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# What Is Tight Money?

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Concerns over deflation have dominated monetary policy during the past several years in Japan, and also in the United States as recently as 2003. As a result, the Bank of Japan and the Federal Reserve have been highly accommodative. In Japan, this took the form of a zero interest rate. In the U.S. context, it was manifest in rates at well below normal yardsticks, such as nominal GDP growth that would call for U.S. policy interest rates close to 6 percent rather than at current levels below 5 percent. Unusually accommodative monetary policies and the substantial liquidity flows they have entailed have boosted asset values and compressed risk spreads. Consequently, demand growth has persisted at high levels for long enough to cause modestly higher inflation. The time has come for tighter monetary policy, and central banks in the United States, Europe, and Japan have all begun to apply it.

### Few Signs of Effective Tightening

Results so far have been remarkably muted, especially in the United States. While the Federal Reserve starting June 2004 has incrementally boosted the federal funds rate from 1 percent to 4.75 percent, economic growth has remained robust and most asset prices have held on to substantial gains. As of late March, ten-year Treasury note yields are only up about 15 basis points, and corporate bond yields are actually 20 to 40 basis points lower than they were in June 2004. Stock prices are up about 15 percent. As described and explained at greater length in the January 2006 *Economic Outlook*,[1] it is almost as if the Fed has been trying to tighten monetary policy by pulling on a rubber band. One possible explanation for continued growth and high asset prices (higher stocks, real estate, and lower long-term interest rates), even in the presence of higher short-term interest rates, is that, despite some hefty tugs on the elastic band, the Federal Reserve is not constraining access to credit either for households or for businesses.

Fed chairman Ben S. Bernanke offered another explanation for low long-term interest rates recently. He simply observed that low and stable inflation, together with stable growth, has reduced risk premiums attached to future economic outcomes. The future is more certain because the Federal Reserve has become more predictable. As a result, investors feel emboldened to employ additional leverage to enhance returns.

For example, a fund manager wishing to offer 12 percent returns to investors may purchase assets such as Treasury bonds yielding 4 percent and employ triple leverage to earn the 12 percent: The manager of a $100 million fund buys $300 million in bonds, borrowing the extra $200 million from a Japanese bank at virtually zero interest. The $300 million in bonds pays $12 million or 12 percent of the $100 million under management. Funds managers wishing to expand their operations may offer 16 percent using quadruple leverage. Of course there are risks, including rising interest rates in the United States, rising interest rates in Japan, and a weaker dollar that boosts the dollar cost of borrowing from a Japanese bank. But low market volatility and a predictable Fed have led many investors to discount those risks.

One could say, viewing monetary policy over a longer time span, that it has been more than

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twenty-five years, going back to 1980 specifically, since the Federal Reserve actually pressed hard on the monetary brakes. To conquer inflation at that time, which was approaching double digits, the Volcker Fed severely restricted the growth of credit and allowed markets (through sharply higher interest rates) to slow the economy. In 1980, less credit was available, and that credit carried much higher interest rates compared with today, when virtually unlimited credit is available at largely stable rates. During tightenings of monetary policy in 1980, 1987, 1990, 1994, and 2000, the Fed essentially kept raising the fed funds rate until weaker asset markets and/or a fear of a financial accident created a slowdown in demand growth. Weaker asset markets were self-correcting insofar as they prompted the Fed to stop tightening and then to ease sharply in order to prevent what it feared might be an asset market meltdown that would damage the economy.

## A Central Bank Dilemma

As we move into the spring of 2006, a familiar pattern is unfolding, yet with a new twist. The Fed is again boosting the federal funds rate while asset markets, stocks, and housing are still rising. Although the Fed's tightening has, so far, been moderate in terms of the real interest rates achieved, for the first time since the 1980 recession, its move has been joined by the European Central Bank and the Bank of Japan, with the latter starting to withdraw from five years of extremely accommodative deflation-fighting policy that has included zero interest rates and a massive 25 percent increase in the monetary base.

A question lingering in the air this time is whether we shall have a significant global monetary contraction that creates uncushioned, sharp, asset-market corrections or whether weaker asset markets will ultimately prompt another Fed reversal to accommodation, with rates lowered to prevent an abrupt sell-off that could harm the economy. This time it looks as if the best that market bulls in the United States can hope for is an end to tightening, perhaps in May, at a 5 percent federal funds rate. Even that wish may be dashed by further rate increases should inflation persist, but a recent moderation of U.S. inflation pressure, indicated by a lower-than-expected 0.1 percent rise in the February core Consumer Price Index, has reinforced market hopes that Fed tightening will cease at 5 percent.

Current inflation data aside, some Federal Reserve governors and regional bank presidents, not to mention central bankers in Europe and the United Kingdom, have hinted that they see lower asset prices as necessary to slow demand growth now that global excess capacity is largely depleted. That said, the same central bankers know that they face a dilemma. Although they are seeing only modest inflation, any signal to markets that they see no need for further tightening means that asset markets will soar and create a need for such tightening.

