TIGHT MONEY?

By Craig T. Callahan, DBA, Founder and President | March 16, 2010

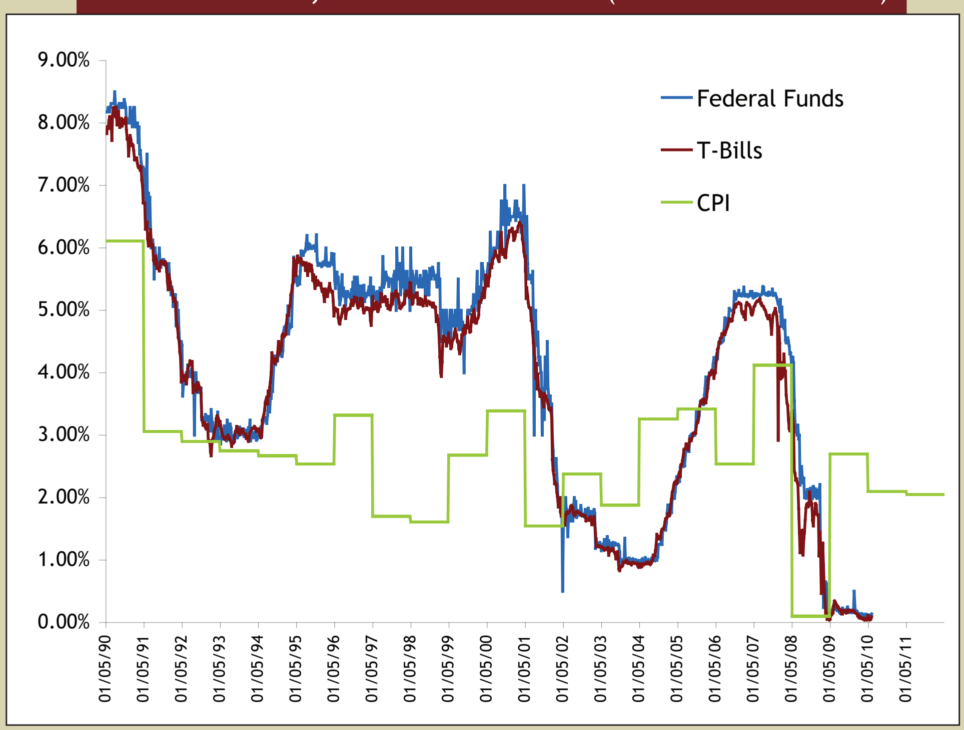
In early February, the Federal Reserve Board announced it may begin increasing the borrowing rate for banks at its discount window. Anxious critics and commentators jumped on this announcement, speculating that the increase would result in a setback to the economic recovery or a double-dip recession.* Addressing these concerns requires us first to define "tight" and "easy" monetary policy. Opinions vary somewhat, but we will offer our own definitions. Using Ibbotson data going back to 1926, we can see the interest rate for Treasury bills, on average, nearly equaled the inflation rate. As most people consider Treasury bills to be risk-free, it makes sense that "risk-free investing" should provide a return in line with inflation. We define a "tight" monetary policy as one in which short-term yields exceed inflation. An "easy" monetary policy is one in which short-term yields are less than the inflation rate.

The graph below shows the weekly yields of federal funds (interbank borrowing) and six-month Treasury bills, the two rates most influenced by the Fed's policies. It also shows the inflation rate, which is the Consumer Price Index (CPI), for each year. By our definition, money was "tight" in 1990 and 1991 as short-term yields exceeded the inflation rate. Subsequently, the economy slowed, bringing rates and inflation in line with historic norms. During the late 1990s, money became "tight" once more, as short-term rates exceeded inflation again. In 2001, we experienced a recession and in response Federal Reserve policy eased, with the Fed dropping short-term rates below inflation to stimulate recovery. As the economy strengthened in 2005, the Fed reversed course and tightened monetary policy, with short-term rates once again greater than inflation.

The consensus forecast for inflation — taken from a survey of 80 economists on Bloomberg — is 2.10% in 2010 and 2.05% in 2011. Typically, the Fed changes the discount rate in quarter-point increments, with 0.50% changes being extremely rare. In mid-February, for example, the Fed raised the discount rate from 0.50% to 0.75%. If the discount rate is increased 0.25% quarterly beginning next quarter, it would take nearly two years just to achieve neutral policy, assuming the economists surveyed by Bloomberg are correct. Naturally, we do not know the Federal Reserve Board's intentions or the potential timing or magnitude of any additional increases, but it seems to us that concerns about "tight" money are premature.

**A double-dip recession is a largely mythical economic creature that has rarely been seen or measured by humans. Some contend a double-dip recession was last experienced between 1980 and 1982. In any event, double-dip recession is quite real to people who are prone to worry about things that may never come to be.*

FEDERAL FUNDS, T-BILLS & INFLATION (1/5/1990 - 1/5/2010)



Source: Bloomberg. CPI data shown reflects actual CPI data through December 2009. CPI data for 2010 and 2011 was calculated using the results of the Bloomberg survey cited above.

The Consumer Price Index (CPI) is the primary indicator of U.S. inflation and is used to make cost-of-living adjustments to billions of dollars in benefit payments. Individuals cannot invest directly in an index.

In the United States, the federal funds rate is the interest rate at which private depository institutions (mostly banks) lend (federal funds) at the Federal Reserve to other depository institutions, usually overnight. Changing the target rate is one form of open market operations that the Chairman of the Federal Reserve uses to regulate the supply of money in the U.S. economy.

A "double-dip recession" refers to a recession followed by an aborted or short-lived recovery, followed by another recession.

Treasury bills are short term debt securities with a maturity rate of one year or less issued by the U.S. government.

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