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Topical Study #24

HARD OR SOFT LANDING?

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HARD OR SOFT LANDING?

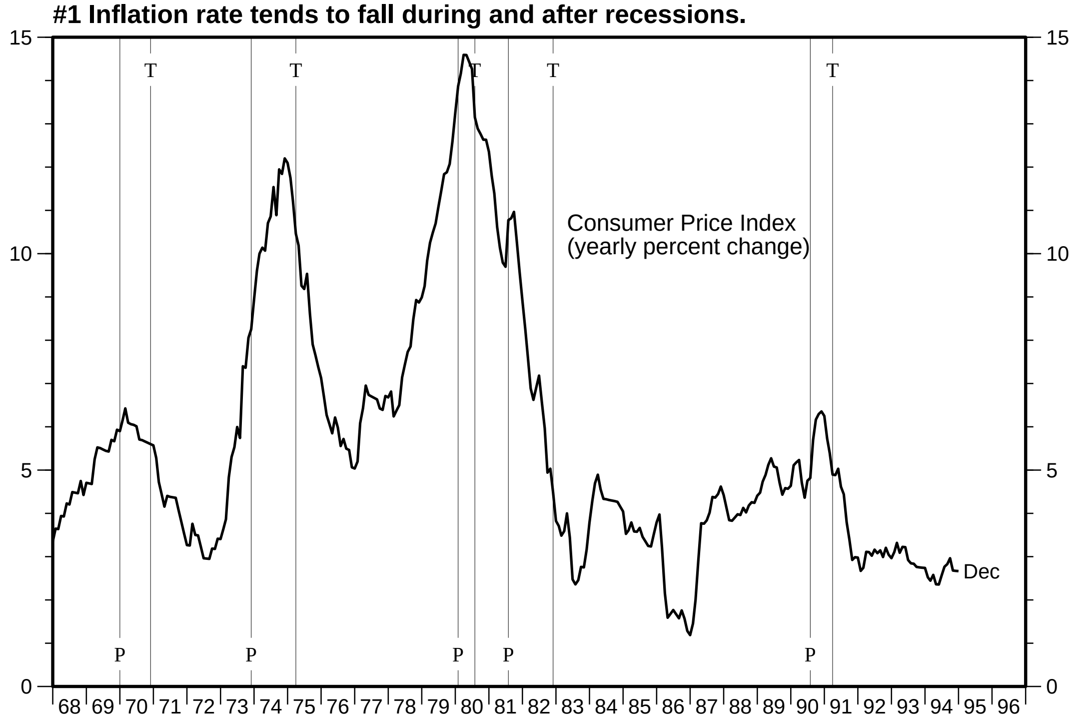
I. Is Monetary Overkill Inevitable?

I believe that the Fed can achieve a soft landing and avoid a hard landing this year, and probably next year too. During past boom/bust cycles, Fed policy purposely caused hard landings with the goal of crushing the cyclical forces of reflation that emerged during the boom phase of the business cycle. If inflation remains dormant, why engineer a recession? In my opinion, the Fed has already set the stage for a soft landing later this year and isn't likely to tighten much further.

In the past, recessions were not a result of monetary "overkill." This word implies that the Fed erred. However, most recessions were not policy mistakes. Rather, the true errors of monetary policy were the cyclical rebounds in inflation during economic booms. The subsequent busts were policy-engineered to correct these failures in managing the booms.

Recessions work: They almost always bring inflation down, at least on a cyclical basis (Exhibit 1). If inflation remains low, as I expect, why would the Fed want a recession? The CPI inflation rate has been hovering around 3% for over three years. This is the longest period of low, stable inflation since the early 1960s. I believe that there are several powerful structural forces of disinflation that will continue to offset the cyclical forces of reflation through the end of 1995; indeed, maybe even through the end of the decade.

#1 Inflation rate tends to fall during and after recessions.



Lines represent business cycle peaks (P) and troughs (T).