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In the United States, we currently have the odd combination of predictions of growth at or above trend rates for the balance of the year with a projected rise in core inflation to 2.5 percent alongside projections that the Fed will stop raising interest rates in May, leaving the fed funds rate at a peak of 5 percent. That scenario is both benign and desirable for central banks and the economy, provided that it does not include a rapid resurgence in asset markets that boosts aggregate demand growth to levels consistent with still-higher inflation.

The persistence of benign inflation readings through much of the highly accommodative stance of monetary policy in recent years is related to an unprecedented expansion in global production capacity—especially for goods. A rapid increase in the supply of labor in China coupled with heavy investment there has boosted capacity in the traded-goods sector and thereby tempered global inflation pressures. The availability of outsourcing to Asia has even reduced inflationary pressure in the non-traded or services sector. Simultaneously, the combination of the extraordinary quantitative easing by the Bank of Japan since 2001 and China's massive recycled dollar buying currency intervention has provided additional liquidity to support asset markets worldwide. The combination of ample liquidity and low interest rates has boosted the American real estate market to a point where the rise in its value contributed $5 trillion, a 10 percent increase, to the net worth of American households over the year ending in the fall of 2005.

## Data-Dependent Monetary Policy

Sustained demand growth, accommodated by central banks facing heretofore benign inflation rates, has supported asset markets so much that wealth effects on

spending have boosted pressure on capacity and thereby threatened higher inflation. Commodity and energy prices have signaled that, even with ample capacity expansion in China keeping inflation contained in the global economy, there are still some inputs whose prices have had to increase. Eventually, those price increases along with capacity pressures and some emerging pressures on the U.S. labor supply will leak through to the core inflation rate monitored by the Federal Reserve.

At present, those U.S. core inflation rates are at the top of, but not above, their desired range, hovering around 2 percent on a year-over-year basis. The interesting question going forward is this: given that virtually no American household or business has been denied as much low-cost credit as it desires, will the Federal Reserve be able to stop raising rates at 5 percent and still see no further increase in core inflation?

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Right now, no one really knows the answer. That is why most Fed speakers are referring to a "data-dependent" path of monetary policy in coming months. The Fed will, in any case, want to delay for as long as possible any hint that it has finished raising rates, for fear that such a signal would reignite asset inflation and thereby threaten further increases in their proximately targeted core inflation rates.

## Asset Markets Hold the Key

If core inflation rates only reach their critical levels for Fed tightening a year from now, with asset markets having risen another 10 to 20 percent, the dilemma the Fed faces will not be eliminated, but will have only intensified. Perhaps this new conundrum explains the half-percentage point rise in U.S. long-term interest rates so far this year to their highest level in two years. Such higher long-term rates may simply reflect the rising possibility that the Fed will have to hold its policy interest rates at high levels for a longer time or may even need to push them higher than the current 5 percent ceiling currently envisioned. Meanwhile, Japanese five-year commercial interest rates have more than doubled from their 50 to 70 basis-point lows of last year as the Bank of Japan has signaled an end to "quantitative easing" and its policy of zero overnight interest rates.

With all three major central banks tightening at this stage, and especially with the withdrawal of Japan's liquidity gusher, asset markets may stabilize and fall by enough to slow aggregate demand growth and keep core inflation from rising above 2 percent. That outcome would be moderately painful in the short run, but highly beneficial in the long run, since it would preclude the future need for more sharply restrictive policies from the major central banks.

Ironically, it may be the Bank of Japan instead of the Federal Reserve that has to give American consumers a taste of restricted availability of credit. The Bank of Japan's newly initiated exit from its extraordinarily easy monetary policy may end up sharply curtailing much of the Asian liquidity that has been supporting the U.S. bond market. Either way, lower asset prices, a signal that monetary policy is actually constrictive, will ultimately be required to keep inflation within the Fed's desired target range. It remains to be seen whether moderately lower asset prices, a result of further tightening by major central banks, will do the trick or whether sharply lower asset prices, after premature cessation and then resumption of central bank tightening, will be required.

So far, the benign, moderate-tightening scenario is playing out nicely in the United States. Growth is staying at a sustainable trend rate of about 3.5 percent, and inflation has remained within a moderate range that is acceptable to the Federal Reserve. The absence of perceived macroeconomic risk lowers the long-term real interest rate, itself a moderate stimulant to the real economy, as Fed governor Ben Bernanke reminded the New York Economic Club in a speech on March 20.

Can this continue forever? No. Can it continue a lot longer than we expect? You bet it can. The longer the benign, low-risk scenario persists, the less risk is priced into asset markets and the higher they will drift until, eventually, demand growth presses inflation a little above the Fed's strongly desired target range. Then we will (re)learn what tight money is.

## Note

1. John H. Makin, "The Fed: Pulling on a Rubber Band," *Economic Outlook* (January 2006), available at www.aei.org/publication23606/.