

# The Huntington Economic Monitor



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## FORECAST EDITION: MONETARY STANCE IS DISINFLATIONARY

Monetary policy moved farther into the disinflationary zone in the third quarter. Policy is on track to become even more disinflationary in the quarters ahead, even if the Fed does not raise the federal funds rate target from the current level of 6.50%. The stance of monetary policy will be a restraining influence on economic activity and inflation (despite the rise in oil prices), but could boost stock valuations.

We developed a direct measure of the stance of monetary policy several years ago, based on the two-rate doctrine of economists Henry Thornton and Knut Wicksell.

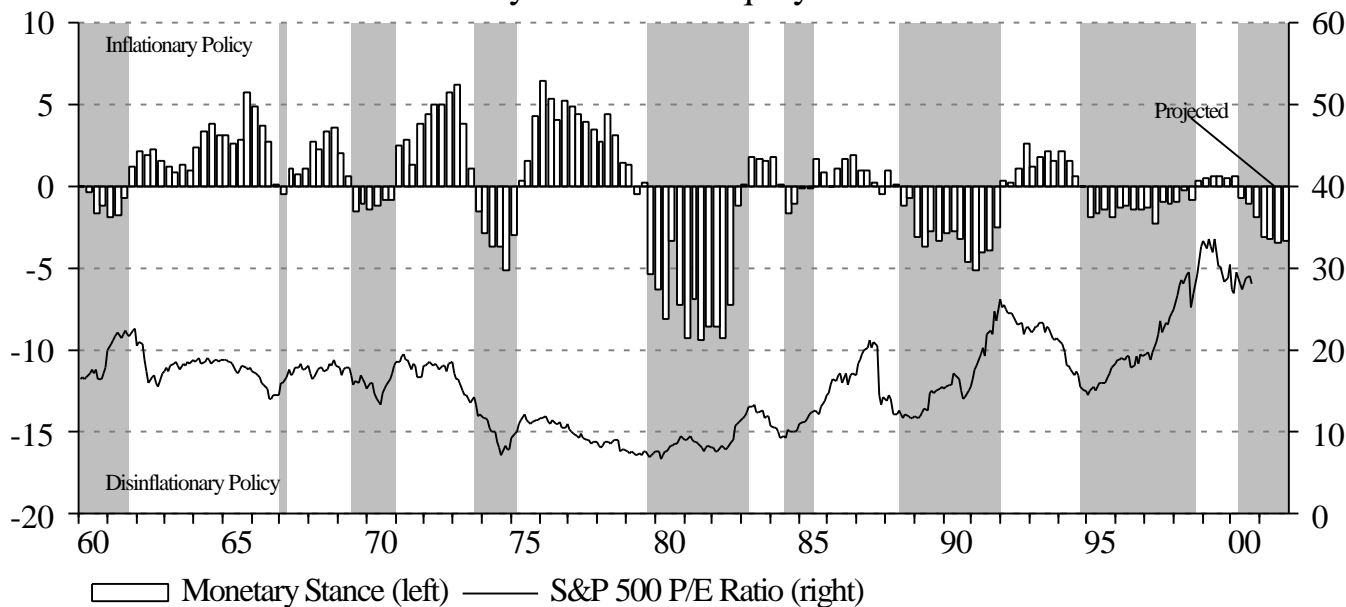
Henry Thornton undertook the first rigorous and systematic analysis of the relationship between inflation and interest rates in the early 1800s. He theorized the existence of two conceptually distinct rates of interest: the market rate that we observe and the expected yield on new capital, which can be thought of as the natural rate.

Thornton hypothesized that sustained changes in the general level of prices were caused by movements of the market interest rate below the natural rate. Such a development would ignite a cumulative expansion in credit, money, and therefore prices.

Knut Wicksell developed the theory further about a hundred years later. Wicksell viewed the market rate as the rate charged by banks on money market loans. The natural rate was the rate that would bring desired saving and desired investment into balance at full employment of the economy's resources. He thought of this as the equilibrium rate.

According to Wicksell, aggregate demand will equal aggregate supply when the market rate equals the equilibrium rate. At a market rate below equilibrium, desired investment will exceed desired saving, with the difference being financed by new bank loans that increase the supply of money and produce inflation.

