Roosting Chickens

By John Tuccillo, PhD
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There's a current ad on TV for an anti-cholesterol drug that discusses the causes of high cholesterol. While we know that eating fatty food can raise your levels, heredity also plays a key role. The pitch is that Grandma Minnie can be as responsible for your problems as the quart of ice cream you ate last night. What ails you might have roots in the distant past as much as in your current behavior.

So it is with the economy. The slowing rate of growth—from 5.6 to 3.6 to 1.6 percent in the first three quarters of 2006—owes little to what's happening now. Yes, the housing sector has slowed down and is contributing to lower growth just as it helped the economy boom in earlier years; but the reality is that the string of interest rate increases engineered by the Federal Reserve over the past two-and-a-half years, ending in June, are as much a culprit as real estate.

Monetary policy works very slowly. If the Fed changes short term interest rates, the impact is not felt until nearly a year later. Say the Fed wants to cool off a growing economy by raising rates. First bank rates rise, then interest rates tied to them go up. As consumer and business costs increase on their outstanding loans, consumption goes down and prices rise. If the Fed has done its job right, lower consumption prevails and the economy slows. All this can take up to a year, so the Fed's action today will show up in the economic growth numbers for the third quarter of 2007.

This makes monetary policy a very delicate tool. Raising rates too much can engineer a recession, and lowering rates too frequently can trigger inflation. Alan Greenspan had exceptional instincts in using monetary policy. In his eighteen year tenure as chairman, he rarely misjudged the timing and use of policy tools. As the tech bubble of the late Nineties (partially brought on by expansive monetary policy) shows, he wasn't perfect, but by and large he did an excellent job.

We are now seeing in the economic growth numbers the fruits of what may have been an excessively tight monetary policy. The economy was expanding when the Fed embarked on its policy of increasing rates three years ago, but not at a rate that called for seventeen consecutive interest rate increases. While real estate was booming, no other industry was showing sufficient strength to propel growth. In fact, the housing boom may have been so strong that it masked significant weaknesses in the economy. The Fed's fear of an outbreak of inflation—fears that some Federal reserve officials still harbor—may simply have reflected the influence of a red-hot real estate sector combined with unconscionable levels of Federal spending, not a general overheating of the economy.

Now, the tight monetary policy pursued by the Fed has come home to roost. We are seeing lower growth numbers, weaker job creation, and higher unemployment. The impact of higher short term rates are hitting the economy at the same time that the one significant growth engine—real estate—is slumping. The problem is that neither of these phenomena has run its course. Given that the Fed stopped increasing rates only this past June, it will be another four to six months before the full effects work through the economy. Additionally, most analysts do not believe that the downturn in housing will be over until sometime in the first half of 2007. This suggests further bad news on growth and employment will be coming for the next several months.

Will the economy slip into recession because the Fed was too strong for too long? The answer is “probably not”. There are some real base strengths in the economy, starting with the demographic profile of the work force, that will prevent a recession. But it is becoming clear that we are entering into a period of slowing growth that has been caused as much by the steak and banana splits we’ve been eating as by the genes passed down to us by Grandpa Ben.