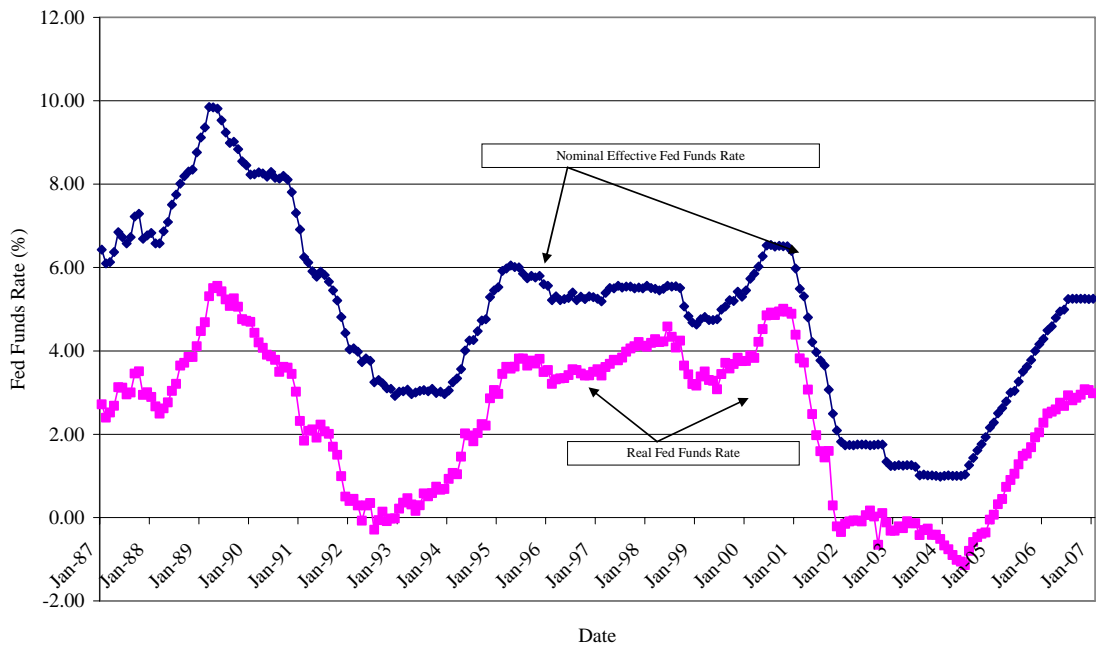


**Will the Fed Cut Rates?
Dr. Kenneth J. Martin
March 9, 2007**

It's been almost two years since I last wrote a piece for the *NM Business Outlook* that was titled "When Will the Fed Stop Raising Rates?" In that article, I examined the "real" Fed funds rate as a way of thinking about how high the Fed might go in raising interest rates in order to achieve a "neutral" monetary policy that neither hinders nor stimulates growth in the economy. I showed a chart of the nominal and real (inflation-adjusted) Fed funds rate, which is reproduced and updated through January 2007 below.

Figure 1: Nominal and Real Fed Funds Rates: 1987 - March 2007
Data Source: Federal Reserve Bank of St. Louis (research.stlouisfed.org/fred2)



I argued that a real rate of 2.5 – 3.0% is a reasonable approximation of what the Fed might like to have. I finished the article by pointing out that if inflation stayed at its then level of about 2.0%, the Fed could conceivably stop raising the Fed funds rates at a level of 4.5%. But, as I pointed out, if the economy grows faster than forecast, or if an

economic shock hits the economy (“think oil prices”), then the Fed may be forced to continue raising rates beyond that level.

Little did I know that just two weeks after I wrote that article, Hurricane Katrina would devastate the southern part of the U.S. and do substantial damage to oil production and refining capacity sending oil prices skyrocketing. In July 2005, the price of West Texas Intermediate Crude oil averaged \$58.70 per barrel. By September of that year, the price was \$65.57. And, by July 2006, the price had zoomed up to an average of \$74.41.

What happened to inflation and growth in the economy? The Fed’s preferred measure of inflation is the price index for personal consumption expenditures less the volatile components of food and energy. In July of 2005, the annual percentage change from July 2004 was 1.98%. By July of 2006, that inflation rate had climbed to 2.31%, higher than what the Fed would like, but still not what one might have anticipated given the large spike in oil prices. This is just one indication of how our economy has changed over the years. What about the economy? Well, the economy was running fairly hot then. The second quarter annualized growth rate in real GDP for 2005 was 4.18%, but by July 2006, it had declined to 1.96%.