Figure 1  
Monetary Stance and Equity Valuations



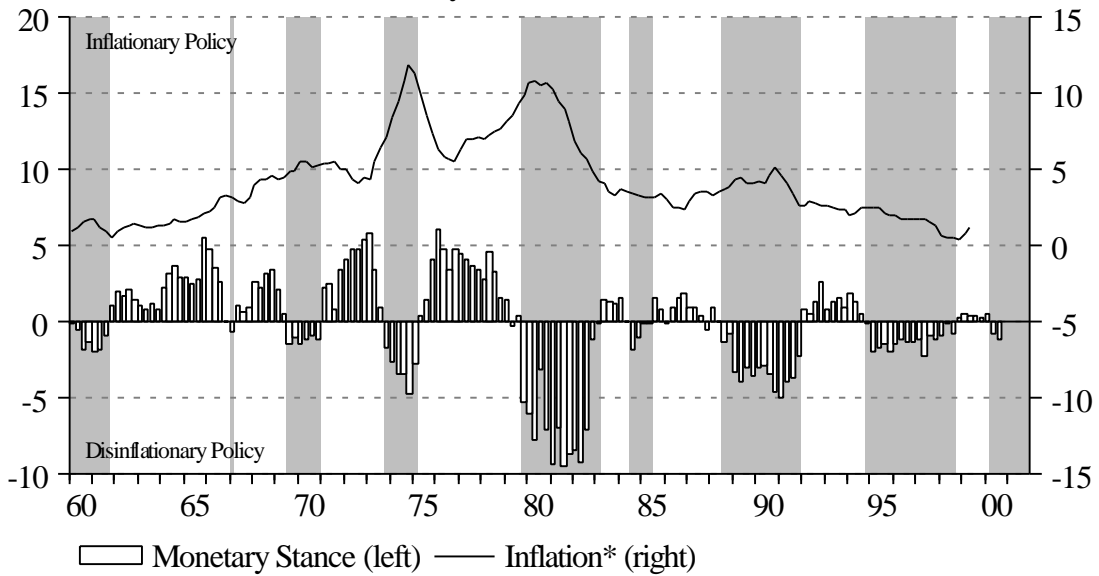
Note: Shaded areas mark periods of disinflationary monetary policy.

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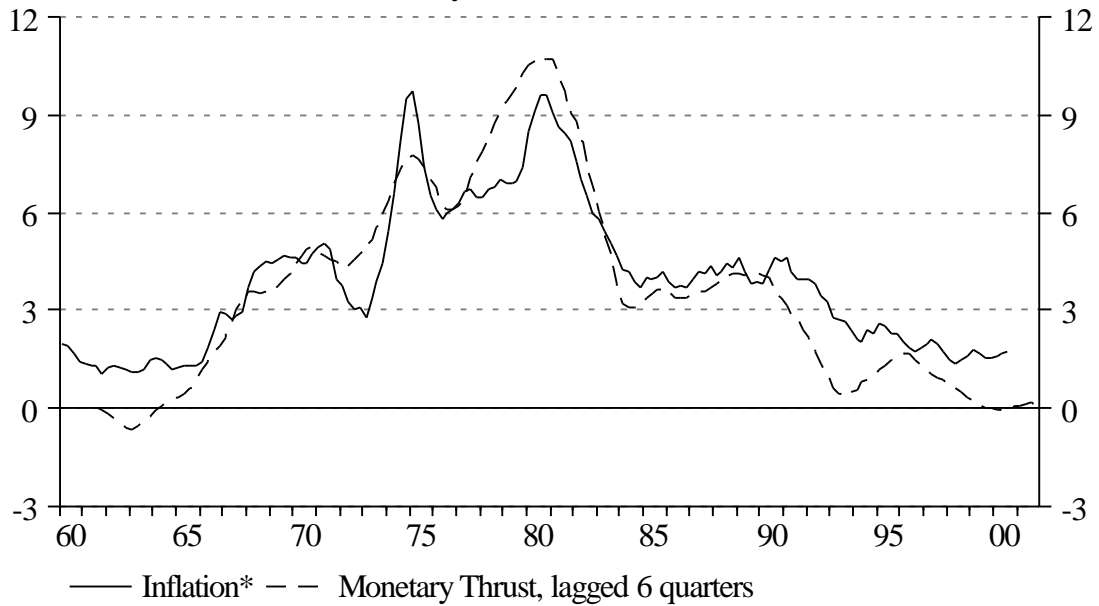
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Figure 2  
Monetary Stance and Inflation



Note: Shaded areas mark periods of disinflationary monetary policy.  
\*4-quarter % change in chain-weighted price index for gross domestic purchases.

