An interview with Laurence Meyer, former member of the Fed

Only a slowdown in the US

At the upcoming FOMC meeting to be held on Tuesday, August 8, market expectations are set for a pause. Uncertainty remains because the Fed could hike rates in reaction to inflation figures. However, Dr Meyer thinks that by year-end the cost of money ought to be at 5.5% (from current 5.25%).

When TheEuropeanSide interviews managers and experts about the risks of the European financial markets, we often get answers which begin illustrating the possibility that a downturn in North America engenders a contraction in Europe as well. The reasoning is sound since the huge size of the US external imbalance allows other countries to maintain a level of production well in excess of domestic consumption. If that source is aborted other outlets have to be found. TheEuropeanSide will assess the prospects for the US economy with the assistance of Dr. Meyer.

Dr. Meyer, could you kindly set out the basic framework for the US economy and monetary policy in the quarters ahead?

"We have to recognize that powerful crosscurrents are at work. Economic activity appears in the middle of a period of below-trend growth, which is likely to persist at least until the turn of the year and probably will extend into 2007. That's the prevailing expectation and the one shared by the Federal Reserve as well."

And what about inflation?

"Of course, the cost of living has been running somewhat higher in recent months. In my opinion, it should trend a little bit higher between now and the end of the year before softening. The focus of next week Fed meeting will be on these two issues…"

Namely?

"The key question for monetary policy is centred on a typical challenge: how significant and how persistent the slowdown in growth is likely to be and how persistent inflation running above the upper end of the comfort zone is likely to be. It's a challenge. The Fed is certainly close to a pause; it may be at 5.25% or at 5.5%, but we have to be aware that the Fed is facing a lot of uncertainty. Next week meeting could be one of those rare cases when the decision has not been taken well in advance."

Let's go back to the economy. The first quarter was very strong, growing at 5.6%, while the second suffered a deceleration at 2.5%. What's the trend?

"The strong first quarter was in part a rebound from the weak fourth quarter of 2005 (when the economy grew at 1.8% ed. notes). If you average the two, you may find a growth of 3.6%, or something like that and close to the underlying trend. But I do believe that the second quarter showed the signs of a fundamental slowing relative to the trend of the previous quarters and presages further below-trend quarters."

Many financial operators have been focusing on the yield curve as a predictor of growth. Since the curve is inverted, some fear a sharp slowdown or even a recession. What do you think about this? Do you fear a recession?

"Not at all. Remember that the inverted curve has not been such a good tool in the last decade or two. Back in the 70s and 80s it had a better record. But I want to stress that the rate on federal funds fluctuated at higher levels. Therefore, I would say this: if the Fed had to push the real rate as high as 6%, then we would have a recession. Instead, the current situation is consistent with a slowdown."

If it comes to a choice between a sharp slowdown and inflation, the odd are in favour of what, in you opinion?

"I can't answer in the abstract. For instance if the choice is between a recession versus inflation staying at 2.25%, then the odds are that the Fed would take the 2.25% inflation rather than a recession."

Where do you see fed funds rate by year-end?

"Probably at 5.5%."

Staff

Dr. Laurence H. Meyer

Laurence H. Meyer served as a member of the Board of Governors of the Federal Reserve from June 20, 1996 until January 31, 2002. He was widely recognized as an influential member of the Federal Open Market Committee and built a reputation for independent thinking and straight talk about monetary policy.

Dr. Meyer is a Senior Adviser to Macroeconomic Advisers .

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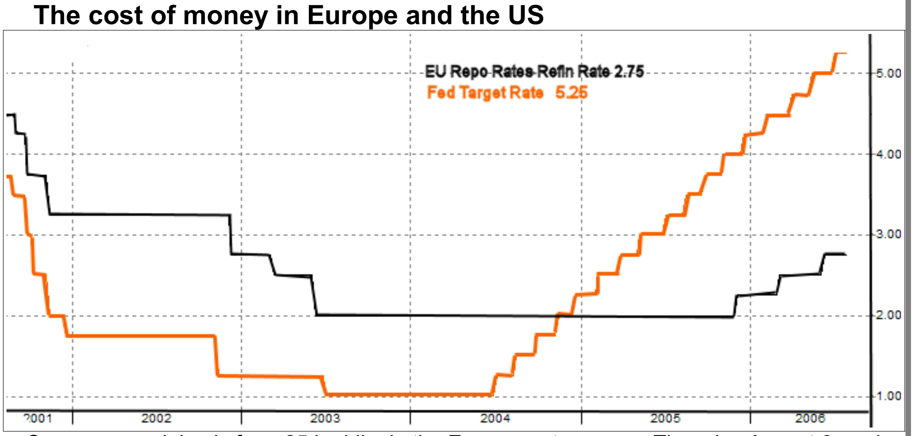
The cost of money in Europe and the US



Consensus opinion is for a 25 bp hike in the Euro-zone tomorrow, Thursday August 3, and for a pause in the US when the FOMC meets next week on August 8. In any case, the fate of the Fed meeting remains to be seen.