

Is the Fed Tight, or Not?

In the waning seconds of one of the most watched women’s college basketball games ever, a foul was called. The University of Connecticut was playing the University of Iowa in the semi-finals of the women’s NCAA championship tournament. Officials called a UConn player for an “illegal screen” on an Iowa defender, which helped Iowa win the game. This happened Friday night, and on X (formerly Twitter) the debate about this call still rages.

In spite of the debate, that game is over. On Sunday, Iowa lost to South Carolina in the finals and the world moves on. Meanwhile, in the realm of economics, a different debate rages. Is Federal Reserve policy tight, or not?

Ultimately, there is an ironclad two-part test to determine if monetary policy is tight. First, has the economy weakened to below trend growth? More clearly, is GDP falling, or unemployment rising? And second, has inflation persistently declined. If those things haven’t happened, it’s hard to argue monetary policy has been tight.

At present, we are tracking Real GDP growth at about a 2.0% annual rate in the first quarter, which is close to the long-term average. This follows all of 2023, and the last two quarters of 2022, where quarterly real economic growth was faster than 2.0% each and every quarter. At the same time, unemployment remains below 4.0%. In other words, we haven’t yet had an economic slump consistent with tight money.

For inflation – after dropping from what appears to be a supply-chain induced spike of about 9.0% in mid-2022 – CPI inflation fell to 3.1% in mid-2023. But lately, CPI inflation has stopped its decline. We estimate that consumer prices rose 0.3% in March and the Cleveland Fed’s CPI Nowcast currently projects 0.3% for April, as well. If so, the overall CPI will be up 3.3% in April versus the year prior.

So, both real growth and inflation show little impact from Fed tightening, in spite of many of the traditional measures of monetary policy signaling tightness. For example, the M2 measure of the money supply peaked in April 2022 and is down 4.3% since. We haven’t had a drop like that since the early 1930s

during the Great Depression. Yes, the monetary base is up 10.7% in the past year, but unless that base money is converted into M2, it likely has little impact. Following the 2008-09 financial crisis, quantitative easing didn’t turn into M2 and inflation remained tame...but during COVID, QE did cause M2 to spike, and inflation jumped.

Meanwhile the slope of the yield curve between the target federal funds rate and the 10-year Treasury yield has been inverted since late 2022, a typical sign of tight money. And while not as clear cut, the federal funds rate has been 2.0 percentage points, or more, above inflation in the past six months. While we would say these rates are roughly neutral, not really helping or hurting growth, this is a huge change from the 2009-2021 period, when rates were held well below inflation.

Think of it this way: imagine you’re trying to freeze water, at sea level. A thermometer shows the temperature is 25°F and the water isn’t freezing. Does this mean the laws of chemistry and physics have been repealed? Of course not! Any sensible person would think that the thermometer must be broken, or maybe the liquid you’re trying to freeze isn’t water after all.

Which brings us to one signal of monetary tightness that hasn’t been triggered yet. History suggests that interest rates should be roughly equal to “nominal” GDP growth (real GDP growth plus inflation) – a cousin to what is called the “Taylor Rule.” Nominal GDP is up 5.9% in the past year and a 6.5% annual rate in the past two years. Yet, the federal funds rate is just 5.4%. That’s not tight money! Maybe that’s the measure of tightness we should have been following all along.

In other words, maybe one of the reasons we haven’t yet experienced economic turbulence is that monetary policy hasn’t been as tight as most investors thought. If so, it could take much longer to bring inflation down to 2.0% than the Fed expects, which means short-term rates could stay much higher for much longer.

In turn, that would mean more economic pain ahead than most investors currently expect. Some calls are hard to make no matter how much time is left in the game.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
4-10 / 7:30 am	CPI – Mar	+0.3%	+0.3%		+0.4%
7:30 am	“Core” CPI – Mar	+0.3%	+0.3%		+0.4%
4-11 / 7:30 am	Initial Claims – Apr 6	215K	217K		221K
7:30 am	PPI – Mar	+0.3%	+0.2%		+0.6%
7:30 am	“Core” PPI – Mar	+0.2%	+0.3%		+0.3%
4-12 / 7:30 am	Import Prices – Mar	+0.4%	+0.3%		+0.3%
7:30 am	Export Prices – Mar	+0.3%	+0.3%		+0.8%