Figure 3  
Monetary Thrust and Inflation



\*4-quarter % change in core personal consumption expenditures price index.

In Wicksell's analysis, it is the acceleration in money that causes inflation, but it is the deviation between the two rates that generates the acceleration in money. To Wicksell, then, the appropriate objective of monetary policy was to maintain the market rate as close as possible to the equilibrium rate.

Wicksell lived at a time when the general price level was probably expected to have no long term trend. Expanding the analysis to explicitly include non-zero inflation expectations demonstrates that equality between the market rate and the equilibrium rate is consistent with a continuation of the prevailing rate of change in the general price level, whether that is negative, zero, or positive. Once a sustained rise in the general price level begins, in other words, it will continue until the market rate exceeds the equilibrium rate by a sufficient amount for a long enough time.

Our measure of monetary stance is computed as the difference between an estimate of the equilibrium interest rate and the observed market rate. Policy is neutral when the difference is close to zero, inflationary when the difference is positive (market rate is below equilibrium), and disinflationary when the difference is negative (market rate is above equilibrium).

Note that the stance of monetary policy can change through either overt actions by the central bank that alter the market rate of interest or shifts in the equilibrium rate resulting from changes in economic conditions. This explains why it is possible for policy to remain inflationary (disinflationary) even when the Fed is raising (lowering) short-term interest rates. It is the difference between the market and equilibrium rates that matters, not the level or direction of change in the market rate, alone.

Stance is an instantaneous measure of the force exerted by monetary policy on the economy, expressed in percentage points. (**Figure 2**) Stance indicates the direction and magnitude of monetary policy. Positive values indicate an inflationary stance. Negative values indicate a disinflationary stance.

The thrust of monetary policy is the cumulative effect of the changing stance over time. In a given quarter, thrust is the sum of all past quarterly estimates of the stance

of monetary policy. (**Figure 3**) The estimated thrust of monetary policy in the third quarter, for example, is the sum of all quarterly estimates of the stance of monetary policy starting with the beginning of the data in 1960. In effect, thrust is the ultimate outcome of policy over time, as evidenced by its close association with observed inflation.

Based on our estimates, the stance of monetary policy was modestly inflationary during the second half of the 1980s, when inflation increased from about 3.5% to about 4.5% (using the chain-weighted price index for core personal consumption expenditures). Policy shifted significantly into disinflationary territory in 1989, where it stayed through 1991. By mid-1994, inflation decreased to 2.1%.

The Fed pushed the market rate down to an inflationary level in 1992 and 1993 as it attempted to ease problems in the banking and savings and loan industries. Despite significant increases in the market rate, policy remained inflationary until 1995 because the equilibrium rate increased as fast as the Fed raised the market rate. Based on most broad measures of consumer prices, the subsequent increase in inflation was modest, although prices of commodities increased very sharply.

Policy abruptly turned significantly disinflationary in 1995 and stayed there into 1998. (The sharpness of the reversal might have helped to limit rise in inflation from the previous period of inflationary policy.) Inflation fell from 2.6% to 1.3% by mid-1998.

Policy was just barely on the inflationary side of neutral from late 1998 to the second quarter of this year, when it turned disinflationary. In the third quarter, monetary stance became the most disinflationary it has been since the second quarter of 1997.

If the Fed were to leave the federal funds rate target at 6.50% and the behavior of the economy were to resemble the consensus forecast, policy would turn the most disinflationary it has been since 1991. From 1991 to 1994, inflation was cut in half.

Our method of gauging the stance of monetary policy is imperfect, but it is based on sound monetary theory and seems to work. The implications of recent developments are that:

- The Fed has raised short-term interest rates by more than enough to arrest and reverse any rise in the broad CPI caused by the increase in oil prices. Our forecast is for a decrease in CPI inflation to the 2.5% range by next year.
- The economic and financial market indicators that the Fed watches should show the effects of the disinflationary stance of policy in coming quarters, prompting the Fed to begin lowering the market rate. Our forecast is that the Fed will reduce the funds rate by 50 basis points to 6.00% next year, starting with a 25 basis point move at the late June meeting.

