The Fed may cut rates sooner than later

A conversation with Nobel Price winning professor Lawrence Klein and former central banker professor William Ford.

Over the last few months, each and every time we have talked to European specialists about the risks for continental markets, they have indicated an external cause, that is to say the possibility of a recession in the US brought on by excessive monetary tightening and the housing sector contraction. Accordingly, this week *TheEuropeanside* has decided to focus on this eventuality, reporting the point of view of two outstanding personalities: Nobel Prize winning professor Lawrence Klein, and professor William Ford, who, early in the '80s, was the chairman of the Federal Reserve of Atlanta and has therefore first-hand experience with the logic of monetary policy. Their verdict? The economy is below potential, but is unlikely to deteriorate into a recession. Moreover, the Fed may cut rates sooner than later.

Prof.William F. Ford

Professor William F. Ford is a former President of the Federal Reserve Bank of Atlanta, and currently holds the Weatherford Chair of Finance in the College of Business School at Middle Tennessee State University. He also served as Executive Director and Chief Economist of the American Bankers Association.

What's your appraisal of the US economy?

"It looks like a soft-landing is coming up - we hope – for all the good reasons which have been largely debated over the last few months."

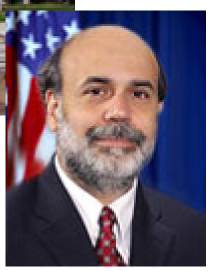
What about Fed policy?

"At the next meeting on October 24-25 the Federal Open Market Committee will probably not raise rates and may even start to think of lowering the cost of money in December or early next year, depending on what kind of data comes in."

You were a central banker yourself; do you try to associate any probabilities with those scenarios?

"Based on what we know now, I would say that

Federal Reserve Board Building

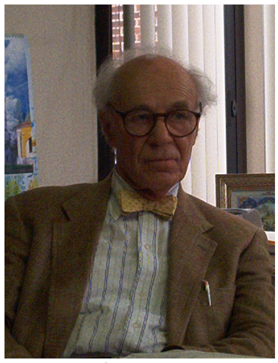


Ben Bernanke

the odds are 90% that they don't change their monetary posture in October. In December, if the economy keeps weakening, the odds of lowering the rate on federal funds go up to maybe 20-25%. And in January the odds become considerably stronger, perhaps 50%. Of course, this is true under the hypothesis that the soft tendency goes on."

Professor Klein, as far as the US economy is concerned, should we expect a soft-landing, a hard-landing or no-landing?

"My primary point is that – soft-landing or not – the average performance of the US is below potential."



Prof.Lawrence Klein

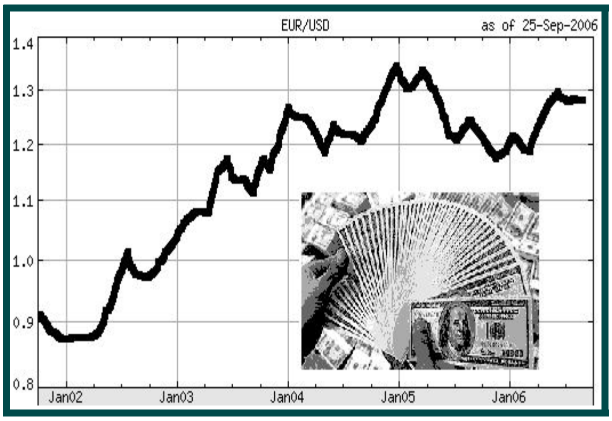
Prof. Klein graduated from the University of California (Berkeley) in 1942 and acquired a Doctor's degree at MIT in 1944. He is one of the drafters of the World Economic Development Declaration. Since 1968, he has been a professor at the University of Pennsylvania. In 1980, Prof. Klein won the Nobel Prize for Economics.

When you speak of below potential growth, what is the life span you are referring to?

"The underperformance has been going on for a while and ought to continue for another year or two."

What is the potential growth, in your opinion?

"I'd say 4% and my estimates now are for a pace between 2 and 3 percent. Do not forget that they played around with the consumer price index. I am speaking of the *hedonic adjustments* or *quality improvement adjustments*, which have lowered inflation and pushed up the GDP figures. I am a critic of the way the innovations were embodied. For instance, since the terrorist attacks many services have been reduced in quality. The most obvious case in point is airlines transportation.



The yield curve has been inverting. Any implications?

"The market is really anticipating a downturn in interest rates. Furthermore, it suggests that participants in financial markets have been gaining conviction that the Fed will keep inflation under control."

Yet, the pessimist camp argues that many recessions since the end of the Second World War have been introduced by the Federal Reserve tightening the money supply, causing an inverted yield curve to appear at some point along the line…

"Yes, most of the time it forecasts a recession, but I don't think that's necessarily true this time. First, the curve is more flat than inverted. Second, the level is low. The time when an inverted yield curve caused a recession was for instance when I was on the Board of the central bank back in 1980 and we had short-term rates as high as 15-20% and long-term rates at 12%. That was really an evilly inverted curve which carried with it the seeds of a recession."

In the present setting, figures are not so extreme, you are saying…

"We are talking basically of a flat curve around the 5% level; this is not necessarily forecasting a recession. Mortgage rates for example are still very low, say at 6% for a 30-year loan. It is slowing housing down, but should not kill it. Back in 1980 when it was 14%, it really killed housing. The current cost of money is not likely to prevent people from buying their cars or consuming in other ways."

Every professional economist seems to focus on housing.

What's your point of view?

"You know, housing starts are still at a pretty high level, up around a million and three quarters, which is historically not a bad level. And the slowdown is above all on the two costal areas. I am inclined to think that the slackening is not going to turn into a rout."

Both energy prices and long-term yields have declined substantially, relieving the pressure on the economy. Do you think this line of reasoning makes sense?

"Well, it is certainly relieving pressure on President Bush – he says, laughing – Whether oil prices are staying around 60 dollars per barrel remains to be seen. We have passed through the driving season and this reduces demand and we are not seeing any important disruptions from the main producers, which could happen any time. So it's good news for America, for our consumers, but I suspect oil prices may start to raise again."

The quality has worsened, but there have been no adjustments in the price indexes for the deterioration of quality in air travel. Thus, in my opinion, inflation and GDP figures don't quite tell the right story. This notwithstanding, if you accept the figures, the potential growth is higher than most people think."

Some claim that a 4% growth rate today would be a 3% growth rate under the old rules. Would you agree?

"Roughly speaking, yes, I would agree."

Long-term bond yields have come down over the last few weeks. What's the message?

"I am in the consensus opinion that government obligations have been responding to the housing slowdown and that people's inflationary expectations are going down. You can see this by computing the spread between the non-inflation protected bond yields and the protected yields."

Gas prices have come down, relieving the pressure on the economy

Do you think Fed policy is in line with the current state of affairs?

"It's not bad. They moved to the sidelines in two meetings. Their reasoning is that they want to drive the economy toward a soft-landing. I say that pausing is the right thing to do because growth is below potential. So our diagnoses are a little different, but the therapy is the same."

Professor Klein, you have been bearish on the prospects of the dollar for several years. What for the future?

"I think our government is doing bad things with our twin deficits, namely the fiscal and current account imbalances. Therefore the US currency will remain under pressure. There are some positive days and some negative days, but look at the trend. The trend is down for the dollar. Other countries aren't performing well, and that is the reason why the decline of the dollar does not deteriorate into a debacle. However, the persistent current account deficit and the persistent fiscal deficit exert a downward pressure on our currency over the medium-term."

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The European Side

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