US Macroeconomics

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Fed Should Proceed Cautiously with Policy Deeply Restrictive

There are two ways to measure the size of the economy. The more popular is adding up spending — consumption, investment, government — to create gross domestic product (GDP). Since one person's spending is someone else's compensation, adding up the various forms of income creates the gross domestic income series. Because the spending data are timelier than the income data, economists almost always focus on GDP rather than GDI.

In theory, **the growth rates in GDI and GDP should track one another closely**, and normally they do. However, over the past year, GDP has grown several points faster than GDI, which potentially has important implications for the economic outlook.

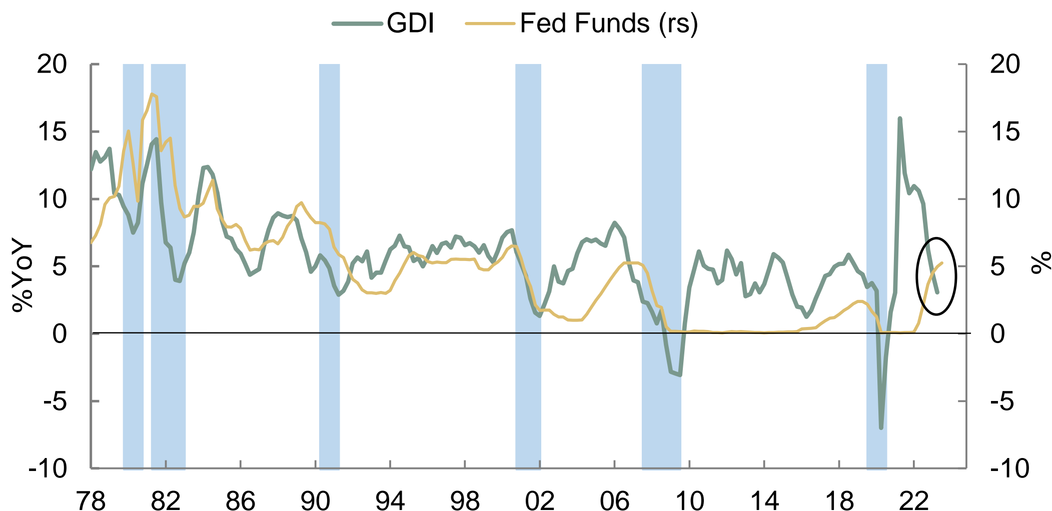
One way to measure the stance of monetary policy is to compare the level of the fed funds rate to the overall growth in nominal economic output. The funds rate represents the risk-free borrowing rate, and the nominal growth rate represents the ability of economic agents to meet interest obligations.

When the funds rate is below the year-over-year rate of nominal growth, borrowing is affordable. Households and businesses can meet their interest expenses through faster growth. But the opposite is true when the funds rate is above nominal growth. **Borrowing is unaffordable when the economy does not expand fast enough to meet rising interest expenses**. We could be at that this point now depending on the chosen measure of economic output.

At present, the fed funds rate is substantially above the growth in GDI, which is shown in the chart below. In Q2 2023, the funds rate averaged 5.0% while the year-over-year growth in GDI was just 3.1%. Excluding the pandemic, this is the largest negative gap since the deep 2008-09 downturn.

More importantly, notice how borrowing costs become prohibitively expensive before the onset of recession. The spread between GDI and fed funds turned negative in Q3 1979, Q1 1989, Q4 2000 and Q1 2007 which all occurred shortly before economic inflection points.

To be sure, the current 6.1% growth rate in GDP tells a completely different story. Monetary policy remains extremely accommodative. What should the Fed do? Given the significant discrepancy between the two measures of economic output, **it would be prudent for monetary policymakers at the Fed to proceed cautiously**. If GDP accelerates further and/or GDI recovers, the Fed could raise rates further. Patience.



Sources: BEA, FRB, Haver, SMBC Nikko

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