



The Northern Trust Company
Economic Research Department
Positive Economic Commentary

"The economics of what is, rather than what you might like it to be."

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Fed Tightening Starts Deep In The Hole

Although there are no sure things when it comes to Fed policy – other than it will create inflation if none exists – the probability approaches 100% that the FOMC will hike the fed funds rate on June 30. The FOMC is starting this round of tightening deep in the hole with regard to the level of the inflation-adjusted, or real, fed funds rate. In fact, since the mid 1960s, there has only been one occasion when the Fed started tightening with the real fed funds rate lower than where it is now.

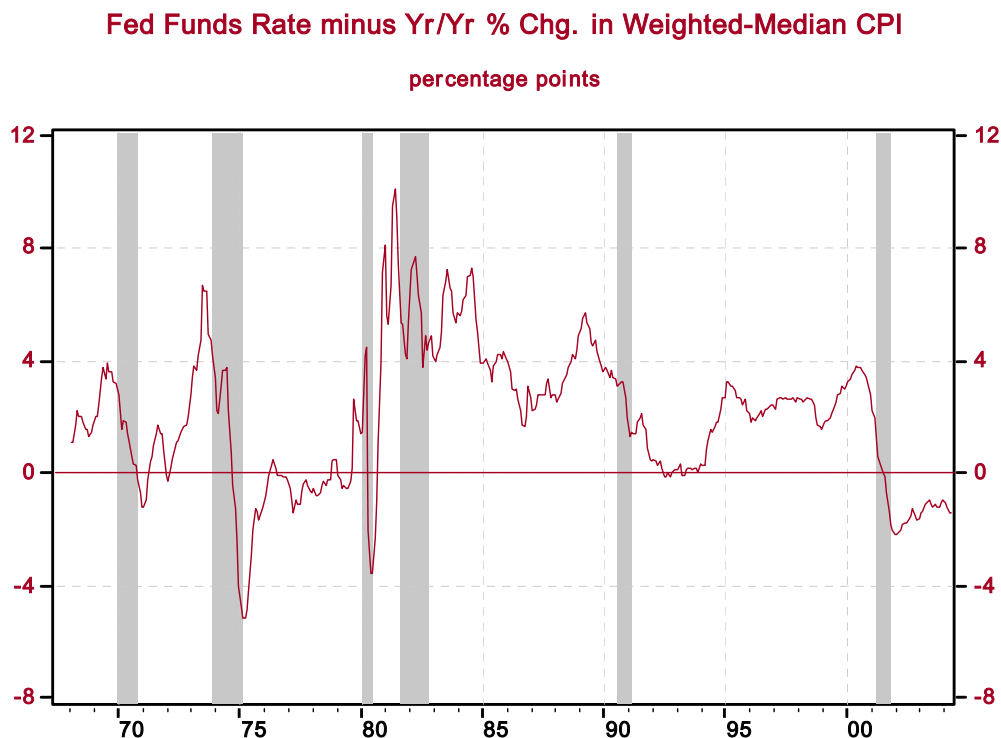
The inflation rate I have chosen to adjust the fed funds rate by is the one calculated by the Federal Reserve itself – the Cleveland Fed's weighted-median Consumer Price Index. This measure of inflation is calculated by arraying the major components of the Consumer Price Index reported by the Bureau of Economic Analysis in descending order from the component with the largest percentage monthly increase to the smallest increase. There is a cumulative weighting based on the weight of each component in the CPI. To find the median monthly change in the CPI, one moves down the array to the percentage change in the component representing 50% of the cumulative rating. In May, the weighted-median CPI was 2.7% annualized, or 0.2% monthly. The table below, compliments of Professor Stephen Cecchetti of Brandeis University illustrates how the weighted-median CPI was calculated in May (http://people.brandeis.edu/~cecchett/pdf/inf_current.htm). For a discussion of the "logic" of the weighted-median CPI, see the Federal Reserve Bank of Cleveland website (<http://www.clevelandfed.org/research/data/mcpi.htm>).