Given all of this, the spike in oil prices, inflation heating up, the economy cooling off, the Fed stopped raising interest rates in June 2006 at a 5.25% Fed funds rate. As you can see in Figure 1, given the inflation rate at the time, this implied a real Fed funds rate of 2.67%, close to the middle of the 2.5 – 3.0% range discussed earlier. Since then, there has been increasing speculation in the markets about a Fed rate cut, in spite of Fed statements to the contrary. In fact, in its press release following the last meeting of the Federal Open Market Committee, the group to which the job of setting the target Fed

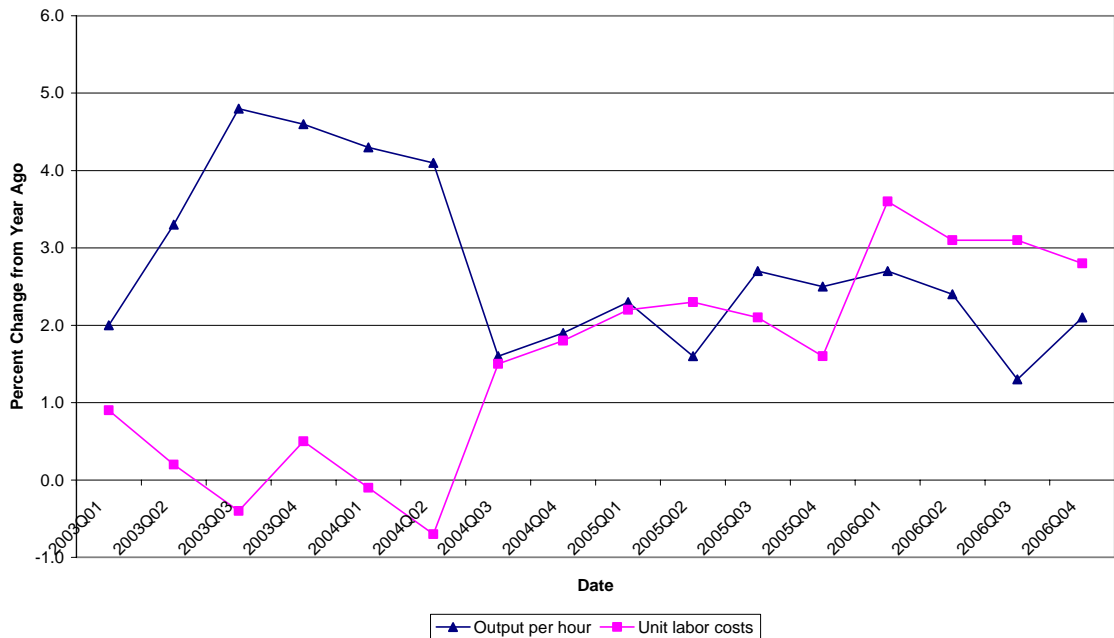
funds rate falls, the Fed stated “The Committee judges that some inflation risks remain”. Publicly, Fed officials such as Federal Reserve Bank of Richmond President Jeffrey Lacker stated, according to the Wall Street Journal (March 9, 2007), that “One might question whether inflation expectations are anchored close enough to the price stability shore.” Mr. Lacker is known to be an inflation hawk and also said that he thought the financial markets thought inflation would remain about 2.25% rather than in the Fed’s preferred range of 1% to 2%. Fed Chairman Ben Bernanke has also expressed that the Fed’s bias is to increase rates, not decrease them, due to underlying inflation pressures. Therefore, let’s do a quick examination of these underlying inflation pressures and the market’s expectations for inflation.

First, let’s look at pressures for higher inflation. Why might inflation rise? It could be that wage increases can force companies to increase prices. Why would there be wage increases? Well, if employment is growing, or conversely, unemployment is falling, then the laws of supply and demand kick in and cause companies to have to pay higher wages to attract qualified workers. Today, the February employment report was released showing that nonfarm payrolls increased by 97,000, January and February’s payrolls were revised upward (to gains of 146,000 and 226,000, respectively), and the unemployment rate fell to 4.5%. Average hourly earnings were up 4.1% from one year ago. The employment report was greeted by the financial markets with mixed views. The stock market liked it since it indicated that the economy was not slowing too much, jobs were still being created (though at a slower pace), and the effects of the stock market correction on February 27 (a 416 point drop in the Dow Jones Industrial Average) seemed to be lessening. The bond market reacted in just the opposite by increasing yields

(meaning decreasing prices) because market participants now viewed the likelihood of the Fed cutting rates as being much smaller.

