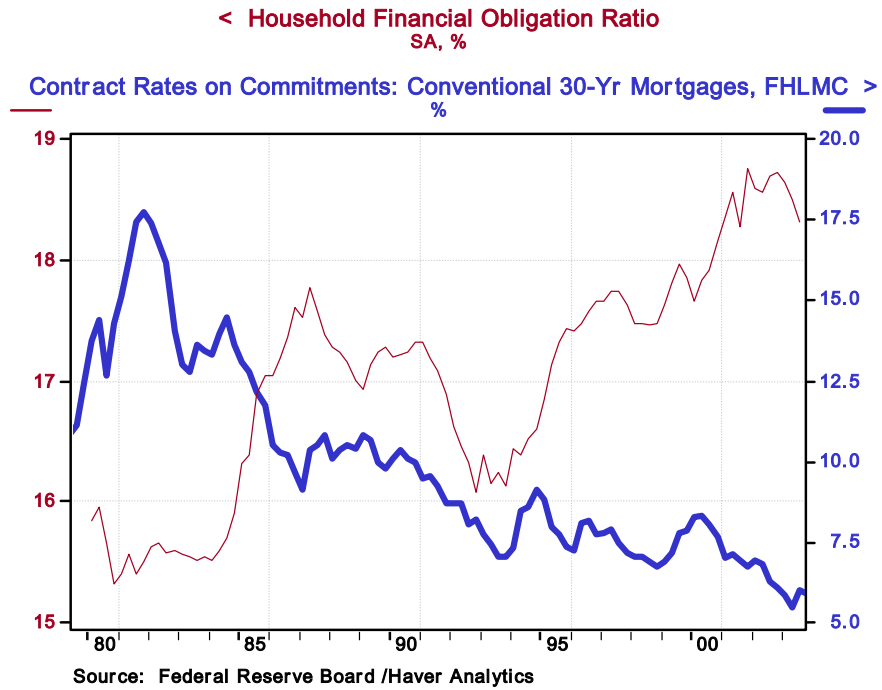
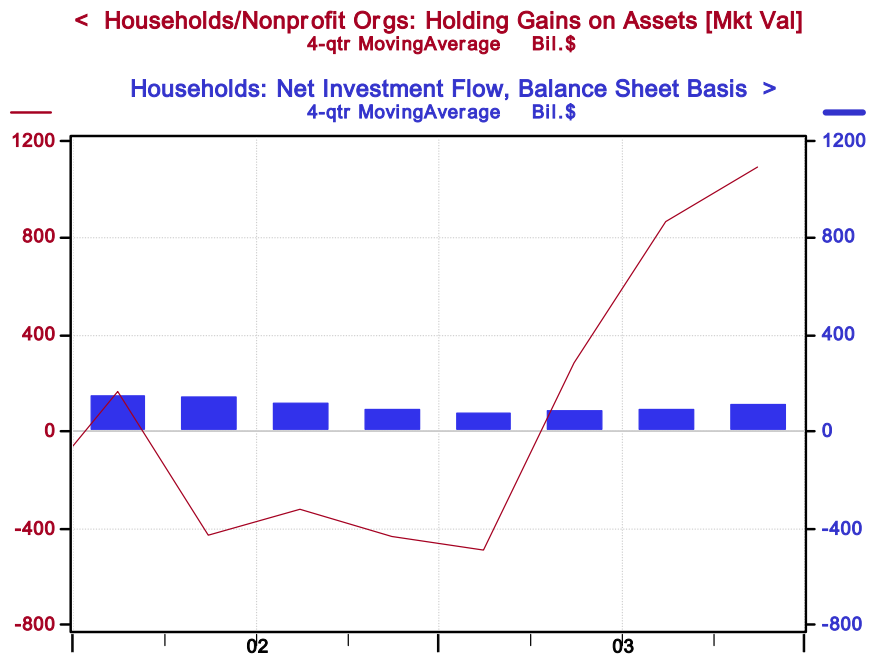


