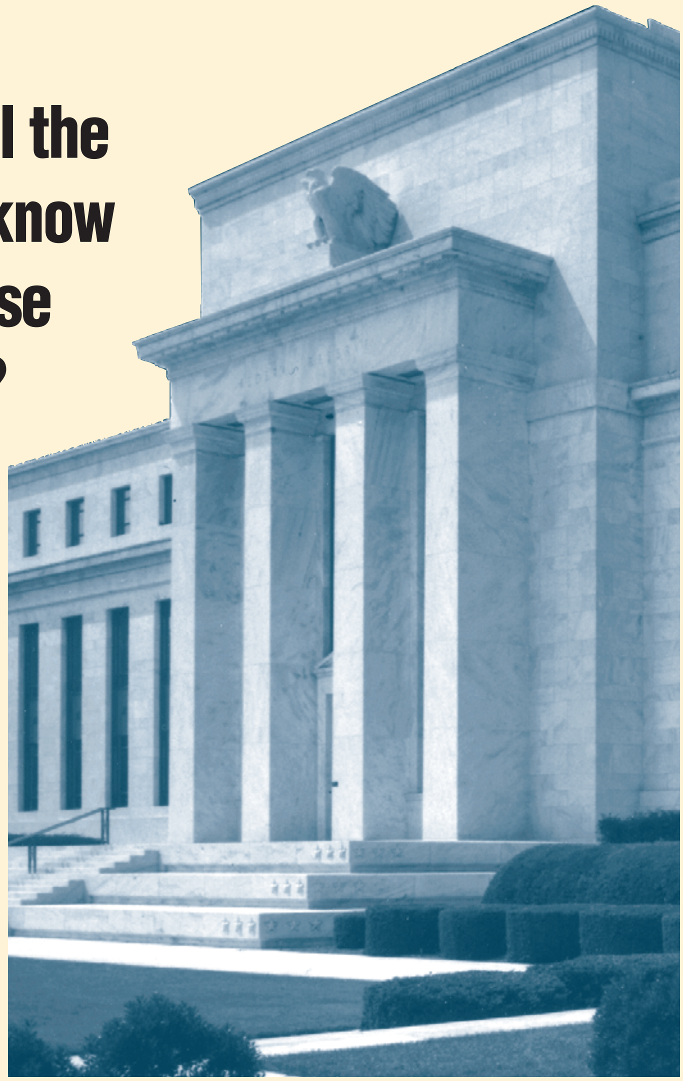
Overshoot? Behind the Curve? *Or Just Right?*

This time, will the Federal Reserve know how high to raise interest rates?



***TIE* surveyed some leading Fed watchers to assess how the FOMC is doing.**

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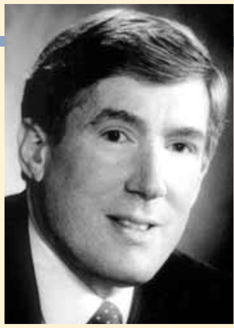
The Fed Will Overshoot the Mark…



ROBERT D. HORMATS
Vice Chairman,
Goldman Sachs

The Fed is likely to overshoot.

Perfection is difficult to achieve in setting Fed funds rates. It is even more difficult in the current environment when longer-term rates are influenced so heavily by foreign capital inflows, which keep long-term credit conditions looser than the Fed desires. Currently, the FOMC is more concerned about curbing inflationary pressures and expectations than dealing with a growth shortfall so it is likely err on the side of tightening rather than stopping too soon.

LARRY KUDLOW
Chief Executive Officer, Kudlow & Co., LLC, and Co-Host of CNBC's "Kudlow & Company"

It looks as if the Fed is still using a traditional Phillips curve tradeoff between falling unemployment and rising inflation. This is despite the fact that non-energy inflation has been holding steady at around 2 percent for ten months, and ten-year Treasury bond rates are low and stable and the yield curve is flattening. The dollar is strengthening. Though gold has been temporarily strong lately, probably from the oil spike, basically a financial and commodity market price rule would suggest that the Fed is overshooting. In other words, on a price rule basis, the weight of the evidence has been suggesting no need for additional tightening measures.