At -1.16 percentage points in Q3, our estimate of stance suggests that the current federal funds rate target is more than 100 basis points above the level consistent with stable inflation. This gives the Fed ample room to lower short-term interest rates. Whether and when they might do so, of course, will depend on policy makers' views.

- Equity valuations have tended to rise during periods of significant disinflationary monetary stance. **(Figure 1)**

Since 1960, there have been seven episodes each of disinflationary and inflationary stance. Although far from perfect, the relationship between the stance of monetary policy and the behavior of valuations has been remarkable.

In each of the seven episodes of inflationary policy, the P/E ratio decreased. In six of the seven episodes of disinflationary policy, the P/E ratio increased. The lone exception was 1973-75, when the ratio did rise toward the end of the period and perhaps had continued to fall at the beginning because of the massively inflationary policy in the previous period.

In the event that policy becomes as disinflationary as now appears possible, the S&P 500 price-to-earnings ratio could rise next year.

This conflicts with our model's projection of a 3% rise in the quarterly average of the S&P 500 price index from 00Q4-01Q4. At this time last year, the model predicted a 3% decrease in the S&P 500 for 2000. It currently looks as though the index will be approximately flat from 99Q4-00Q4. ■

Figure 4  
Real Gross Domestic Product  
Q-Q Percent Change, Annual Rate

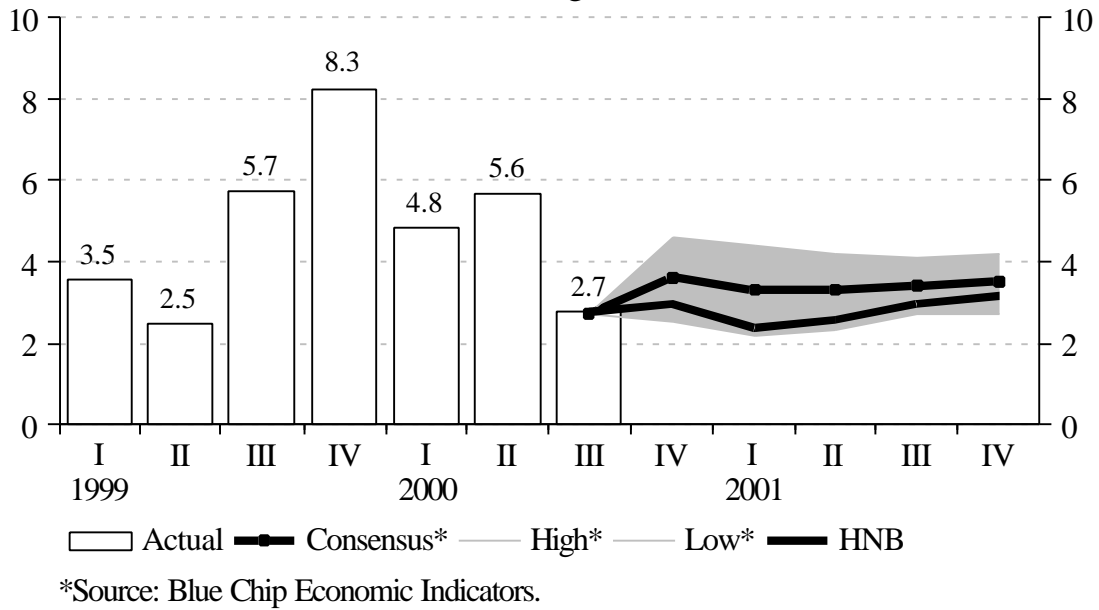
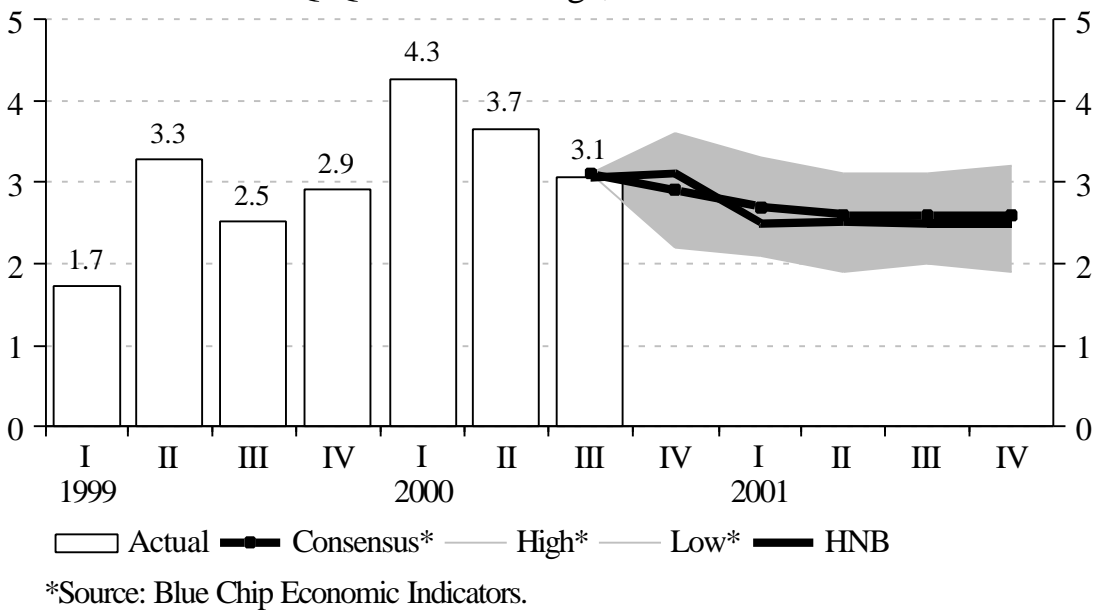