II. The Fed Is Following The Business Cycle Script.

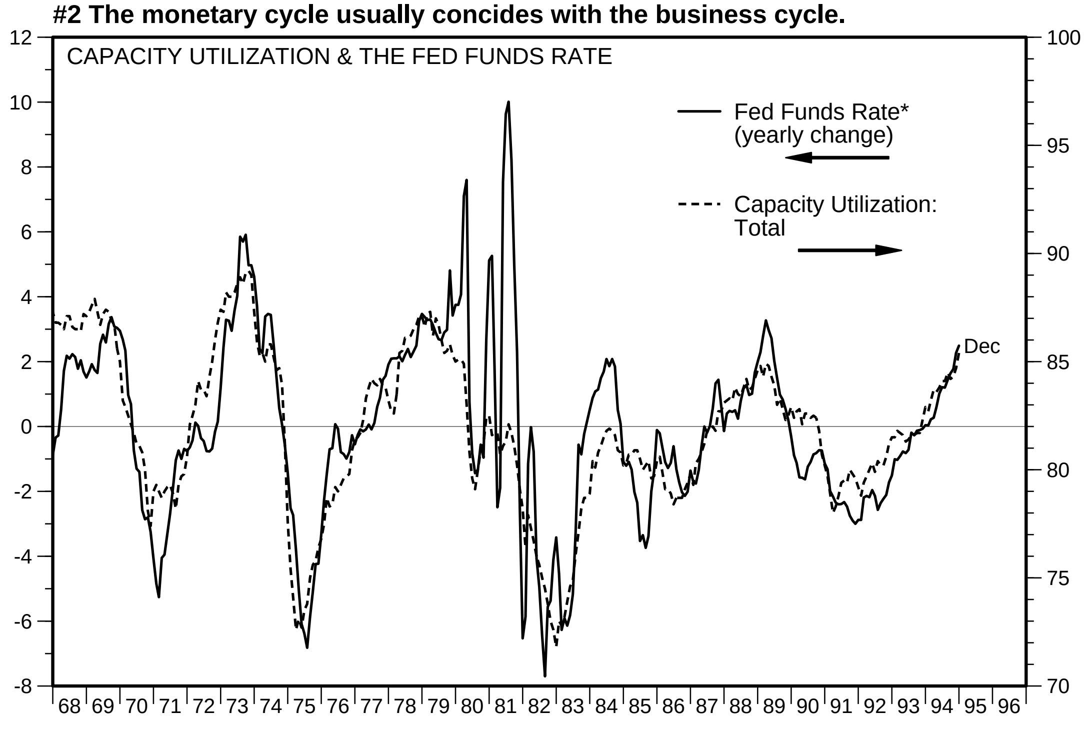
Hoping to avert the typical boom/bust cycle, the Fed launched a preemptive attack against inflation a year ago, as soon as business cycle indicators suggested that a boom was starting. There is an extremely strong correlation between the capacity utilization rate–a useful business cycle indicator–and the year-over-year change in the federal funds rate. Most noteworthy is that the fit between these two variables is as tight as ever (Exhibit 2).

The Fed has been acting NO DIFFERENTLY than in the past! According to Exhibit 2, the federal funds rate rose above its year-ago level during February 1994, at the same time the capacity utilization rate moved up to 82%. This is the magic level that has always prompted Fed tightening in the past, as measured by the yearly change in the federal funds rate. In Exhibit 2, the 82% utilization rate lines up perfectly with the zero line for the yearly change in the federal funds rate. (I am indebted to Mr. T. Kamiya of the Chiyoda Life Insurance Company in Tokyo for bringing this fascinating relationship to my attention recently.)

The Fed certainly hasn't preempted the business cycle boom. Monetary policy is neither "ahead of the curve" nor "behind the curve." It has almost always been "right on the curve" and remains so to this day, according to Exhibit 2.

To repeat, the Fed's behavior isn't different this time*.* The monetary cycle continues to coincide perfectly with the business cycle.

#2 The monetary cycle usually concides with the business cycle.



* The federal funds rate is higher (lower) than a year ago above (below) zero line.

III. Has The Fed Preempted Inflation?

If the Fed hasn't preempted the business cycle boom, it certainly can't take any credit for preempting a cyclical rebound in inflation. Nevertheless, the Fed started to tighten a year ago under the premise that inflation would revive. But the magnitude and timing of the Fed's response to this concern was no different than in the past.