DAVID M. JONES
Chairman of the Board, Investors' Security Trust, and author of Unlocking the Secrets of the Fed

In all likelihood, the Greenspan Fed is in the process of overshooting in its effort to shift from an accommodative to a neutral policy stance.

The recent weakening in the stock market underscores this prospect. The Fed's press release from its September 20 meeting, following its eleventh rate hike in the last fifteen months, places primary emphasis on fighting "potential" inflation rather than focusing on the possibility of a pronounced slowing in economic growth. The Fed is failing to emphasize sufficiently the potential for the post-hurricane (Katrina and Rita) spike in energy prices to severely depress consumer spending.

Moreover, after seeing people lose everything in the hurricanes, consumers may be in the process of a longer-term upward adjustment in their record-low savings rate, thereby depressing consumer spending over a longer period. According to recent business surveys, there is also a deepening concern on the part of businesses that higher energy prices will have a negative effect on orders and production. In addition, as business profit margins are squeezed by higher energy costs, there could be a chilling effect on fixed-investment spending.

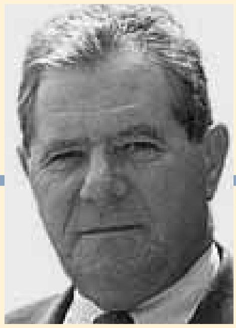
JAMES R. SCHLESINGER
Senior Advisor,
Lehman Brothers

We will overshoot. There is an inevitable lag or gap between recognizing the need to ease, and the easing taking effect.

The Fed Will Overshoot the Mark (continued)...

WOLFGANG ROTH
Vice Chairman of the Board of Directors, European Investment Bank

Yes, they will overshoot.



RICH MILLER
Senior Writer, Business Week

The Fed has overshot for three reasons: First, history suggests they will. Even during the successful engineering of a soft landing of the economy in the mid-1990s, growth still slowed sharply to just 0.7 percent in the second quarter of 1995.

Second, the Fed's risk management approach suggests they should if they perceive a rising threat of inflation. And judging by their public and private comments, they do see an inflationary risk.

And finally, internal Fed dynamics will push them in that direction. Chairman Greenspan wants to end his career with his reputation as an inflation fighter intact. And his successor will want to establish his bonafides on that score as well.

H. ROBERT HELLER
Former member, Board of Governors of the Federal Reserve

The Fed stands poised to overshoot in the current cycle. While the Fed funds rate increased, long-term rates have decreased or remained stable. This is the classic constellation showing that the Fed has been "ahead of the curve." Now short rates are about to catch up with the longer rates and may even surpass them. Markets are giving clear signals that the Fed is overshooting in an environment of basic monetary and price stability. Not even Hurricane Katrina was able to stop the Fed in its determination to invert the yield curve.

ALAN REYNOLDS
Senior Fellow, Cato Institute

Whenever oil prices spike, the Fed has always pushed the funds rate about 2 percentage points above nonenergy CPI inflation (currently 2.2 percent) and also above the ten-year yield (toward a flat or inverted yield curve). The emphasis on energy prices as a Fed target has always ended in global recession—in 1974–75, 1980–81, and 1990–91. If the funds rate goes much above 4 percent, they're doing it again.

On the Contrary! The Fed Is Behind the Curve…

"Definitely behind the curve."

SUSAN M. PHILLIPS
Dean, School of Business & Public Management, George Washington University, and former member, Board of Governors of the Federal Reserve

MARC E. LELAND
President, Marc E. Leland & Associates

EDWIN M. TRUMAN
Senior Fellow, Institute for International Economics, and former Assistant Secretary of the Treasury for International Affairs

The Federal Reserve is a bit behind the curve in achieving its objective of full employment and price stability. The most telling evidence is the FOMC's inability to communicate to the market what will be required to remove the substantial monetary accommodation it has supplied over the past several years without triggering home-grown inflation pressures. In addition, the FOMC has focused more than is appropriate on the growth of output rather than the growth of domestic demand with the result that U.S. monetary policy has exacerbated the U.S. current account deficit and increased the risk of a sharp and disruptive correction that would endanger U.S. full employment, price stability, or both.