Figure 5  
Consumer Price Index  
Q-Q Percent Change, Annual Rate



**U.S. Economic Forecast**  
**October 31, 2000**

	00-I	00-II	00-III	00-IV	01-I	01-II	01-III	01-IV
REAL GDP (bln 92\$)	9191.8	9318.9	9382.2	9450.9	9506.3	9566.9	9637.5	9712.6
% change	4.8	5.6	2.7	3.0	2.4	2.6	3.0	3.2
NOMINAL GDP (bln \$)	9752.7	9946.1	10063.3	10199.8	10317.9	10442.9	10581.7	10724.2
% change	8.3	8.2	4.8	5.5	4.7	4.9	5.4	5.5
IMPLICIT PRICE DEFLATOR (Index)	106.1	106.7	107.3	107.9	108.5	109.2	109.8	110.4
% change	3.3	2.4	2.0	2.5	2.3	2.3	2.4	2.3
CONSUMER PRICE INDEX (% change)	4.3	3.6	3.1	3.1	2.5	2.5	2.5	2.5
PRODUCER PRICE INDEX (% change)	4.8	3.2	2.6	2.7	1.7	1.8	1.8	1.6
U.S. DOLLAR (FRB Index)	94.7	97.5	99.2	102.8	102.6	100.9	98.9	99.0
CORPORATE PROFITS, PRE-TAX (bln \$)	920.7	942.5	956.0	974.1	988.5	1000.0	1014.7	1033.2
% change	25.0	9.8	5.9	7.8	6.0	4.7	6.0	7.5
INDUSTRIAL PRODUCTION (% change)	6.4	8.1	2.9	3.0	2.9	2.4	2.4	2.9
CAPACITY USE (%)	81.5	82.3	82.2	81.6	81.6	81.4	81.2	81.3
TOTAL EMPLOYMENT (mln)	130.6	131.6	131.6	132.0	132.4	132.9	133.4	134.0
AVERAGE MONTHLY CHANGE (thous)	324	213	40	116	132	186	172	219
UNEMPLOYMENT RATE (%)	4.1	4.0	4.0	4.1	4.2	4.1	4.2	4.1
HOUSING STARTS (mln)	1.73	1.60	1.53	1.58	1.58	1.54	1.54	1.56
NEW HOME SALES (thous)	926	856	884	793	820	833	822	822
EXISTING HOME SALES (thous)	4803	5093	5080	4960	4925	4841	4714	4835
TOTAL MOTOR VEHICLE SALES (mln)	18.2	17.2	17.4	16.4	16.6	15.9	16.5	16.3
CONSUMER CREDIT (bln \$)	1418.9	1448.6	1480.8	1509.9	1538.9	1565.8	1590.7	1619.3
% change	10.9	8.6	9.2	8.1	7.9	7.2	6.5	7.4
C&I BUSINESS LOANS (bln \$)	1018.9	1053.7	1078.4	1099.6	1118.7	1135.1	1148.3	1162.4
% change	10.8	14.4	9.7	8.1	7.1	6.0	4.7	5.0
PRIME COMM. BANK RATE (%)	8.69	9.25	9.50	9.50	9.50	9.48	9.25	9.00
FEDERAL FUNDS RATE (%)	5.68	6.27	6.51	6.50	6.50	6.48	6.25	6.00
3-MONTH LIBOR (%)	6.11	6.61	6.70	6.77	6.61	6.60	6.49	6.52
3-MONTH T-BILL, Equiv. Bond Yield (%)	5.68	5.87	6.20	6.18	6.05	6.02	5.86	5.70
1-YEAR T-NOTE (%)	6.19	6.22	6.13	5.93	5.90	5.92	5.88	5.84
2-YEAR T-NOTE (%)	6.53	6.56	6.22	5.89	5.92	5.97	6.00	6.02
3-YEAR T-NOTE (%)	6.56	6.52	6.16	5.84	5.90	5.96	6.02	6.07
5-YEAR T-NOTE (%)	6.59	6.42	6.06	5.80	5.88	5.97	6.06	6.15
7-YEAR T-NOTE (%)	6.64	6.43	6.08	5.88	5.97	6.04	6.15	6.26
10-YEAR T-NOTE (%)	6.48	6.18	5.89	5.79	5.90	5.97	6.10	6.23
30-YEAR T-BOND (%)	6.30	5.98	5.80	5.87	5.95	6.02	6.15	6.29
BANK AUTO LOAN RATE, 48-Month (%)	8.82	9.08	9.08	8.90	8.73	8.73	8.74	8.74
MORTGAGE RATE, 30-Year Fixed (%)	8.26	8.32	8.03	7.73	7.57	7.52	7.57	7.65

