

A conversation with Edward Boehne,  
former president of the Federal Reserve of Philadelphia

## Don't be surprised if US bonds rally

The central bank has succeeded in taking the "froth" out of housing and may be succeeding in containing inflation. This should help government obligations.

By Sciarretta Vincenzo

Many economists did not expect 10-year US bond yields to decline from a top of 5.25% last summer to the current level of about 4.7 per cent. On the contrary, Dr. Edward Boehne thinks that the drop was quite reasonable. And would you like to know something? Yields are likely to go down even further, conceivably reaching 4.25% in the next few months. Why? Because the economy is cooling and the outlook for inflation is improving. As far as monetary policy is concerned, the "Fed-is-done" consensus is very reasonable. And, yes, in the long-term, the path of least resistance leads to a lower dollar.

**T**he return on 10-year US bonds has come down to around 4.7 per cent. How do you judge this level and the fact that the yield curve is mildly inverted?

"What's happening here is that the markets are anticipating forward downward pressures on inflation and a weakening in

housing and may be succeeding in containing inflation. What is your view?

"Certainly the housing market is cooling and the steps are in motion for inflation to be contained, although the tendency is not entirely reflected in the current figures. As it typically happens, you need a deceleration in growth, and then, after a while, you get a diminution in the price dynamics. All in all, I believe the Fed has succeeded in doing its job."

**Are you saying the Fed is done raising interest rates?**

"Yes, I am."

**Is the central bank about to lower the rate on federal funds?**

"Probably market participants are a little bit ahead of the Fed on this, which is typical after all. In my opinion, the Federal Reserve is not yet ready to cut the cost of money and will not be at that point until, I would say, the second quarter of next year."

**Do you think it possible that the US economy reaccelerate in response to lower oil prices and declining long-term and mortgage rates?**

"I suppose it is possible, but not likely. Observers widely recognize that



economic activity. Further, the Fed's credibility on the cost of living front is fairly high and this is pushing long-term bonds on the upside. My hunch is that yields ought to decline more, say, toward 4.25% in the coming months as increasing signs of a slowing economy emerge."

**Prevailing professionals' expectations are that the slight inversion of the yield curve is not presaging a recession. Would you agree?**

"Yes, I think it is suggesting we are entering a period of below-average growth, but the curve is not inverted enough to point to a period of contraction."

**Some say the Federal Reserve has succeeded in taking the "froth" out of**

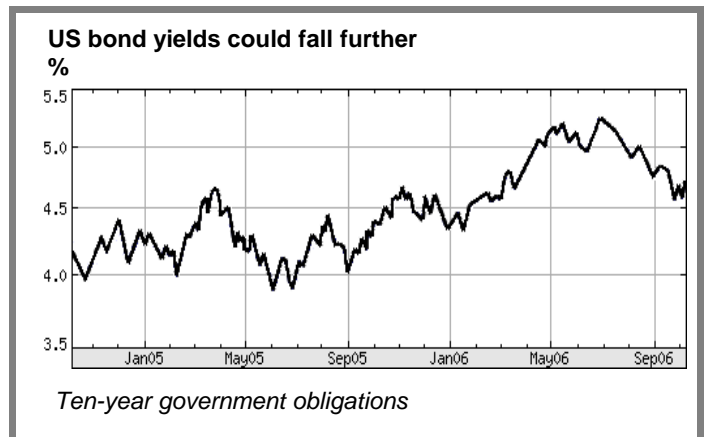
one of the main factors weakening the economy is the cooling of the housing market and the housing market is not clearly dependent on interest rates at present. It is true that borrowing is historically cheap enough for helping real estate, but what's happened here is that supply has got ahead of



Edward G. Boehne

Mr. Boehne joined the Federal Reserve Bank of Philadelphia in 1968 and subsequently was promoted to Vice President, Senior Vice President, and President and CEO in 1981. He retired from the Federal Reserve Bank in 2000. He was active in determining the nation's monetary policy as a member of the Federal Open Market Committee. He currently is a director of several corporations. Mr. Boehne is a graduate of Indiana University in Bloomington, Indiana, where he also received an M.B.A. and Ph.D. in economics.

demand. There is excess inventory. It has to be worked off. Buyers now believe that prices are likely to fall, and, accordingly, they are waiting. In conclusion, lower interest rates will not turn the housing market around."

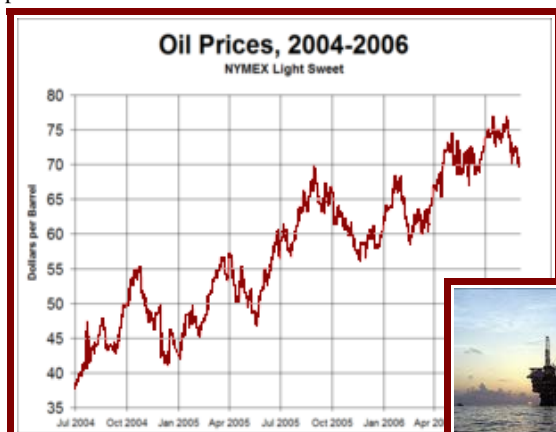




**Out of curiosity:  
Lobby of the Federal Reserve Bank of Philadelphia. The lobby features a 25 foot (7.6 m) tall tower filled with shredded U.S. currency.**

**Thus, no re-acceleration in sight?**

“I would put the probability of a re-acceleration of the US economy very low at the moment. It is a scenario for the latter part of 2007.”



**Can you summarise your general assessment of the current state of the US economy?**

“The growth rate is lessening from around 4% to possibly 2% or under. As it has been amply discussed, the housing sector is the weakest, and still deteriorating. Consumer spending is holding up, even if it shows a more moderate pace. Business investment is enjoying a good growth. Inflation remains at an elevated altitude, but, if historical patterns prevail, while the economy decelerates and the time goes on, inflation should ease.”

**The press has stressed the possibility of a consumer-led recession caused by falling home prices. Can you elaborate a little bit on this?**

“It is my contention that the influence of housing on consumer spending was probably exaggerated and declining housing prices and their influence also are exaggerated. Clearly, falling home prices have a negative effect, but the negative effect is dwarfed by the good trend in wages and salaries coupled with low unemployment. Therefore I don't see housing as a dominant factor for consumer spending.”

**Fuels have given ground noticeably. If you were still a central banker, would you indicate the drop of energy prices in your communications?**

“No, I don't think so. Crude oil has declined in reaction to two major factors: one, some compression in demand on account of a softer economy, and, second, some hedge funds pulling out of the speculative arena. However, oil prices are so volatile and hinge on so many unanticipated influences that it is largely unpredictable in the short-term. What I am saying here is that as a central banker I would not emphasize the drop in energy prices because next week they might be higher again.”

**Do you have an opinion on the prospects for the dollar?**

“Well, I am not a speculator, of course. But if you ask me whether in 3 or 5 years I see the dollar higher or lower, my answer is that it will be lower. As long as we have the kind of trade deficit we have, the forces will tend to push down the greenback.”

**Some argue that your current account deficit is the consequence of the fact that we Europeans, Asian people and people in the Middle East want to invest massively in America...**

“I am not inclined to buy this line of reasoning because, in my opinion, the single most important reason driving our deficit higher is centred on US consumption, which has been one of the strongest elements in world economic growth, attracting imports. In other words, our deficit is the result of uneven growth around the world. If we had more dynamism outside the United States, we would see the phenomenon moving into reverse gear.”

**Dr. Boehne, many thanks for our conversation.**



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