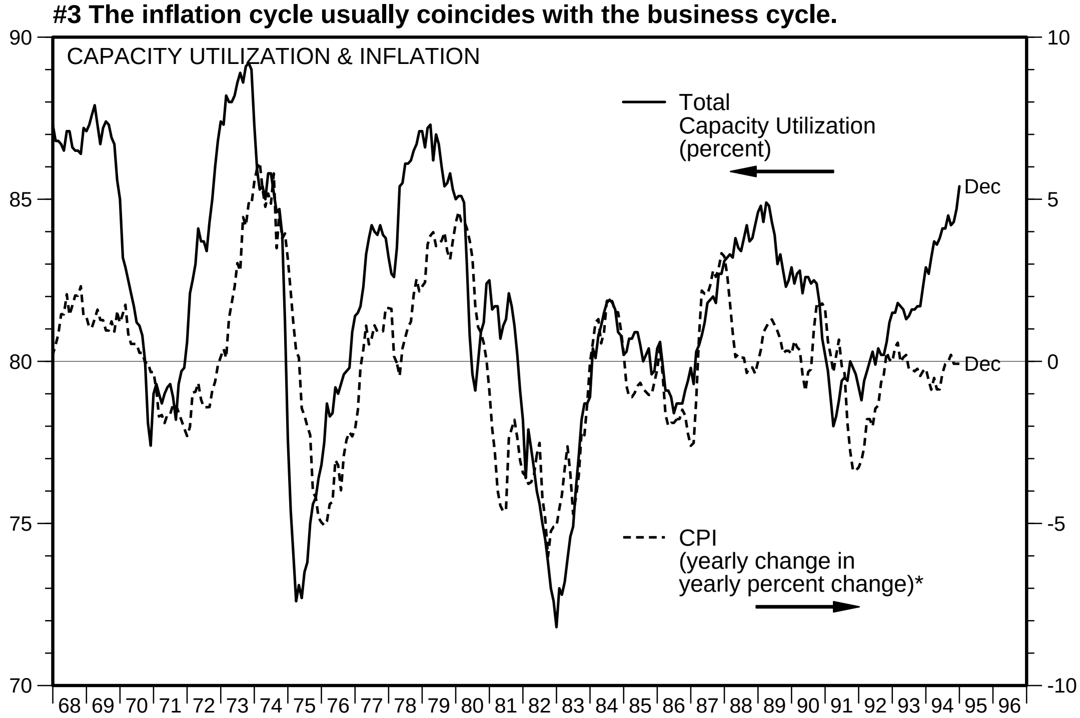
The Fed has been acting NO DIFFERENTLY than in the past. It is inflation that is behaving DIFFERENTLY!

Historically, there has been a very strong correlation between the capacity utilization rate and the year-over-year change in the CPI inflation rate. Interestingly, the popular notion that an 85% utilization rate triggers a rebound in inflation is wrong, according to the relationship shown in Exhibit 3 below. Historically, the magic inflation-trigger is a utilization rate of 80%. Inflation tends to rise above its year-ago rate whenever the utilization rate exceeds this level.

The capacity utilization rate rose above 80% during October 1992, and now is at 85%. Yet the CPI inflation rate is unchanged from a year ago. The CPI inflation rate was 2.7% in 1994, the same as in 1993.

Again: It is inflation that is behaving differently this time. The current inflation cycle does not coincide with the current business cycle.

#3 The inflation cycle usually coincides with the business cycle.



* Inflation is higher (lower) than a year ago above (below) zero line.