Chart 3



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Chart 4

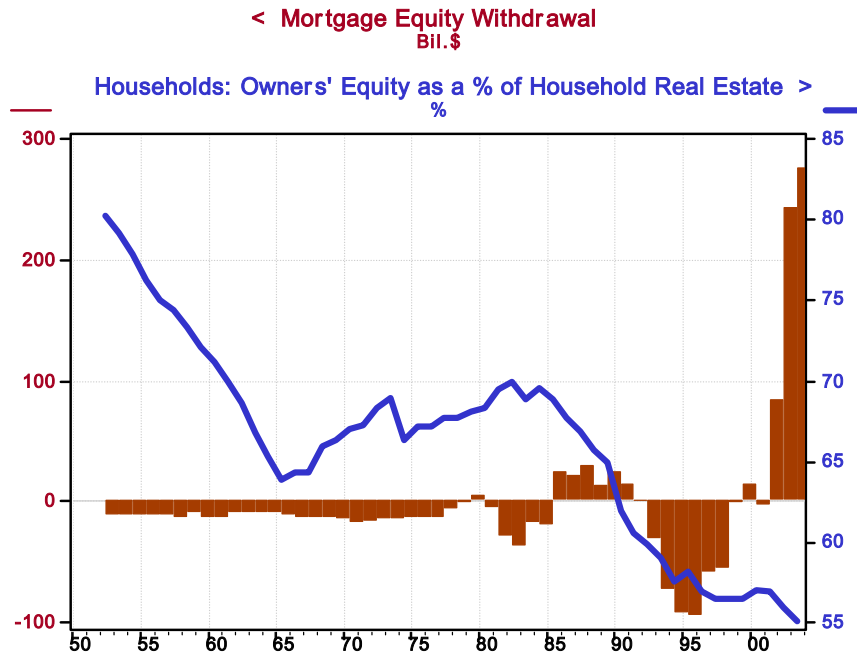
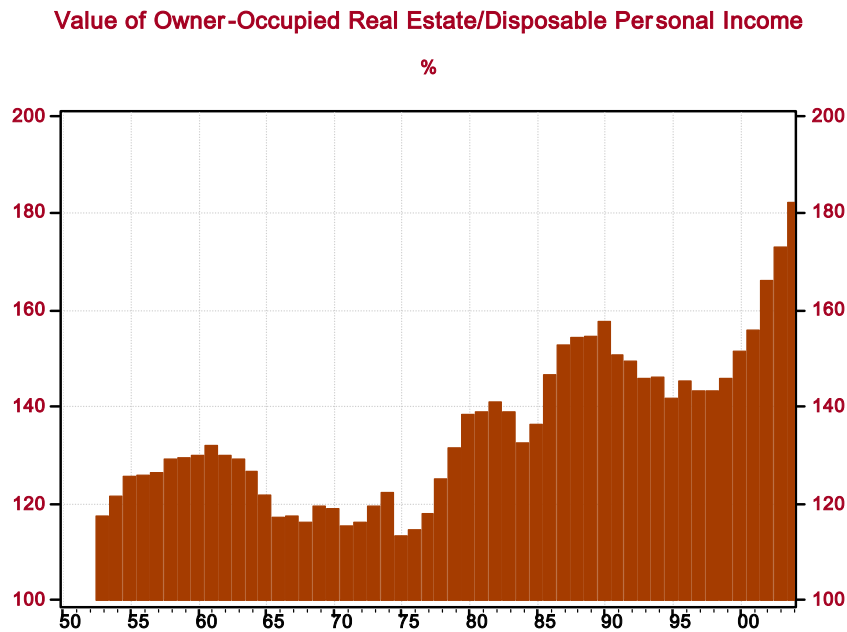
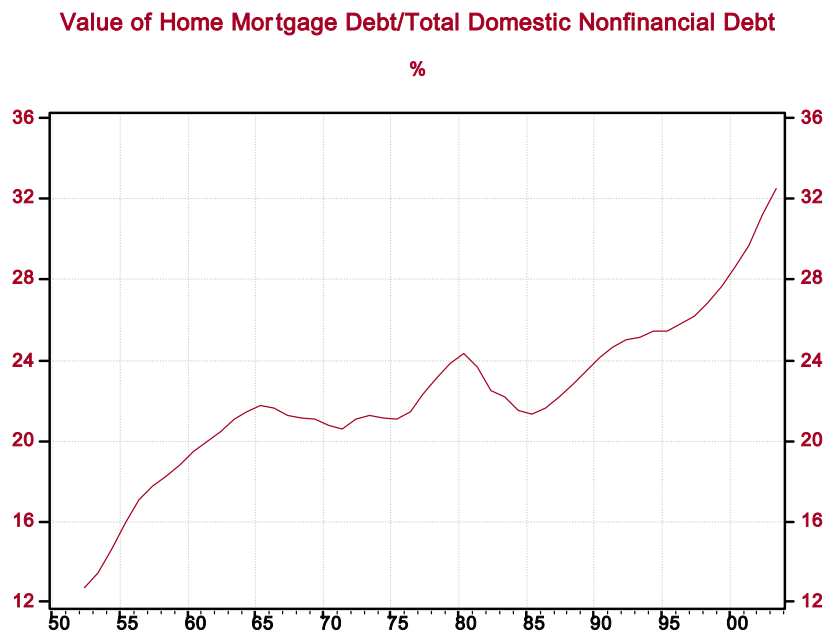


Chart 5



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Chart 6



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