STEVE H. HANKE
Professor and Co-Director of the Institute for Applied Economics and the Study of Business Enterprise, Johns Hopkins University

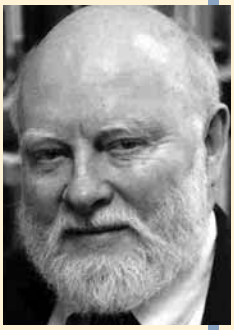
Since early 2002, precious metals prices have surged upward. The Fed has knowingly downplayed these precursors of general inflation. Indeed, the Federal Open Market Committee—since its January 30, 2002, meeting—has routinely characterized its policy stance as "accommodative," acknowledging that it has been "behind the curve." But this isn't the end of the story. On August 2, 2005, the Bureau of Economic Analysis made revisions to the national income and product accounts data for 2002, 2003, and 2004. These resulted in upward revisions in price indices. In consequence, the real federal funds target rate (ex post) was lower and the Fed was even more "accommodative" than the FOMC had reported.

JEFFREY A. FRANKEL
James W. Harpel Professor, Kennedy School of Government, Harvard University

In retrospect, the Fed started tightening at least one meeting too late in 2004—perhaps understandable in light of the preceding asymmetric fear of deflation. In retrospect too, the "measured pace" at which stimulus has been withdrawn has for some reason not been sufficient to raise long-term rates and thus to have the desired breaking effect on the economy, particularly the housing sector. One can characterize recent monetary history by saying that "the curve" is leaving the Fed behind. It seems unlikely that the Fed would catch up by jumping the Fed funds rate more than one-quarter or one-half a percent at some meeting in the near future; it would be too much of a shock to the markets. The result is that monetary policy remains somewhat loose, as it has been for four years now. The excess liquidity has temporarily pumped up not just housing but also long-term bonds, emerging market securities, and commodity prices. The Fed has also aided and abetted profligate fiscal policy.

Behind the Curve (continued)...

RONALD I. MCKINNON
William D. Eberle Professor of International Economics, Stanford University



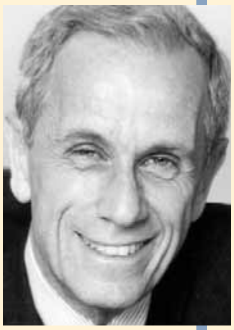
For more than a year, the Fed has been far too lax. Real interest rates have been negative. Now in the fall of 2005, we have a serious inflation problem. Although the price of oil is always influenced by circumstances peculiar to the petroleum industry, an important ingredient in its high and rising price was (is) the unduly easy monetary policy of the Fed—as was also true in the 1970s.

ALLEN SINAI
Chief Global Economist and President, Decision Economics, Inc.

A classic, slowly unfolding, inflationary upcycle appears to be part and parcel of the current U.S. business cycle expansion and well in process.

Initially, massive demand stimulus from aggressively stimulative fiscal policy and extremely easy monetary policy kindled the demand side of the economy. With it came considerable absorption of much slack and rising price inflation—particularly for commodities and oil and energy prices—over 2002-04. Large tax cuts added to demand-pull inflation in 2004. From early 2004 a shift in trend for unit labor costs from declining to rising, diminishing slack in labor markets, and an override of rising oil and energy costs represented the next stage in the cyclical inflationary upward movement. Subsequently, with a strongly growing economy, markup pricing over costs has set in, a typical feature of mid- to late-expansion. The Fed's hikes in the federal funds rate, which started late in the cycle because of a focus on deflationary risk, have lagged the rises of inflation. As a result, on average, rising inflation is ahead of rising interest rates as the U.S. central bank attempts to "remove policy accommodation at a measured pace." Odds are that the policymakers are behind the curve in their attempt to restrain actual inflation and inflationary expectations to within a reasonable range. Expected inflation lags actual inflation so that well-contained inflation expectations can be misleading on the process by which actual inflation picks up to later produce inflation expectations that are not contained.

