FQ INSIGHT:

Where Monetary Policy Hits the Pavement: Normalization vs. Tightening

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While it is not clear, even to the Federal Reserve (the Fed), when they will begin raising interest rates, the media often refer to such a rise as "tightening" monetary policy. The Fed, on the other hand, has taken great pains to avoid the "T" word and instead uses the term "normalization." In fact, in the June 2, 2014 Economic Letter[1], the San Francisco Fed President, John C. Williams, specifically says, ". . . "normalizing" should not be confused with "tightening.""

The difference between these two words goes back to the intent of the Fed. While both policies require the Fed to raise interest rates, the purpose behind the action is quite different. "Tightening" refers to the past Fed practice of raising interest rates to slow the economy and relieve building inflationary pressures. "Normalization" means the Fed seeks to move monetary policy away from massive stimulus to a level that still promotes growth, but will not lead to inflation.

It might be helpful to think of monetary policy in the following way. The Fed drives a car that represents the US economy. The Fed steps on the gas (by lowering interest rates) to speed the economy up, but eases off the gas by tightening monetary policy so the economy does not go out of control. If the car is headed for an inflationary wall, the Fed puts on the brakes (by increasing interest rates more aggressively) to slow the economy faster or even stop and go in reverse. This commonly used metaphor assumes that steering the economy is always like driving on a paved road.

However, monetary policy in a deflationary environment can be likened to driving a car in the sand. You have to apply a lot of gas to move a small distance; but once you hit pavement, it takes less gas to go at the same speed.

Since 2008, the Fed has been driving a car in the sand, with their foot pressing the accelerator to the floor, applying massive stimulus to help the economy out of the recession, but only achieving slow growth. Most of the Fed's members now believe the US economic car is about to reach more solid ground so they can ease up on stimulus to achieve the same level of growth. If they continue pressing the stimulative pedal to the floor, the economy could careen out of control at high speed and eventually crash.

But there is a further complication. The Fed is driving in the dark. The exact location of the pavement is unknown, so they are going by the "feel" of the road beneath them. If the Fed is wrong (as they were in 1937), they could ease off the gas when the economy is still in the sand, ending momentum and possibly coming to a halt. On the other hand, the pavement could be closer than they think. The dune buggy could suddenly lurch forward and spin out of control.

As a result, the Fed has a difficult decision ahead of them. We should not think, however, that raising interest rates automatically leads to a slower economy. That is the goal of "tightening", not "normalization." If the US economy is indeed hitting the pavement, economic growth can be expected to continue. The real question is whether we are truly on firmer ground...

Endnotes

[1] "The Economic Recovery and Monetary Policy: The Road Back to Ordinary" by John C. Williams; The Federal Reserve Bank of San Francisco Economic Letters; June 2, 2014

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