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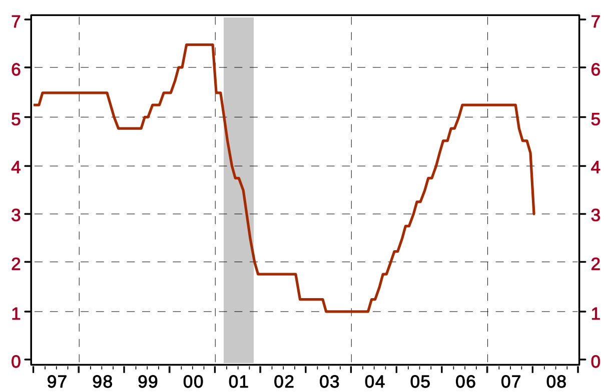
# Economic Commentary

## Fed Hesitation Hurting Economy

**O**ur preference in recent months was that the Federal Reserve not address the turmoil in financial markets by cutting the federal funds rate. Instead, we thought it should use tools such as the discount window or new Term Auction Facility, which target liquidity problems at specific institutions. In other words, we wished the Fed had followed the European Central Bank's lead.

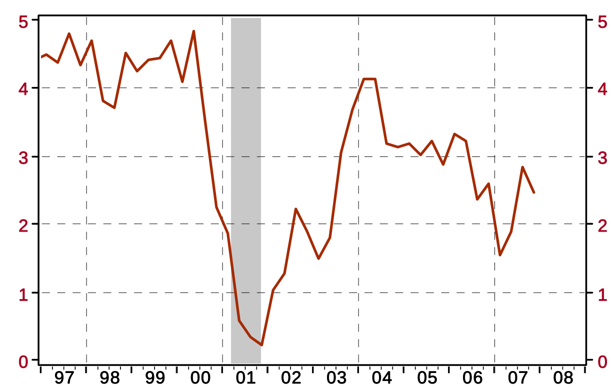
The "economic insurance" generated by interest rate cuts is not cost free. Reducing the federal funds rate will push up inflation, which is already too high. Eventually, this will force the Fed to retract all of its rate cuts and then some.




Another reason we are suspect of the Fed's actions is that in the short-run, a drawn out period of interest rate cuts can actually create a self-fulfilling prophecy of economic weakness, as businesses and consumers hold back to wait for lower interest rates.

Despite the Fed having already cut the funds rate to 3% from 5.25%, investors expect more: futures markets have priced in a 2% funds rate by summer. Even though this will boost economic activity and inflation in future quarters, it is paradoxically a hindrance to near-term economic activity.

When businesses and consumers expect more rate cuts they will wait before entering into new contracts, convinced the cost of capital will be lower in the months ahead. This could postpone the recovery in housing if prospective homebuyers wait until interest rates are cut again – a consequence that is unwanted.




Because of this, and because the Fed has left the door wide open for more rate cuts, we are lowering our first quarter economic growth forecast to 2.5% (previously 3%). But, the Fed will finish cutting rates by summer. The end of rate cuts as well as the cumulative impact of all the rate cuts since August will boost our forecast for the second half of 2008 to an average of 4%. (See our full quarter-by-quarter forecast below.)

The biggest worry is that we get into a negative feedback loop, where expected rate cuts cause businesses and consumers to hold back. Then the Fed assumes the economy is slowing down and promises to give even more rate cuts, which then causes economic activity to slow again.

In an ideal world, the best solution to the current economic situation would be for the Fed to make no further cuts and make it clear that no further rate cuts were forthcoming. But the Fed is worried that making such a statement will hurt stock prices, and cause further dysfunction in credit markets.

As a result, the Fed will probably cut rates again. If that is really the case, the Fed should act as soon as possible – not at the March meeting, but well before – to cut rates a full 100 basis points to 2%, perhaps even lower. At the same time, the Fed should issue a statement that makes it 100% clear that it will not cut rates again.

By removing expectations of further rate cuts, businesses, investors, and consumers would have no reason to postpone activity and the economy would quickly re-accelerate, absorbing the massive amount of monetary stimulus the Fed has provided.

The paradoxical relationship between monetary policy and short-term economic growth fosters a wrong-headed belief that the Fed has lost power to influence the economy, a belief which pops up anytime the Fed moves forcefully to either cuts rates or raise them.

When the Fed is hiking rates, people accelerate economic activity to get it in before rates go up again. This makes it appear that rate hikes are not slowing the economy and the Fed is less powerful. The Fed is then encouraged to get more aggressive and hike rates further. This is what happened in 1999/2000, when the Fed overshot in an attempt to restrain the stock market and slow the economy. A recession was the result, but it did not happen until the Fed stopped hiking rates.

Then, when the Fed cut rates 11 times in 2001 (during a recession) and kept the door open for more in the early 2000s, the economy was slow to respond. Many argued then that the Fed could not fight deflation and was unable to help the economy.

In retrospect, this was not true. But it was not until the final rate cut was in place in 2003 (and no more cuts were expected) that real GDP growth started to accelerate. In addition, having been lured into extremely low interest rates, the Fed fueled the credit problems that exist today.

We fear that another drawn out period of interest rate cuts, and one which was not preceded by a period of monetary tightness, will create further problems down the road. Our models show US monetary policy has not been overly restrictive at *any* point in the past seven years. At 5.25% in August, both the nominal (and real) federal funds rates were well below the average of the booming l995-1999 period. A 5.25% federal funds rate was not an impediment for normal borrowers.

What created current problems was not tight money in 2007, but 1% interest rates in 2003-04, and incredibly lax lending standards. Those loans are now being adjusted or going into default. Lower interest rates may make this process more palatable to those involved, but they are not necessary. The Fed often overshoots in its policy, causing deeper recessions and more inflation than would otherwise be the case. In the current environment, it is inflation that our models are flashing warning signs about. And yet, as long as the Fed hesitates, the economy will suffer too. But then, in the second-half of 2008, once the market knows the Fed is done, the economy will roar.

**Brian S. Wesbury, *Chief Economist***
**Robert Stein, *Senior Economist***

| | Actual | | | | Forecast | | | |
|---|---|---|---|---|---|---|---|---|
| | **Q1.07** | **Q2.07** | **Q3.07** | **Q4.07** | **Q1.08** | **Q2.08** | **Q3.08** | **Q4.08** |
| **Real GDP Growth:** | | | | | | | | |
| Q/Q Annual Rate | 0.6 | 3.8 | 4.9 | 0.6 | 2.5 | 3.5 | 4.5 | 3.5 |
| Year-to-Year Change | 1.5 | 1.9 | 2.8 | 2.5 | 3.0 | 2.9 | 2.8 | 3.5 |
| **Unemployment Rate*** | 4.5 | 4.5 | 4.7 | 4.8 | 4.9 | 4.9 | 4.8 | 4.8 |
| **CPI**** | 2.4 | 2.7 | 2.4 | 4.0 | 4.0 | 3.3 | 3.6 | 3.3 |
| **GDP Deflator**** | 2.9 | 2.7 | 2.4 | 2.6 | 2.4 | 2.4 | 2.7 | 2.7 |
| **Rates (End-of Period):** | | | | | | | | |
| Federal Funds Target | 5.25 | 5.25 | 4.75 | 4.25 | 2.50 | 2.50 | 2.75 | 3.25 |
| 10-Year Treasury | 4.65 | 5.03 | 4.59 | 4.04 | 3.85 | 4.20 | 4.55 | 4.90 |

*quarterly average ** year-to-year percentage change