STEVE AXILROD
Global Economic Consultant, and former Staff Director for Monetary and Financial Policy, Board of Governors of the Federal Reserve System



The Fed is (somewhat) behind the curve not because they've permitted the build-up of any particularly powerful inflationary pressures, though some modest pressures are in process. Rather, it is because in their anxiety to keep the economy moving ahead, the Fed has kept real short-term rates so far below the real return on capital for so long that the economic structure has developed "speculative" weak spots. These weak spots, such as housing, partly related strong consumption, and an enlarged domestic demand-driven international payments deficit, threaten to make the economy excessively sensitive to further rate increases (somewhat like the effect from the build-up of speculative stock market pressures and related excess business spending in the late 1990s). The next Chairman will probably need to make policy in the face of a more difficult short-run trade-off between price stability and growth than needed to be the case.

WILLIAM A. NISKANEN
Chairman, Cato Institute

The Fed's monetary policy is still behind the curve. Domestic demand (nominal final sales to domestic purchasers) has been growing at an annual rate of over 7 percent for two years. That is too high to maintain an inflation rate in the 2 percent range. Given an expectation of 3.5 percent real growth, demand growth must be reduced to around 5.5 percent to maintain a 2 percent inflation rate. Katrina, Rita, et al. should not change this policy. Given a steady growth of demand, these supply disruptions will temporarily increase the inflation rate and reduce the real growth rate but have no effect on long-term conditions.

The Fed's Policy Represents Perfection
(or at least as good as possible). . .

AL BROADDUS
Former President, Federal Reserve Bank of Richmond

My sense is that the FOMC has it about right. The Committee has tightened persistently, but in small steps. The economy was clearly gaining momentum before the hurricanes hit, and while the Gulf Coast area will feel their effects for some time, much of the recent data and anecdotal information suggest the impact on the overall economy will be manageable and transitory. So I don't think the Committee has tightened too aggressively. Some make the case that they've fallen behind the curve, and it's true that TIPS [Treasury Inflation-Protected Securities] breakeven inflation has accelerated a bit lately. But I don't think there's compelling evidence yet that the Fed is moving too slowly. By this process of elimination, I think things are about where they should be at this point.

ANDREW BALLS
Chief Economics Correspondent,
Financial Times

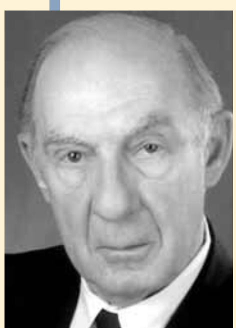
They have it about right, though probably not perfect.

GEORGE L. PERRY
Senior Fellow, Economic Studies Program, Brookings Institution

As good as possible.

BARTON BIGGS
Managing Partner, Traxis Partners

Everyone revels in disparaging Greenspan, but to me he has done a masterful job. The role of the central bank is not to prick incipient bubbles. It is unclear whether the United States is on the brink of reflation or more disinflation. Furthermore, oil, Iraq, the housing bubble, and hurricanes produce a growth uncertainty level that is unusually high. Therefore, the Fed should continue to gradually move to a "neutral" stance and keep an open mind, which seems to be what it is doing. Perfection!



"Perfection."

LYLE E. GRAMLEY
Senior Economic Adviser, Stanford Washington Research Group, and former member, Board of Governors of the Federal Reserve

RICHARD COOPER
Maurits C. Boas Professor of International Economics, Harvard University

Perfection, or about right (continued)...

ARTHUR B. LAFFER

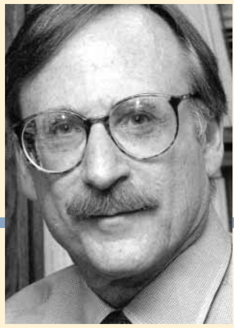
Founder and Chairman, Laffer Associates

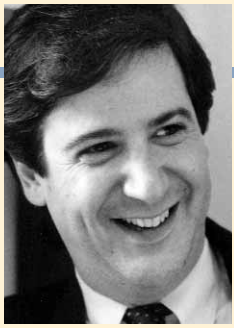
The Fed doesn't use the Federal Funds target rate as a proactive policy tool. For this they primarily use changes in the monetary base and to a far lesser extent changes in reserve requirements. The Fed has been quite tight in its control of the monetary base basically assuring the absence of inflation for as far as the eye can see.

