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Jan. Rate Outlook

Economics Group **Point of View**

Interest Rate Watch

Into The Fray of Monetary Policy

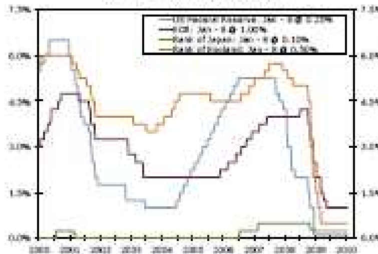
The latest episode in the current saga of monetary policy in the Unites States happened last week between the Fed Chairman Ben Bernanke and "Taylor's Rule" proponent John Taylor. The latter argues that monetary policy was at the heart of the causes of the last recession, while Bernanke argues that lack of regulation, not lax monetary policy, was the problem.

This is nothing new. Economists are still arguing about what caused the Great Depression back in the 1930s. The only thing that is clear is that when you generate economic activity by pushing interest rates too low it causes the economy to grow faster than its long-run sustainable rate. At the beginning of the cycle demand outpaces supply and when supply catches up and many times surpasses demand, something unexpected happens. This could be a shock to the economy, like a reversal in capital flows, or a sudden collapse of the financial sector, etc., and the house of cards collapses.

This is what happened to the East Asian countries (the so called Asian Tigers) back in the late 1990s. They put forward a development model that was dependent on exports and very low, subsidized interest rates. This policy of very low interest rates pushed demand over its sustainable limit and supply way over this limit.

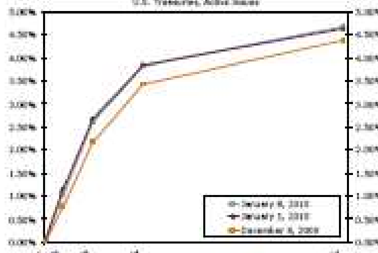
Monetary policy exists to support economic activity but if this policy is not also conducive to sustainable growth, the responsible monetary institution or central bank has to adjust its course. And it is very difficult to argue that interest rates were not extremely low during the preceding period in the United States and that housing demand was not growing without bound. True, the Fed was arguing that a "world awash in savings" was the problem, not Fed policy. This gives the impression that the Fed has lost its ability to influence monetary variables. Both Bernanke and Taylor have good arguments, but the question remains, why did the institutions not work to prevent the crisis?

Central Bank Policy Rates



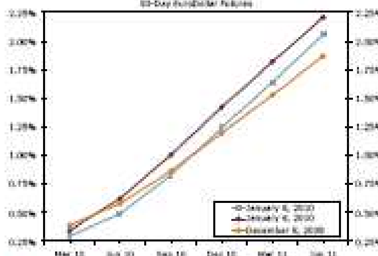
Yield Curve

U.S. Treasuries, Active Issues



Forward Rates

90-Day Eurodollar Futures



Consumer Credit Insights

Did the Holidays Lead to Credit Use?

Consumers have been cutting their outstanding credit balances at unprecedented rates. Consumer credit balances outside of mortgage loans have been cut in 13 of the 15 months through October 2009—with an aggregate decline of $98.7 billion. At the same time the personal saving rate has remained well above the levels we saw during the last expansion. However, did consumers change their minds about credit use again during the holiday season? Perhaps just as importantly, did banks change their minds on credit standards in the early stages of the recovery?

Holiday sales have come in better than expected than in early reports. November retail sales were considerably better than originally anticipated and reports from retailers have been generally positive on December sales as well. The question about credit providers remains: did consumers use savings, income or credit accounts to finance this year's holiday buying? We get an early reading late on Friday afternoon with November consumer credit data. The market is looking for another drawdown in outstanding balances of $5 billion.

Strong gains in outstanding credit are unlikely before the labor market shows more meaningful improvement. And while gains are likely on trend within the next few months, December data showed an unexpected setback.