Note: Data and percent changes are at seasonally adjusted annual rates, where applicable.

**U.S. Economic Forecast  
October 31, 2000**

	Annual Average			Q4 - Q4 Change		
	1999	2000	2001	1999	2000	2001
REAL GDP (bln 92\$)	8875.8	9336.0	9605.8	429.6	366.8	261.6
% change	4.2	5.2	2.9	5.0	4.0	2.8
NOMINAL GDP (bln \$)	9299.2	9990.5	10516.7	584.8	640.1	524.4
% change	5.8	7.4	5.3	6.5	6.7	5.1
IMPLICIT PRICE DEFLATOR (Index)	104.8	107.0	109.5	1.5	2.7	2.5
% change	1.5	2.1	2.3	1.5	2.6	2.3
CONSUMER PRICE INDEX (% change)	2.2	3.4	2.8	2.6	3.5	2.5
PRODUCER PRICE INDEX (% change)	1.8	3.6	2.1	2.9	3.3	1.7
U.S. DOLLAR (FRB Index)	-1.8	4.8	1.9	-0.3	10.9	-3.7
CORPORATE PROFITS, PRE-TAX (bln \$)	823.0	948.3	1009.1	128.4	103.4	59.0
% change	8.5	15.2	6.4	17.3	11.9	6.1
INDUSTRIAL PRODUCTION (% change)	3.5	5.5	3.1	4.2	5.1	2.6
CAPACITY USE (%)	80.6	81.9	81.4	0.0	0.6	-0.3
TOTAL EMPLOYMENT (mln)	128.8	131.4	133.2	2.8	2.2	2.1
AVERAGE MONTHLY CHANGE (thous)	229	173	177	nm	nm	nm
UNEMPLOYMENT RATE (%)	4.2	4.0	4.2	-0.3	0.0	0.0
HOUSING STARTS (mln)	1.68	1.61	1.56	-0.03	-0.11	-0.02
NEW HOME SALES (thous)	907	865	824	-40	-112	28
EXISTING HOME SALES (thous)	5197	4984	4829	-50	-96	-125
TOTAL MOTOR VEHICLE SALES (mln)	16.8	17.3	16.3	0.8	-0.6	-0.2
CONSUMER CREDIT (bln \$)	1352.6	1464.6	1578.7	85.0	127.3	109.4
% change	6.7	8.3	7.8	6.6	9.2	7.2
C&I BUSINESS LOANS (bln \$)	968.2	1062.6	1141.1	46.6	106.4	62.8
% change	7.0	9.8	7.4	4.9	10.7	5.7
PRIME COMM. BANK RATE (%)	7.99	9.24	9.31	0.45	1.13	-0.50
FEDERAL FUNDS RATE (%)	4.97	6.24	6.31	0.45	1.19	-0.50
3-MONTH LIBOR (%)	5.41	6.55	6.56	0.86	0.63	-0.25
3-MONTH T-BILL, Equiv. Bond Yield (%)	4.76	5.98	5.91	0.81	1.00	-0.48
1-YEAR T-NOTE (%)	5.08	6.12	5.89	1.22	0.32	-0.09
2-YEAR T-NOTE (%)	5.43	6.30	5.98	1.56	-0.05	0.13
3-YEAR T-NOTE (%)	5.48	6.27	5.99	1.59	-0.16	0.23
5-YEAR T-NOTE (%)	5.54	6.22	6.02	1.67	-0.26	0.35
7-YEAR T-NOTE (%)	5.78	6.26	6.11	1.66	-0.41	0.38
10-YEAR T-NOTE (%)	5.64	6.09	6.05	1.47	-0.35	0.44
30-YEAR T-BOND (%)	5.87	5.99	6.10	1.14	-0.38	0.42
BANK AUTO LOAN RATE, 48-Month (%)	8.46	8.97	8.74	0.06	0.22	-0.16
MORTGAGE RATE, 30-Year Fixed (%)	7.43	8.09	7.58	1.06	-0.10	-0.08

