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Federal Reserve Monetary Policy: What's Next?

The Federal Reserve (Fed), the central bank of the United States, is responsible for setting the nation's monetary policy. Created with the ability to change the money supply and interest rates, the Fed can appreciably alter the path of the economy. In a recession, for example, the Fed can ease credit conditions by expanding the money supply and lowering interest rates. The increased liquidity and reduced borrowing costs will in turn stimulate home-buying, consumer durable spending, and business investment, giving the economy a shot in the arm.

One of the important monetary policy tools at the Fed's disposal is the federal funds rate. Sometimes called the "overnight rate," it is the short-term interest rate at which member banks borrow and lend among themselves. The Fed can influence the level of the federal funds rate through open market operations (i.e., by buying and selling treasury securities). While the federal funds rate is just one of many interest rates, it can literally affect all other rates. Not surprisingly, the policy meetings of the Federal Open Market Committee (FOMC), where the federal funds rate target is set, are highly anticipated events.

On May 20, 2004, at a luncheon sponsored by the Seattle Branch of the Federal Reserve Bank of San Francisco and the University of Washington, Ben Bernanke, Governor of the Federal Reserve Board, discussed Fed monetary policy with regard to the federal funds rate, giving some helpful clues as to where interest rates are heading. In his talk and the subsequent question-and-answer period, he made three main points:

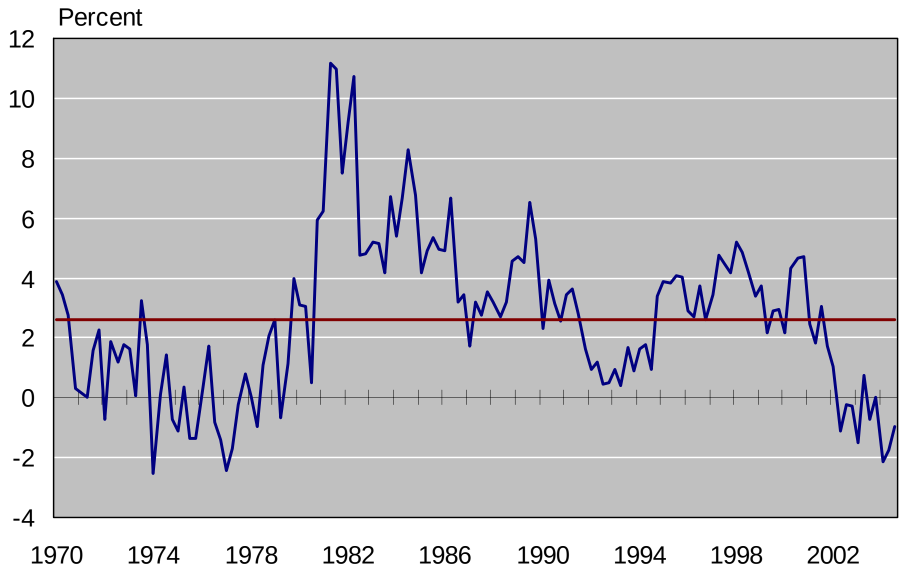
1. *The Fed generally adjusts interest rates incrementally in a process called "gradualism."* Rather than changing interest rates immediately and totally in response to the apparent condition and course of the economy, interest rates are raised or lowered in "a series of small or moderate steps in the same direction." In reaction to the last recession, for example, the Fed reduced the federal funds rate 550 basis points (5.5 percentage points) in thirteen individual actions between January 2001 and June 2003. This summer the Fed reversed direction, raising the federal funds rate in three equal steps from 1.00 percent in June to 1.75 percent in September.

2. *There are three reasons for adhering to a policy of gradualism: uncertainty about the economy; better ability to control long-term rates; and increased financial stability.* A complex economy is difficult to read and even more difficult to forecast. Such uncertainty raises the possibility that an interest rate change may over-correct a perceived problem or may even be inappropriate. Taking small steps gives policymakers the opportunity to assess how the economy is responding to interest rate changes and time to refine their actions.

   By sticking to a policy of gradualism, the Fed is able to communicate its general intentions about future short-term interest rates. Since long-term interest rates, such as the mortgage rate, are based in part on expectations about the future path of short-term interest rates, the Fed has an effective means of indirectly influencing all interest rates. The Fed's impact on long-term interest rates was evident earlier this year. Simply by signaling its intention to raise the federal funds rate, through communications such as Bernanke's talk, long-term interest rates began to increase. Of course, many factors not dependent upon Fed actions also play a role in determining long-term rates.

Finally, by lessening the erratic movements of short-term interest rates, a policy of gradualism helps to maintain orderly financial markets, which is one of the Fed's broad responsibilities. As Bernanke pointed out, an environment of unstable short-term rates would create financial stress for commercial banks, whose profits depend significantly on the cost of short-term funding. Volatile rates would also be problematic for households with adjustable-rate mortgages and businesses with significant short-term financing requirements.

Real Federal Funds Rate*



*Nominal fed funds rate less the annualized percent change in U.S. personal consumption deflator.

3. *The currently low federal funds rate cannot be sustained in a growing economy*. At the time Bernanke spoke, the federal funds rate had been pegged at 1.00 percent for nearly a year. Given that the inflation rate, as measured by the U.S. personal consumption deflator, was about 2 percent, the real federal funds rate (the nominal rate less the inflation rate) was about -1 percent. Clearly, the negative federal funds rate "would have to be normalized."

   At its meeting on May 4, the FOMC issued the following statement: "At this juncture, with inflation low and resource use slack, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured." In other words, the FOMC was almost certainly going to raise the federal funds rate soon. As noted previously, the Fed raised the funds rate three times during the summer, but the real rate still remained in negative territory.

> Thus, one question remained unanswered: how high would the federal funds rate go over the course of the current expansion? Replying to a question from the audience, Bernanke was surprisingly specific. He first pointed out that the long-run average for the real federal funds rate is about 2.7 percent. He then noted that the Fed's inflation target was 1-2 percent, though board members would be more comfortable if the inflation rate were between 1.5 and 2.0 percent. This suggests that the nominal federal funds rate might return to a 3.7-4.7 percent range or, perhaps more likely, to a 4.2-4.7 percent range.

Interestingly, this is well above the level forecast by most economists, at least for the short-run. For example, in its October 2004 outlook, Global Insight, a well-known national forecasting firm, predicted that the federal funds rate would rise steadily but would only reach 3.00 percent in the fourth quarter of 2005 and 3.50 percent by the fourth quarter of 2006.

Postscript

There have been two interesting developments since this article was originally written. First, as Ben Bernanke hinted in his speech, the Federal Reserve did embark on a protracted series of rate hikes designed to keep the U.S. economy from overheating. With the December increase, the federal funds rate now stands at 4.25 percent, close to the Fed’s apparent long-run target. But the four-fold increase in the federal funds rate since June 2004 has done little to raise long-term rates, as the world economy still seems flooded with cheap money. In fact, the 30-year conventional mortgage rate, at 6.3 percent, is no different today than it was when the Fed began its credit-tightening measures. As a consequence, U.S. existing home sales in October were still near record level, while the average home price was up 12 percent over the year. Considering the real threat of a housing bubble, it seems likely that the Fed has two or three more rounds of interest rate hikes in mind.

The second development of note is that Bernanke will inherit Alan Greenspan’s mantle as Chairman of the Federal Reserve when Greenspan retires in January. Greenspan’s act will be difficult to follow: a 15-year record of steady growth (just two minor recessions) and moderate inflation. Although we know little about Bernanke’s background, we will say this about him: if the clarity and candidness of his Seattle speech are any indication, he will be up to the task.