



How Do We Know Whether the Fed Is Done Tightening?

After deliberating for two days, the Federal Open Markets Committee (FOMC) raised the federal funds rate by one quarter of a percentage point to 5.25% on June 29. The major stock indices took off at the news and had some of the largest increases in years. In what the media called a “relief rally,” the Dow Jones industrial average jumped more than 200 points and the NASDAQ composite index rose 63 points.

Now, the question is whether the Fed has finished tightening. Are any more rate hikes still to come? The Fed’s official answer, of course, is, “It depends.” The latest FOMC statement included the usual clause about its future actions being dependent upon “incoming information” about the economy.

Four types of key economic indicators

What economic data, then, will determine the course of monetary policy? While the staff at the Federal Reserve must be looking at a wide range of economic indicators, they generally fall into four categories:

1. Output Data

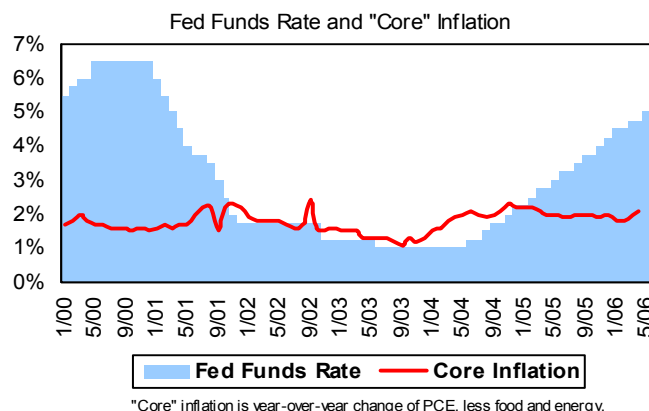
The Fed can stop raising rates when it sees economic growth clearly moderating. The most common measure of economic output is Gross Domestic Product (GDP), and as the economy cools, its real growth rate (adjusted for inflation) approaches and eventually falls below the long-term potential rate.

Most economists estimate the long-term growth rate to be somewhere between 3.0% and 3.5%. The Fed has historically shifted its direction of monetary policy when the growth rate falls below this range. (Please refer to our August 2005 report, “*What Macroeconomic Data Say about Interest Rates.*”)

The U.S. GDP expanded 5.6% during the first quarter of 2006, staying far above the aforementioned long-term potential rate. We estimate that the second-quarter growth fell below 3.5%. The Fed seems to share this view, as its recent statement reads, “... economic growth is moderating from its quite strong pace earlier this year.” The initial reading of the second-quarter GDP will be released on July 28, before the next FOMC meeting on August 8.

2. Price Inflation Data

During the hearings for his confirmation as a new Fed chairman, Ben Bernanke established a de facto inflation



target of between 1.0% and 2.0%. Year-over-year changes of the “Core” Consumer Price Index (CPI)—excluding food and energy items—have remained over 2% for the past 21 months.

The Fed is believed to rely more heavily on the Personal Consumption Expenditure Price Index (PCE) than the CPI. The “Core” PCE (less food and energy) has also drifted upward in recent months. (See the above chart.) Its year-over-year increase in April 2006 was 2.1%. If the current rate of inflation persists, the Fed will have to tighten its monetary policy further.

3. Employment Data

Because stable inflation and full employment are the two explicit policy goals of the Federal Reserve, employment trends weigh heavily on the Fed’s decisions.



The May employment data showed that the economy still had good momentum. The United States gained almost two million payroll jobs over the previous twelve months. The unemployment rate was 4.6%, the lowest level in almost

five years. During the first six months of 2006, weekly initial jobless claims averaged 308,000, down 7% from the same period in 2005.

These numbers suggest very little slack in the labor market. In fact, stories of worker shortages, especially among skilled workers, are becoming increasingly common. The Fed would be more comfortable ending its tightening actions if job growth were slowing and the unemployment rate were stable or gradually rising.

The labor market, however, may not be as strong as those figures imply. Employment data are known to be a lagging indicator, and they respond to changes in general economic conditions with a significant delay.

4. Financial Data

A “real” interest rate is defined as the difference between a nominal interest rate and a prevailing rate of price inflation. It is the “real” cost of borrowing. As the chart on the previous page shows, the real interest rate in the United States turned negative in 2001.

Negative real interest rates are considered an anomaly, but the rate did not turn positive again until the end of 2004. Currently, the difference between the fed funds rate and the core inflation rate is about 3%. Many regard this level of real interest rate as neutral—neither stimulative nor restrictive.

It has been expected that the Fed would increase rates until the real interest rate is back to the normal level. We have now reached that point.

Driving by the rear view mirror?

Because it takes time for the cooling impact of higher interest rates to spread through the economy, monetary policy is believed to work with some lag. If the Fed stops

raising interest rates when economic conditions are just right, then it has tightened too much; the residual impact of higher rates is bound to chill the economy further.

Also, all economic data provide readings of the past only. They are about previous months or quarters, and published with delays. In addition, some economic data (such as employment data) are lagging indicators, as previously noted.

Chairman Bernanke has consistently emphasized the importance of economic data, but conducting monetary policy based solely on available economic data is akin to driving a car by looking at a rear view mirror alone. (With inherent errors and lags in economic indicators, it's more like driving a car by the rear view mirror—in the fog.)

A tough call for the Fed

Currently, the four groups of economic indicators are sending mixed signals. The combination of rising real interest rates and stable oil prices suggests that the Fed can rest, but the above-the-target core inflation rate and the tight labor market are fueling inflation concerns.

Another rate hike or two? It's a tough call to make. In all likelihood, the Fed itself doesn't know yet. We see less than a 50/50 chance for a 25-basis-point hike in August, but again it all depends on what we will find out about the economy before the next FOMC meeting.

So, if you know for sure which way the Fed should proceed, give Mr. Bernanke a call. He can use all the help he can get.

*Keitaro Matsuda, Senior Economist
Union Bank of California, NA
Office of the President, Economic Research*

Economic Forecasts – July 2006

UNITED STATES	2004	2005	2006	2007
Real GDP Growth (%)	4.2	3.5	3.7	3.1
Unemployment (%)	5.5	5.1	4.6	4.6
CPI Change (%)	2.7	3.4	3.3	2.2
Federal Funds (%)	1.3	3.2	5.0	5.2
Housing Starts (millions)	1.95	2.07	1.96	1.83
Car/Lt. Truck Sales (millions)	16.9	16.9	16.9	16.9

Bold: Actual.

The information in this report is based on data available as of July 3, 2006, and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied upon as the sole source of information and opinion.