Detail for Computation of the Median CPI
May 2004

Component	Annualized 1-month% change	Relative Importance	Cumulative Relative Importance
Motor fuel	151.5	3.8	3.8
Dairy and related products	120.3	0.9	4.6
Fuel oil and other fuels	43.5	0.2	4.9
Jewelry and watches	32.8	0.3	5.1
Meats, poultry, fish, and eggs	20.4	2.3	7.5
Processed fruits and vegetables	19.4	0.3	7.7
Gas (piped) and electricity	13.8	3.7	11.4
Fresh fruits and vegetables	10.8	0.9	12.3
Water and sewer and trash collection services	10.3	0.9	13.2
Women's and girls' apparel	7.7	1.7	14.9
Motor vehicle insurance	7.4	2.5	17.4
Education	7.0	2.9	20.3
Other food at home	5.2	1.8	22.1
Used cars and trucks	4.7	2.0	24.1
Nonalcoholic beverages and beverage materials	4.4	0.9	25.0
Tenants' and household insurance	4.2	0.4	25.4
Rent of primary residence	4.1	6.2	31.6
Medical care services	3.4	4.7	36.2
Food away from home	3.3	6.2	42.4
Personal care services	3.1	0.7	43.1
Men's and boys' apparel	3.1	1.0	44.1
Lodging away from home	2.9	3.1	47.2
Medical care commodities	2.7	1.5	48.7
Owners' equivalent rent of primary residence	2.7	23.5	72.2
Motor vehicle maintenance and repair	2.4	1.4	73.5
Cereals and bakery products	2.4	1.2	74.7
Household furnishings and operations	1.9	4.5	79.2
Miscellaneous personal services	1.7	1.5	80.6
Motor vehicle fees	0.9	0.5	81.1
New vehicles	0.9	4.8	85.9
Personal care products	0.8	0.6	86.5
Tobacco and smoking products	0.5	0.8	87.4
Motor vehicle parts and equipment	0.0	0.4	87.7
Alcoholic beverages	-0.6	1.0	88.7
Recreation	-2.2	5.9	94.6
Footwear	-3.0	0.8	95.4
Miscellaneous personal goods	-6.6	0.2	95.6
Communication	-6.7	3.1	98.6
Public transportation	-14.3	1.1	99.7
Infants' and toddlers' apparel	-17.5	0.2	99.9
Car and truck rental	-42.6	0.1	100.0

The information herein is based on sources which The Northern Trust Company believes to be reliable, but we cannot warrant its accuracy or completeness. Such information is subject to change and is not intended to influence your investment decisions.

In calculating the "real" fed funds rate, I have subtracted from the nominal fed funds rate the 12-month percentage change in the weighted-median CPI. In the 12 months ended May 2004, the weighted-median CPI was 2.46%. Thus, with a fed funds rate of 1.00%, my version of the real fed funds rate in May was -1.46%. The chart below shows the behavior of this real fed funds rate from February 1968 (the beginning of series on the 12-month change in the median CPI) through May 2004. Notice that up until recently, it was in the 1970s when negative real fed funds rates were most common. The median real fed funds rate over the period is 2.09%.



The table below shows the level of my version of the real fed funds rate in the month prior to the commencement of a major Fed tightening cycle. In the nine tightening cycles prior to the one that will begin at the end of this month, only two were immediately preceded by a negative real fed funds rate – March 1971 at minus 0.98% and July 1980 at minus 3.54%. Even at the beginning of the 1994 tightening cycle, when the nominal fed funds rate was at a multi-decade low of 3.00%, there was a slightly positive real fed funds rate (0.36%). And on the eve of the last tightening cycle, in May 1999, the real fed funds rate was at 1.94% -- almost equal to the median of the series history. So, the Fed is starting this tightening deep in the hole from an historic perspective of the real fed funds rate.

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Real Federal Funds Rate At the Beginning of Tightening Cycles

Year/Month Just Prior To Tightening	"Real" Fed Funds Rate**
1968/February*	1.06%
1971/March	-0.98%
1974/February	2.18%
1980/July	-3.54%
1983/February	3.99%
1987/February	2.23%
1988/February	2.55%
1994/January	0.36%
1999/May	1.94%
2004/May	-1.46%

* Actual prior-to-tightening month was 1967/October. Year-over-year median CPI data begin in 1968/February.

** Fed funds rate minus yr./yr. % chg. in weighted-median CPI.

I mentioned that it was in the 1970s when the real fed funds rate was most often in negative territory. And one of the two prior tightening cycles that started with a negative real fed funds rate was March 1971. Recall that it was in the 1970s that the fires of inflation raged. Paul Volcker was called in as chairman of the Fed to extinguish inflation. For the Fed to keep the fed funds rate below the inflation rate for an extended period of time is to play with fire. It is, in effect, a "carry" trade. If the prices of goods and services are rising at a rate faster than the base-rate financing cost, then there is an incentive to borrow funds in order to buy goods and services. This act of borrowing to buy just drives up the prices of goods and services even faster. If Alan Greenspan is not careful, he is going to reignite the fires of inflation that Paul Volcker brought under control. In a certain touch of irony, Al Broadus, who began his career at the Richmond Fed about 35 years ago when the inflationary fires were starting to flare, is now about to leave his post as president of the Richmond Fed when the embers of inflation are beginning to glow again. Broadus was a staunch inflation fighter throughout his career. In 2006, both he and Volcker may have to be called out of retirement to once again fight inflation.

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