Did the Fed Cut Too Much?

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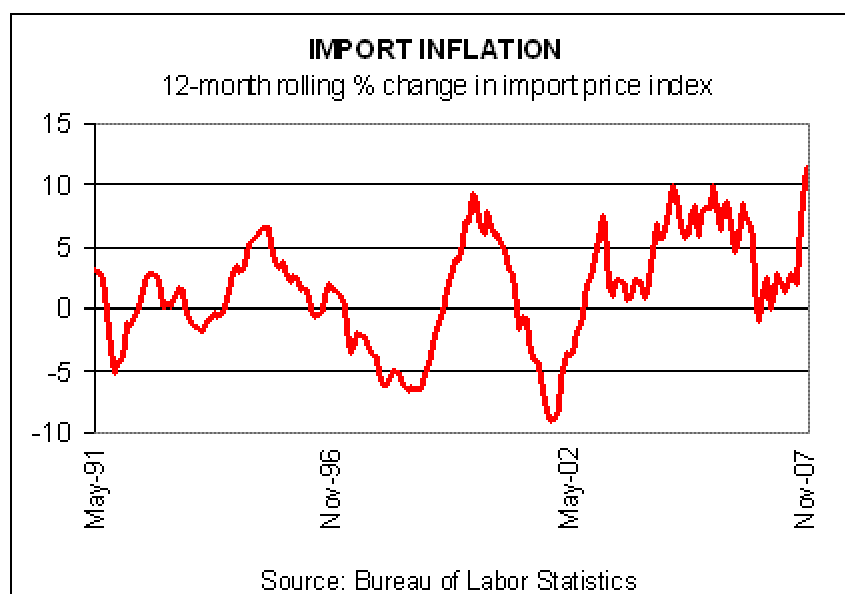
The Fed dropped interest rates on Tuesday, as expected. The 25-basis-point cut looked overly cautious in the eyes of some, but after reading Wednesday morning's report on import prices, the question is whether a 1/4-point cut is a 1/4-point too much?

Yes, there's the problem of credit crunching and a slowing economy. By that standard, the central bank is doing its job of easing the pain. But then there's the issue of the Fed's other mandate: price stability.

The subject promises to be topical today, and in the days ahead after investors digest the fact that import prices last month rose 2.7% - the largest monthly increase since 1990, the Bureau of Labor Statistics reported. That elevates the 12-month gain in the import index to an extraordinary 11.4% through the end of November. Such levels haven't been seen since the 1980s, as our chart below reveals.



Of course, we can almost hear the optimists countering that the rise was due largely to the surge in energy prices in November. Quite true, and if you exclude petroleum from the figures, import prices rose by a substantially lesser pace of 0.7% last month. Yet, the fact remains that prices paid for imports are on the rise generally, and in more than a few cases the pace is in the upper range for recent if not distant history. Indeed, a review of the various categories of imports shows that the annual pace of price increases through November is generally advancing at or above the 3.5% annual inflation rate for the U.S. consumer price index.

The U.S., in short, runs the risk of importing inflation at a higher dosage than we've seen in quite a few years. It's not a huge problem today, next week or next month. But over time, left untended, the disease will take its toll. The U.S., after all, is the world's biggest economy with a taste for imports to the tune of nearly $200 billion a month, and growing at more than 6% a year, according to the latest numbers from the Commerce Department *(pdf file)*.

It's possible that the import price problem may fade away, but don't count on it. Yes, the month-to-month numbers change with the wind. We could very well see import prices for December decline. But the larger, longer trend has been long coming, and reversing the economic forces that brought this problem aren't easily or quickly reversed.

The reasoning starts with the dollar, which has been weak relative to most of the leading foreign currencies, as the U.S. Dollar Index reminds. A weaker dollar, of course, brings higher import prices, and so to the extent that the buck continues to suffer in the forex market, import prices will stay high and/or rise.

In the short term, the great hope for temporary relief comes from oil. Although imports of crude have a large and

growing impact on the overall import price level, it's not beyond the pale to think that energy prices could fall in the short term, all the more so if the U.S. economy weakens, which would pare demand for energy and other imports at the margins. For a time. But in the long run, the U.S. will continue to import more oil, which will put pressure on the dollar, which supports higher import prices. And as far we can tell, no economist is predicting U.S. imports in non-petroleum items will decline or stay flat as a long-term proposition.

But what of the Fed? Can the central bank ride to the rescue? Perhaps, although that would require a hawkish stance for monetary policy. Alas, just the opposite is in play at the moment, and the odds of that changing any time soon look dim. And so as the Fed drops interest rates, the bearish pressure on the greenback looks set to rise.

The great squeeze play, in short, is upon us. The Fed has the thankless task of picking its poison and living with the consequences. The potential for a short-term economic boost, or inoculation against deeper trouble is one choice, and lower interest rates are the means. Defending the dollar and keeping inflation at bay is the other. The inherent conflict in the choice is always lurking, of course, but until recently the stakes have been fairly low, thanks to disinflationary winds blowing. The future, however, may not be so agreeable when it comes to monetary policy.

This article has 1 comment:

- Jeff Osterberg

04:38 PM
Fri Dec 14th
Everyone is caught in the debate about the current direction the fed should take. However, here's a question... If they are so smart why did they take the rate straight up to 5.25% before "feeling" any of the rate hike effects? Apparently, it's common knowledge that rate changes take 6-9 months to be felt in the economy. With all the extra speculation this was shielded even more until absolute chaos gripped the housing market.
I don't know about anyone else, but in my opinion (no formal economic training but the 101 class I slept through), they should have stopped at 4% and played it by ear.
My point is, if they got it so wrong on the way up, what makes anyone think they'll get it right on the way down!
What did the fed have to loose by pausing at 4%? Nothing, inflaction was incheck at that time.