So, maybe the Fed is right and inflation is still a problem. One way that inflation can be held in check is by continuing productivity gains by businesses. Businesses can pay workers more, but if they are more productive then businesses can still make profits without increasing prices. However, the trend on this front is bit troubling. In Figure 2, I have plotted output per hour (a productivity measure) and unit labor costs as reported by the Bureau of Labor Statistics for the past 4 years (2003 – 2006). We can see that productivity has begun trending down and unit labor costs have been trending up. This does not bode well for inflation or for lower interest rates.

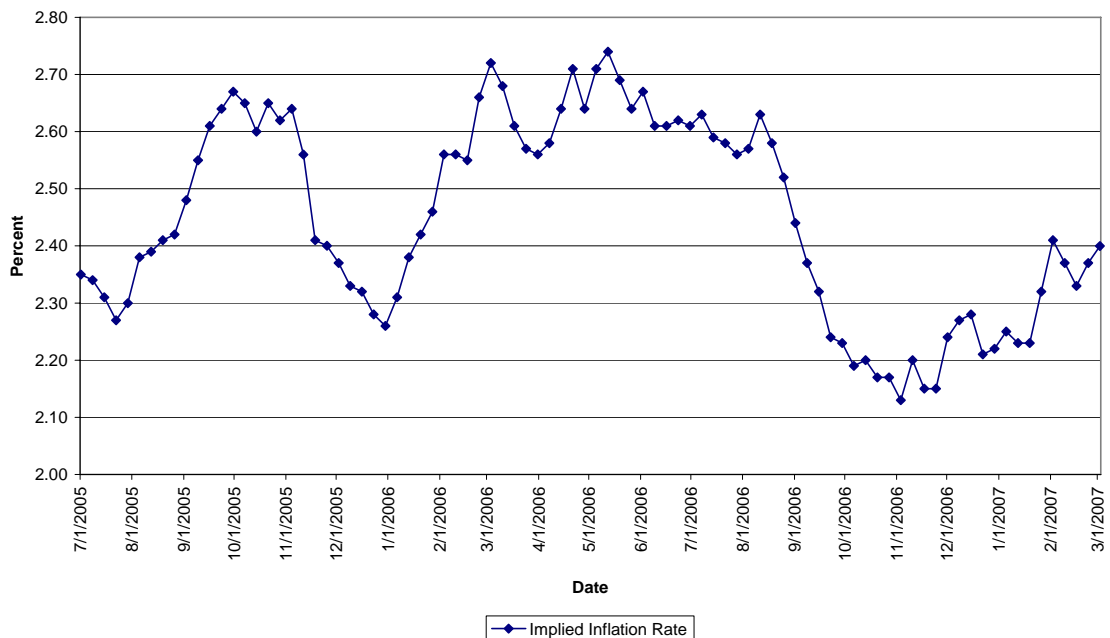
Figure 2: Productivity vs. Unit Labor Costs
Nonfarm Business: 2003 - 2006
(Source: Bureau of Labor Statistics - www.bls.gov)



But, what does the market think about inflation? One way of assessing the market's take on inflation is by looking at the yield on Treasury Inflation Indexed

Securities. TIPS promise investors a real rate of return and so if we compare their yield with the yield on regular Treasury securities of the same maturity, we can obtain the market's estimate of inflation. In this case, in Figure 3, I have plotted the implied inflation rate using the 5-year Treasury securities, the shortest maturity inflation-indexed security available. As you can see on the chart, inflation expectations bottomed out in November 2006 at about 2.13 percent and have climbed steadily since then.

Figure 3: Implied Inflation Rate
5-year Treasury Rate - 5-year Treasury Inflation Indexed Security
 (Data source: Federal Reserve Bank of St. Louis - www.research.stlouisfed.org/fred2)



So, will the Fed cut interest rates in 2007? Given today's employment report and the pressures on inflation shown in Figures 1 and 2, the market is responding with a "No", an assessment that I would have to agree with. Is this bad news for the stock market? I think not, given the slowing, but not cratering, economy and the fact that real interest rates are not exceedingly high. Of course, there are some assumptions built into this analysis. Perhaps the most important one is that the correction in the housing market

and the problems in the sub prime lending market will not bleed over into the rest of the economy. As of this writing, they appear not to be doing that. However, as we saw in the stock market on February 27, a little provocation can really make the market jump. Stay tuned . . .