Note: Data and percent changes are at seasonally adjusted annual rates, where applicable.



<b>ECONOMIC RELEASE CALENDAR</b>				
November 6	7	8	9	10
	<ul style="list-style-type: none"> <li>• Consumer Credit (9)</li> </ul>	<ul style="list-style-type: none"> <li>• Import/Export Prices (10)</li> <li>• Challenger Report (1)</li> <li>• Wholesale Trade (9)</li> </ul>	<ul style="list-style-type: none"> <li>• Jobless Claims</li> <li>• Money Supply</li> <li>• PPI (10)</li> </ul>	
13	14	15	16	17
	<ul style="list-style-type: none"> <li>• Richmond Fed Survey (10)</li> <li>• Atlanta Fed Survey (10)</li> <li>• Retail Sales (10)</li> </ul>	<ul style="list-style-type: none"> <li>• FOMC Meeting</li> <li>• Industrial Production (10)</li> <li>• Business Inventories (9)</li> </ul>	<ul style="list-style-type: none"> <li>• Jobless Claims</li> <li>• Money Supply</li> <li>• CPI (10)</li> <li>• Phila Fed Survey (11)</li> <li>• NAHB Housing Index (10)</li> <li>• FOMC Minutes</li> </ul>	<ul style="list-style-type: none"> <li>• Housing Starts (10)</li> </ul>
20	21	22	23	24
	<ul style="list-style-type: none"> <li>• International Trade (9)</li> <li>• Treasury Budget (10)</li> </ul>		<ul style="list-style-type: none"> <li>• Jobless Claims</li> <li>• Money Supply</li> </ul>	
27	28	29	30	December 1
<ul style="list-style-type: none"> <li>• Existing Home Sales (10)</li> </ul>	<ul style="list-style-type: none"> <li>• Durable Goods Orders (10)</li> <li>• Consumer Confidence (11)</li> </ul>	<ul style="list-style-type: none"> <li>• GDP and Profits (Q3)</li> </ul>	<ul style="list-style-type: none"> <li>• Jobless Claims</li> <li>• Money Supply</li> <li>• APICS Survey (11)</li> <li>• PMAC Survey (11)</li> <li>• Help-Wanted Index (10)</li> <li>• Farm Prices (11)</li> </ul>	<ul style="list-style-type: none"> <li>• Construction Spending (10)</li> <li>• NAPM (11)</li> </ul>

Note: Announcement and meeting dates are from publicly available sources and are subject to change without notice.