US monetary policy: time for a break

For the last 12 months there has been an increasing pressure over the Federal Reserve to move into a more contractionary monetary policy than before. The basis for such a case has been the apparently low absolute values of the Fed Funds target rates being in place and some inflationary indexes that have been showing some restlessness. The real picture seems to be quite different.

M1, the most meaningful monetary aggregate, has been showing no nominal growth at all for the last 12 months, and since July 2000, grown by 24%, approximately. On the other hand, consumer price indexes considering all items have been lately growing close to 4 % in annual terms, but when food and energy is excluded – a proxy for core inflation -, that rate of growth goes down to a much more comfortable 2,5% figure. For the whole period since July 2000 these price indexes grew by 18% and 14%, respectively. In other words, M1 has been falling on real terms for the last 12 months but grown since July 2000 close to 9% over that same core inflation basis. During the same 6 year period, real GDP grew by almost 16% and for the last 12 months close to 3,5%, being both growth rates surprisingly much higher than those of monetary aggregates adjusted for inflation, dangerously extricating liquidity out of the system.

Why consider year 2000 as a longer term reference ? Economic conditions in the US were then within normal operational ranges, in terms of inflation (2,6%), growth (3,7%), full employment, federal budget balance (+1,4% of GDP) and current account balance (-4% of GDP), and no external shocks had yet come into being. Moreover, given those "long and variable monetary lags" Mr. Milton Friedman long ago described, it seems reasonable that within this period one can see their impacts, especially those to be monetarily born after September 11th, 2001.

To make the explanation more simple, we could just consider the following quantitative monetary identity: MV = PQ , where M stands for a monetary aggregate, V for money velocity – primarily a function of inflationary expectations -, P for price level and Q for aggregate activity. If we now take into account that V is most possibly stable, given persistent inflationary expectations anchored around 2,5% per year as inferred from the evolution of nominal and inflation indexed US Treasury Bonds, the only way to keep this identity working, given our previous figures, is via a simultaneous downward pressure on price movements and the level of activity. But after a certain point, where prices start to show inflexibilities on the downside and monetary restrictions do continue, the whole adjustment ends falling into Q.

How sure can we be about this impending scenario ? Long term risk free interest rates in the US, inflation indexed, are already neutral and now getting closer to 2,5% per year, the historic average since the 1950´s. Its slight downward pressure is surely explained out of an excess saving from emerging economies that will sooner or later be used for their own domestic purposes, gently pushing international real interest rates up again.

Moreover, an additional controlling pressure on US domestic aggregate demand has arisen out of the dollar correction, which in trade weighted terms has shown a significant decrease of almost 20% since year 2000. No doubt its effect will have to show up, relatively promoting exports and taxing imports. If we look at foreign trade figures, the flattening tendency for its deficit is getting clear: foreign trade deficits have stabilized around US$ 65 billion per month for almost a year.

In summary, monetary aggregates are now on a contractionary path that could overshoot its purpose, in the sense that it is no longer needed for long term inflation controlling purposes and could be potentially damaging for the US economy. Inflation indexes, always subject to short term influences, cannot escape their reason to exist, which is a permanent excess of liquidity over that one needed for the normal aggregate activity. At present US monetary conditions, this is apparently not the case.

Patience is a better advice. Again, “long and variable monetary lags” is a good reminder of monetary intricacies, and a nominal growth objective for a monetary aggregate such as M1 closer to the sum of inflationary expectations and real GDP growth is a useful good rule of thumb for a stable equilibrium growth path, along already centered long term interest rates.

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