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Fed Sets up for December, not September; Don Kohn's View on Rates

Friday, 3:10 p.m., EDT

A lot of Fed talk this week with some, like Bill Dudley of the New York Fed, raising the specter of a possible September increase. But I'm sticking to my guns, there won't be any increase in September, but in that meeting the FOMC will set the market up for a December increase, which I rate now as a slightly odds-on.

As readers know, last week I had the privilege of interview Federal Reserve Bank President James Bullard for one hour about his new framework for appropriate monetary policy. His research says that the equilibrium short term real rate for the funds rate is now significantly negative With a 2% Fed inflation goal, he believes the equilibrium nominal funds rate of only 63 bps, just one 25 bp hike from the Fed's current target. Bullard did not say that 63 bps is a "long-run" Fed funds rate, but the right level in the current "low-growth, high liquidity" regime which he see as lasting for at least a few years.

John Williams of the SF Fed followed Bullard by suggesting this week that if the equilibrium real rate is significantly lower, the Fed might set a higher inflation target to raise the equilibrium nominal rate and give the Fed more room to stimulate the economy if aggregate demand softens. His words imply that another Fed official believes that future interest rates, under the current inflation target, might be a lot lower than the Fed consensus.

Early this afternoon I interviewed Don Kohn, former Vice Chair of the Fed and a current member of the Brooking Institution. Don has said that his target for the funds rate has also dropped significantly in the last few years, but not as far at Bullard. Don believes a 2% target fund rate is appropriate, still far less than the 3%+ median of current FOMC members. He said he was higher than Bullard's level because he sees job creation as currently exceeding the number than can be absorbed in the economy without tightening the job market.

To be sure, Goldman Sachs this week published a report indicating that the monthly growth in jobs that keep the labor market in equilibrium (i.e., neither tightening nor loosening) is 85,000. This is less than half the level of job growth over the past two months and 100,000 less than August's estimated growth of payrolls. So unless we have an unexpected and persistent rise in the participation rate, the level of demand is too high to be consistent with current rates, forcing the Fed to raise their level. The increased uncertainty in the equilibrium real rate is apt to keep the Fed conservative in coming months.

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