The Fed's interest-rate rudder isn't working

ALAN GREENSPAN, chairman of America's Federal Reserve, has often been called "the most powerful man in the world", and those who think of him this way have not been joking. He is, indeed, the mightiest of the world's central bankers, an influential group by any measure. But lately Mr Greenspan has seemed not powerful but impotent. This week the Fed under his direction raised interest rates for the tenth time since June 2004. And yet monetary policy is no tighter than it was—thanks to lower bond yields.

Central bankers are often viewed as drivers or pilots of their national economies. Commentators urge them to put their foot on the accelerator, to tap the brakes, or to aim for a soft landing. Yet in reality they have more in common with early sea-faring navigators. Like them, central bankers lack reliable maps and compasses. Because of statistical lags and huge uncertainty they do not know where the economy is today, let alone where it is heading. Some of the policy dilemmas they face (eg, whether they should try to prick a housing bubble) are the equivalent of not knowing whether the Earth is flat or round. Now on top of this, today's "navigators" have a big new problem: their interest-rate rudder appears to have jammed.

Judged by the obsession of financial analysts and newspapers with the meetings of the Fed's key policymaking committee, one would conclude that America's federal funds rate is the most important price (ie, of money) in the world. Yet it matters less than most people believe. Economies are driven by overall financial conditions, which also depend on long-term bond yields, exchange rates and share prices, none of which are controlled by the Fed. The Goldman Sachs Financial Conditions Index, which incorporates these three factors along with short-term rates, suggests that overall monetary conditions are roughly the same today as they were when the Fed started to raise rates in June 2004. Although bond yields have edged up during the past two months, they are still lower than before the Fed started to tighten—indeed, they are unusually low in real terms—offsetting the rise in short-term rates.

Long-term bond yields have more influence on America's economy than do short-term rates, not least because most Americans still have fixed-rate mortgages. Low yields are thus frustrating the Fed's effort to tighten monetary conditions. Despite the rise in short-term rates over the past year, America's GDP growth is well above trend, and although consumer prices remain tame for now, slowing productivity and a strengthening labour market could push up inflation. But the economy is unlikely to slow until the housing market cools, and that is unlikely to happen without higher bond yields.
Push harder

As a result of the international integration of capital markets, bond yields are increasingly set by global economic developments rather than just by domestic factors. But while it is convenient to blame the global bond market for America's lax financial conditions, some of the blame also lies in Washington. Ten increases in short-term interest rates may sound tough. However, the truth is that American rates are still unusually low in real terms and well below the 6% pace of nominal GDP growth. The Fed still needs to tighten financial conditions in order to put the economy on a sustainable course. If bond yields remain low, the Fed will have to raise rates by more than otherwise. Most economists interpret that as implying that the Fed will continue to lift rates by a quarter-point at each meeting, but to keep going for longer. Yet if the Fed really wants to withdraw the current monetary stimulus, it might be better to opt for a half-point rise to get there faster.

The most popular explanation for low bond yields is global excess saving. However, excessively loose monetary conditions worldwide may also be a factor (see article). Global excess liquidity (for which the Fed is partly responsible) is inflating the prices of not just shares and houses, but also of bonds. It may be time to call out the lifeboat.