# MACRO PULSE™

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## Pushing on a String?

"Will they, won't they? Should they, shouldn't they?" are questions endlessly being bandied about on financial TV and radio shows, referring to a possible increase in the federal funds rate (FFR) during the Federal Reserve Open Market Committee (FOMC) meeting in December. Because the FOMC left the rate unchanged in October, the talking heads have spun themselves into a tizzy speculating whether the next meeting will finally be "the one" in which the target rate is raised for the first time since July 2006.

The justification given for slashing the FFR (which has varying ripple effects on all "downstream" interest rates) in the first place was "to revive the economy" and keep price inflation rising at the Fed's desired annual rate of around 2%. In theory, lower borrowing costs stimulate final demand and, in turn, production and jobs. As the economy subsequently regains its footing, the theory goes, interest rates can be ratcheted back up to keep the economy and prices from overheating. Theory and reality seem to have parted company this time around, however, as the economy continues to only limp along and official price indexes are well below the upper limit of the Fed's preferred range.

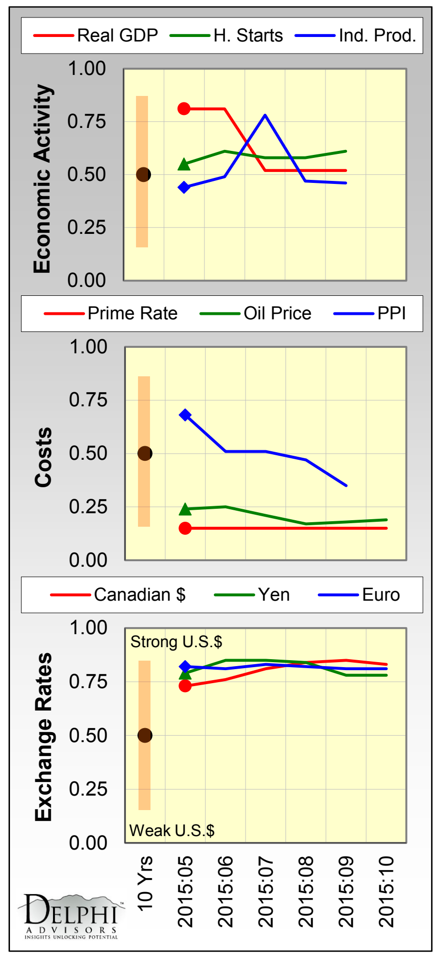
In fact, a growing body of research is turning the old theory on its head. Instead of stimulating activity, low rates may actually be restraining it. The most recent research, published by J.P.Morgan Asset Management, claims the relationship between short-term interest rates and aggregate demand is non-linear, and that low rates create a "stagnation" equilibrium. That stagnation occurs because the low cost of money spurs a tendency first for capacity investment and production that, unless quickly matched by rising demand, ultimately proves greater than necessary; excess production exerts downward pressure on non-asset prices. Prescriptions of further interest rate cuts to realign supply and demand only exacerbate the problems of over-production and declining prices.

These findings suggest that central banks – including the Fed – have backed their respective economies into a corner with repeated rate cuts and other extraordinary measures. The Bank of International Settlements (BIS), "the central bankers' central bank," said much the same thing this past summer. "Rather than just reflecting the current weakness," wrote Claudio Borio, head of the monetary and economics department at BIS, "[low rates] may in part have contributed to it by fueling costly financial booms and busts and delaying adjustment. The result is too much debt, too little growth and too low interest rates. In short, low rates beget lower rates."

"Raising short-term interest rates from very low levels could actually increase aggregate demand," concluded J.P.Morgan's analysts, "as positive income, wealth, expectations and confidence effects outweigh relatively innocuous negative price effects and ambiguous exchange rate effects."

So, what is our prognostication for the outcome of the December FOMC meeting? We have no idea, and are waiting to find out just like everyone else; moreover, we suspect even the FOMC members do not yet know what the final decision will be. Regardless, in the end we anticipate the Fed will indeed find itself behind the proverbial curve, and that the impact of any policy change will be little more than pushing on a string. ■

*This report is typically a compilation of articles posted on our website; those articles relate recent economic developments to the U.S. forest products sector in greater detail.*




**Previous six months' behavior of macroeconomic variables indexed relative to their historical 10-year min, max and average (lower and upper ends of the orange bars, and black dots, respectively)**