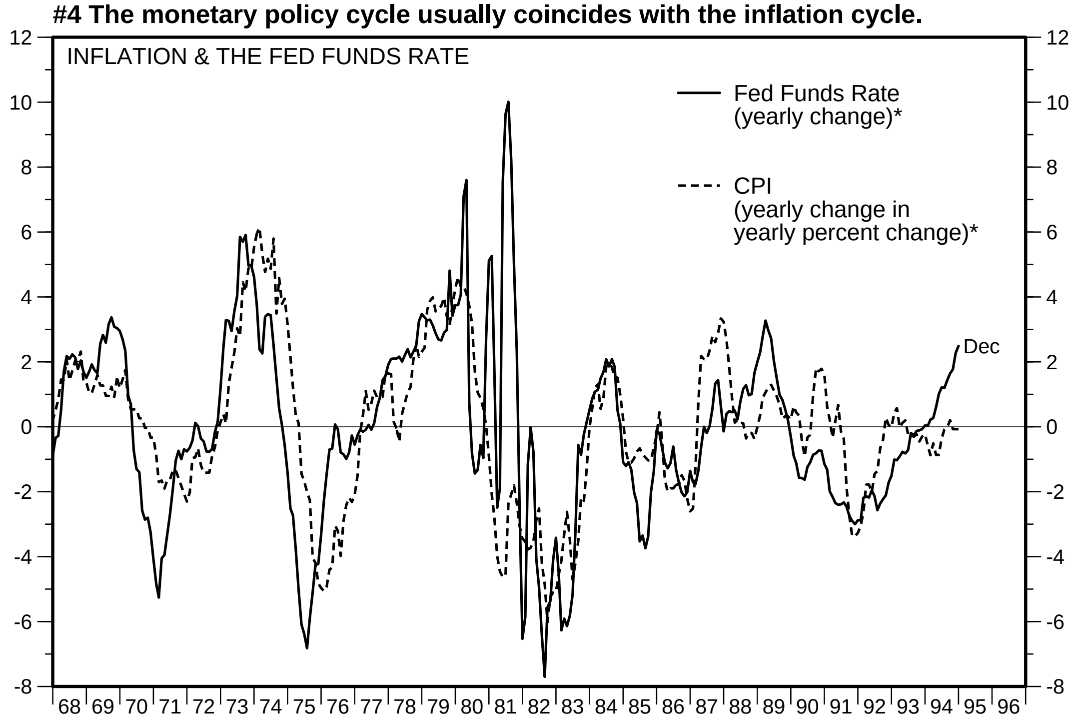
IV. The Fed Has Done Enough.

In the past, the inflation cycle coincided with the business cycle and the monetary policy cycle coincided with both. In the current cycle, the monetary and business cycles still coincide, but inflation remains remarkably subdued compared to past cycles. Currently, inflation is unchanged from a year ago, yet the federal funds rate is 2.5 percentage points above last year (Exhibit 4). I doubt that the Fed will push interest rates much higher if inflation remains so well behaved.

The Fed's goal is to slow economic growth to a pace that reduces the risk that business cycle pressures will boost inflation. *The Fed may already have done more than enough to achieve this soft-landing goal.* Exhibit 5 shows a strong inverse correlation between the year-over-year percent change in real GDP and the 2-year change in the federal funds rate plotted 12 months into the future. The zero line for the federal funds rate series lines up with a growth rate of 2.8% for real GDP. This rate is in the 2.5% to 3.0% range that Fed officials are targeting for noninflationary growth in real GDP. (Again, my thanks to Mr. Kamiya.)

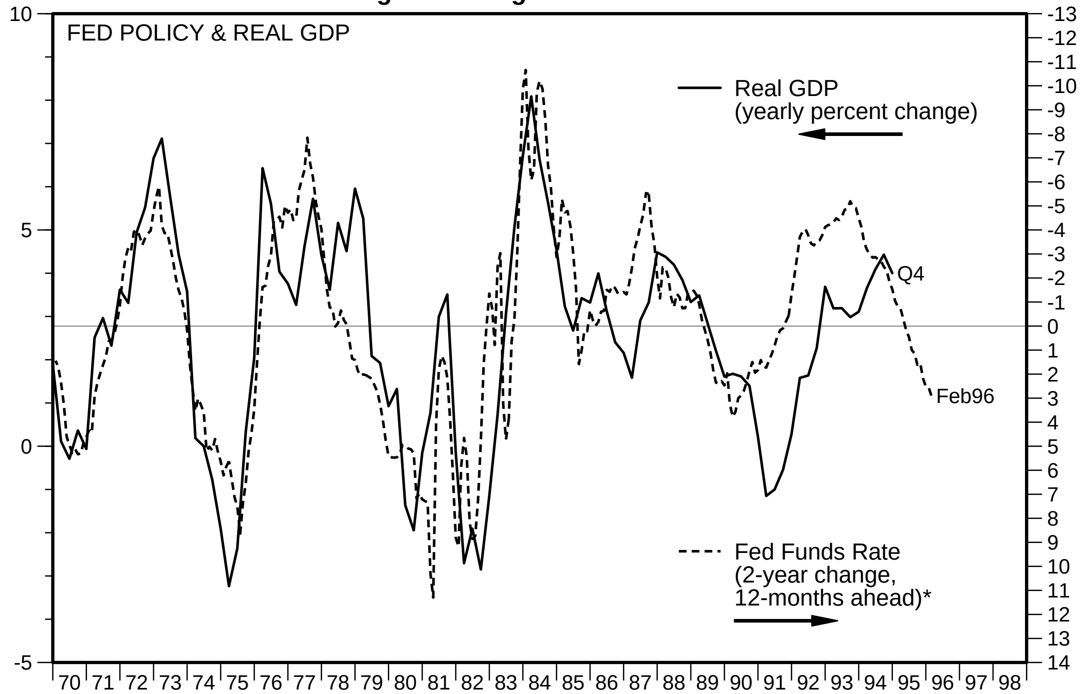
The relationship shown in Exhibit 5 suggests that the monetary tightening over the past year is likely to slow real GDP growth down to 1.5% by the beginning of next year. Exhibit 6 shows that real GDP will continue to grow at this pace in 1996 if the Fed leaves the federal funds rate unchanged at 6.0% over the remainder of 1995. This landing may be too soft, so the Fed might actually lower interest rates next year to boost growth. This year, I still expect real GDP growth of 3%-3½% during the first half and 2½%-3% during the second half.

