FOCUS ON THE ECONOMY

STABILITY: THE REALPOLITIK OF THE COMING DECADE

by Hugh F. Kelly, CRE

Streetwise New Yorkers have their own rules of economic forecasting. One ironclad axiom is, "Betting your money on three-card monte is a definite leading indicator of a personal recession." The game is all about misdirection, and few are those who can penetrate the dealer's sleight of hand.

Most traditional economists have little better success in predicting the direction and magnitude of interest rate changes. And for a similar reason. Fed watchers, financial journalists, and the public markets continue to look intently at widely-published inflation indicators, including the monthly *Consumer Price Index* and *Producer Price Index* reports, expecting that Alan Greenspan and company will use these as guides in adjusting the price of money.

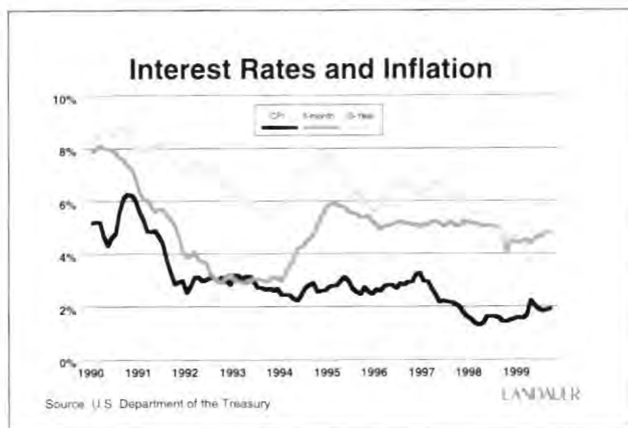
Such an assumption is, of course, the result of received academic training and learned experience. We have all been taught that interest rates are built up from a base of risk-free return on capital, an inflation premium, and additional compensation for the risk assumed regarding return of capital. This is the classical pricing model for bond rates. Furthermore, most of us have grown up in the business world since 1967, when inflation became a significant factor in the economy. For more than a quarter of a century, we have watched interest rates rise and fall in consonance with shifts in the level of consumer prices. We have bought into the notion of a necessary correlation between the two.

What has not been generally appreciated, though, is the degree to which that relationship has been severed in the middle- to late-1990s. With only modest exaggeration, I will state that since 1993 there has been *no relation whatsoever* between the direction and size of interest rate swings and underlying inflation. *Figure 1* is familiar to CREs, as it has been a regular feature in *The Counselor* newsletter. Note how the slope of short-term Treasuries dropped steeply between 1990 and 1992, following the CPI down to an interest rate trough in 1993 and early 1994. Over the same period, the 10-year T-Bond also showed a decline in its yield, albeit in a more gradual trend.

Then a peculiar thing happened: inflation remained stable and low over the course of the next year, but both long and short Treasury rates shot up dramatically. What was going on? Simply this: the Fed, during the early Nineties, kept its discount rate low to enable banks to borrow cheap capital for reinvestment in Treasury issues, allowing teetering financial institutions to rebuild their capital bases using the arbitrage on the rates. By 1994, all large U.S. banks had sufficiently rebuilt their capital to meet the Bank of International Settlements reserve requirements, and the Fed raised rates to eliminate the subsidized arbitrage. This was a quiet strategy, and some may think it was a bit of a shell game. But it was, in my view, a brilliantly conceived and executed policy of Greenspan and the Board of Governors; it rescued the banking system when a repeat of the 1930s was a real possibility.

Between 1995 and 1997, the relationship between inflation and interest rates

Figure 1



stayed basically stable, especially if we use the three-month bill rate as a benchmark. In 1997, a drop in sensitive materials prices caused inflation to drop to nearly the vanishing point. Short-term rates didn't budge, though, as all of the so-called "managed rates" (bankers' prime, the Fed Funds rate, and the Fed discount rate) were held tight. I believe that our central bankers recognized the combination of suddenly increased risks on the international scene and the massive momentum sustaining the domestic economy. The decision was to keep U.S. "real" (inflation-adjusted) rates high to draw capital toward the U.S. as a "safe harbor" while avoiding the untimely stimulation of an already robust business cycle.

In the autumn of 1998, of course, U.S. financial markets were quaking as a result of Asian banking difficulties and the default in Russia's sovereign bonds. The Fed adroitly engineered a three-step drop in rates, using the flexibility afforded by the immediately previous policy of keeping real rates high. The concept was that the U.S. economy would be stimulated to forestall any potential recession and that we would serve as the market of final resort for the world's goods. The gambit worked, markets stabilized, and the Fed (in due course) has moved rates back toward the *status quo ante*. Meanwhile, inflation has stayed benignly in the same range it has been since the start of 1997.

At this point, we should remind ourselves that all of the post-1993 moves in interest rates caught the financial markets only in a reactive mode. Stock prices, in particular, failed to anticipate the changes, although they derived quite salutary effects once the Fed's policies were put into place. Against that general upward trend in stock prices, though, the market saw tremendous day-to-day volatility as investors, Wall Street analysts, and financial commentators continued to react to periodic signals of some change in the inflation outlook.

What are the lessons? The first is that we need to re-learn the nature of the inflation/interest rate relationship. Our intellectual context needs to get beyond the bounds of the 1967 – 1990 period, when inflation was indeed the greatest of economic issues. As we look at 2000 and beyond, the key issues will be world economic stability as a platform for improved living standards. Stability is the *realpolitik* of the coming decade. Central banking policy will be driven by this imperative.

The second lesson returns us to the fundamentals of supply and demand in determining the price of money. Just as the huge federal deficits of the Eighties and early Nineties bid rates upward, the present and anticipated budget surpluses of the next few years will enable the Treasury to retire debt. This will free capital for more productive use, promoting real economic growth, and putting downward pressure on rates.

This is not a prediction of unremitting decline in interest rates. Such a forecast would be as foolish as trying to beat the monte-dealers at their own game. Although I fully expect levels of interest rates in the coming decade to resemble those of the Fifties more than those of the Seventies, a lot could go wrong to thwart such a hopeful outlook. My point is much more modest. In this era – now already six years old – the direction and magnitude of interest rate change will be primarily a tool of international policy, and only secondarily about consumer prices. Those who continue to read the traditional inflation indicators will only leave the table shaking their heads, wondering why they can't keep track of the elusive cards. Those who base their investment strategies on the rate/price correlation will, I'm afraid, also wonder why their wallets seem continually lighter.REI

ABOUT OUR FEATURED COLUMNIST

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