MICHAEL BOSKIN

T. M. Friedman Professor of Economics & Hoover Institution Senior Fellow, Stanford University

The Fed has monetary policy about right. Getting the Fed funds rate back up to about 4 percent gradually was a no-brainer. From there, it should, and will, depend upon prospective core inflation and real growth.





ROBERT SHAPIRO

Chairman, Sonecon, and former Under Secretary of Commerce for Economic Affairs

Globalization often makes it harder than it used to be to judge whether the Fed is moving too early or too late, with too much force or not enough, to head off inflation. At a minimum, the rules we all learned about lags assumed that when the Fed moved, the rest of the world didn't matter much—and that's not the way monetary policy works anymore. My own best guess is that the Fed's current unenthused approach to raising rates is probably about right. Even with much higher energy prices and all that money creation, globalization, technology, and organizational changes (think Wal-Mart) have intensified competition so much that business and job creation now have to absorb most price pressures. Anyway, the real issues for inflation involve the Bush Administration's perverse preferences for fiscal recklessness and unprecedented current account deficits. Globalization and technology haven't yet rewritten the economic code which dictates that when any country runs either large budget deficits that persist, or huge and rising current account deficits that similarly persist, higher inflation follows. Unbelievably and irresponsibly, we do both today. The Fed is right to save ammunition for a day of reckoning down the road. Its only real mistake is its silence in the face of these clear (if not yet quite present) dangers.

NORMAN A. BAILEY

Senior Fellow, Potomac Foundation

I'm sorry to begin this short paragraph like a professional economist, but unfortunately I am one. All other things being equal, a year from now I believe the Fed will be seen as having managed the interest rate tightening just about right. I believe they will stop tightening in three to five months and that will put the rate at an appropriate level to balance inflationary and deflationary forces, both of which are currently present. However, the balance is shifting towards the side of inflationary expectations, so stopping the tightening now would send the wrong signal to the markets.

GARY CLYDE HUFBAUER
Reginald Jones Senior Fellow, Institute for International Economics

Right now, Fed rates are priced to perfection. But, as Dallas Fed President Richard Fisher recently implied, the only plausible direction going forward is higher, higher. There's another side to this story. To make a real start on bringing world current account imbalances into line, Europe, Japan, and many other surplus countries must *not* march up the rate ladder in lock step with the United States. Instead, they must keep central bank rates below neutral, to promote domestic growth and imports.

ULRICH RAMM
Chief Economist, Commerzbank AG

Based on what we know today, it seems the Fed has managed to bring off the difficult feat of engineering a gradual normalization of interest rates without letting inflation out of the box or strangling the expansion. However, the final verdict on this performance will have to wait. Higher inflation may yet force the Fed to turn restrictive. Imbalances related to the past period of monetary ease—such as low national saving, the housing boom, and the current account deficit—may yet turn into serious problems for the economy. As for the risks ahead, at this point it seems more likely that the Fed has been too timid rather than too aggressive in its tightening.

MURRAY WEIDENBAUM
Honorary Chairman, Weidenbaum Center on the Economy, Government, and Public Policy, Washington University in St. Louis

I hesitate to accuse any government agency of perfection. Rather, I believe the Fed will be in the ballpark. More fundamentally, the lags between monetary actions and desired results are usually shorter than for fiscal policy actions. That's key to the continued emphasis on using monetary approaches to economic policy.

And Last…

MR. JIM O'NEILL
Head of Global Economic Research, Goldman Sachs International

I am not sure whether the Fed has overshot its conduct or fallen behind the curve! If you look at the implied level of real interest rates, the past level of interest rates adjusted for inflation, gold prices, and some indications of inflationary potential, these would all suggest that the Fed is behind the curve. However, if you look at the flatness of the yield curve, the static state of the stock markets, and some signs that the housing market maybe be peaking out, you would conclude that the Fed may be close to overshooting if they continue. Part of the dilemma in answering this question is the style of policy that Chairman Greenspan has increasingly presided over, in which he responds to the latest challenge rather than within some defined forward-looking framework. Much economic analysis would suggest this would be likely to fail as a methodology for running a credible central bank but of course Greenspan has done such an incredible job.