#4 The monetary policy cycle usually coincides with the inflation cycle.



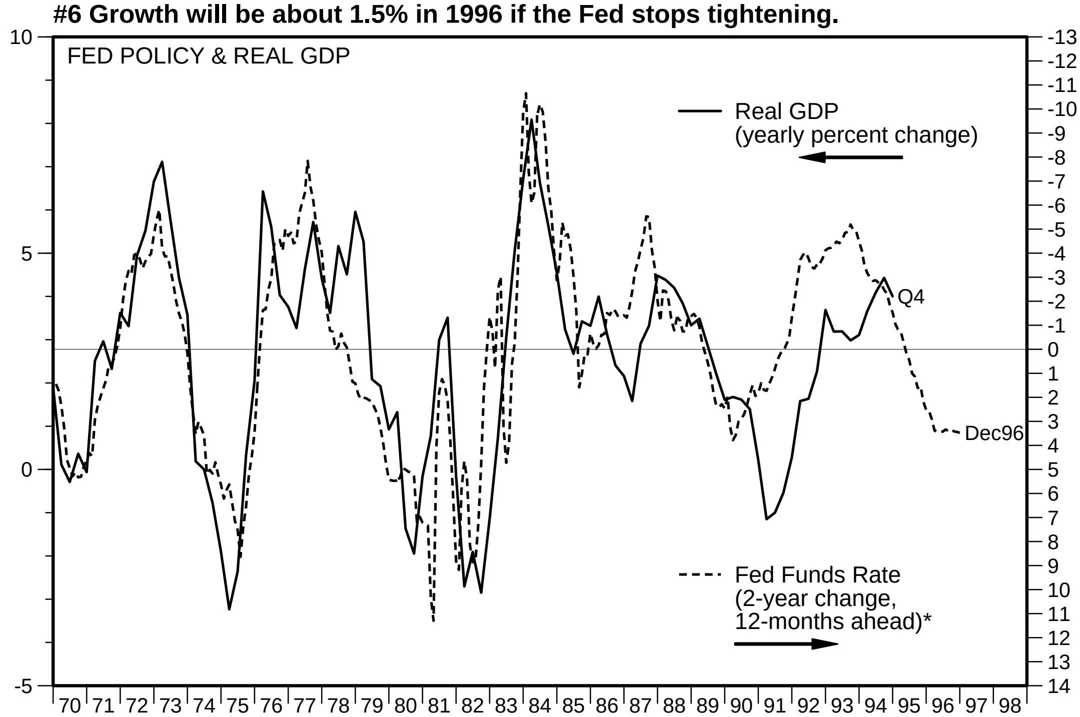
* Inflation and the federal funds rate is higher (lower) than a year ago above (below) zero line.

#5 The Fed has done enough to slow growth.



* Inverted scale.

#6 Growth will be about 1.5% in 1996 if the Fed stops tightening.



* Inverted scale.

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* Out of print.