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Fed Mania on ZIRP

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Summary of Discussion

Chairman Yellen of the Federal Reserve Board announced on September 17th that the Fed would not move away from ZIRP (its zero interest rate policy). I suspect that the Fed believed a rise in the Fed Fund's target rate by 25 basis point would "freak out" stock and bond markets. Markets proceeded to freak out anyway on the news short-rates would not rise. Stocks plunged and bond prices shot up (yields fell). I would argue that the Fed's view on maintaining ZIRP has become a perilous mania in and of itself.

The basic problem for the Fed is that its dual legislative mandate from Humphrey-Hawkins, to maintain low inflation and full employment, is impossible for it to accomplish on its own. Fiscal policy—high tax rates and burdensome regulation—are the cause of slow real economic growth, issues monetary policy has little if any control over. Yet, as a result of the dual mandate, the Fed has been "forced" to push down and hold the Fed Funds rate at 0%, believing somehow that the desire of businesses to invest and hire will be stimulated or "encouraged" by such low rates. Yet, the Federal Reserve Board's interest rate policies have less control over the real economy than it perceives, not to mention that reaching full employment should not even be one of its mandates. Unfortunately, it is.

The Fed does have control over short-term interest rates and over the narrowly-defined monetary base and M1, and its actions and regulations can have an impact on the future price level and rate of inflation. As a result, the primary goals of Fed policy should be the following:

1. Prevent or contain panics.
2. Protect the value of the unit of account (the purchasing power of the U.S. dollar).
3. Encourage the proper pricing of credit risk.
4. Stabilize the exchange value of the U.S. dollar, to the extent this is compatible with goal #2.

Even though the Fed doesn't control employment growth, if the Fed were to successfully pursue these policies, it would at least, for its part, create conditions conducive to price stability and real economic growth.

Why doesn't the Fed have control over the levers of real economic growth? For that answer one has to go back to 1981 and the elimination of Reg Q. Reg Q limited the interest rate banks and S&L's could pay on passbook savings accounts. If the economy appeared to be overheating, the Fed could raise short-term rates above the Reg Q limits and cause disintermediation of deposits from financial institutions as depositors sought higher rates in non-bank financial instruments and funds. Lending for housing and autos would contract, and the economy would slow or head into recession. Conversely, lending would and could expand as interest rates fell and depositors re-deposited money into bank savings accounts.

With the elimination of these interest rate constraints, the Fed lost much of its control over the process of intermediation and disintermediation of financial institutions and the ability to directly impact bank lending activities. Now it takes the pain of extraordinarily high interest rates or the benefit of extraordinarily low interest rates to impact economic activity.

When panic set in in August of 2008, causing interventions by the Fed and Treasury to become the last resort for liquidity, the financial system and employment intially benefitted from TARP, QE1 and other targetted liquidity measures. Such measures did achieve goal #1 of containing the panic, but it is difficult to substantiate that subsequent attempts to lower short and long-term interest rates with programs like QE2, QE3 and "Operation Twist" added much to employment and real economic growth. It is arguable that subsequent measures actually impeded economic growth.

So how do these four goals of the Fed apply to today's economy and financial markets?

- The Fed's role in preventing panic involves both regulation such as bank rules on equity capital and reserve margins and reaction to contain a run on a bank or to establish temporary market halt triggers. This is not a mandate, however, to smooth out financial market movements and attempt to control volatility. Preventing volatility is impossible in today's world when market-moving news is distributed simultaneously to every desktop around the world. No amount of liquidity will satisfy the wave of investor decisions to buy or sell on the basis of such news that results in huge daily or intra-day swings in markets and individual securities.

- With reported inflation rate currently running at a relatively benign level, goal #2 appears to be accomplished – at least for now. If the Fed were able to keep the inflation rate at a low and stable level and also accomplish goal #4 of exchange rate stability against major trading partners, such conditions would foster economic growth simply due to the increased certainty about the outlook that businesses desire for making long-term investment decisions. Yet exchange rate stability is extremely difficult to achieve from unilateral Fed action—it took Bretton Woods to accomplish it, whereas the Fed has much greater control over the general purchasing power of the U.S. dollar.

- What the Fed should do that it has so far failed to is to facilitate the proper pricing of credit risk (goal #3). This function isn't the support of any particular level of net interest margin for banks or credit spreads. The spread is far less important than is the level of rates to the proper pricing of credit risk. If deposits cost 0% and loans can be made at 3%, this spread does not have the same economic impact as if deposits cost 3% and loans can be made at 6%. The difference is significant because low absolute yields that are deliberately suppressed by Fed actions lead to the subsidization of the borrower at the expense of the lender. It's part of that old economic rule – *If you subsidize an economic activity, you get more of it; if you tax it or heavily regulate it, you get less of it*. Low absolute yields subsidize financial risk taking and other forms of leverage for risky real investments (like excessive investment in production of commodities) as well as subsidize profligate federal government spending with artifically cheap credit. It further encourages too much corporate borrowing as subsidized yields are too attractive to pass up for corporations to lever up and buy back stock.

But that's just the borrower side of the equation. There's another mathematical identity at work – *One borrower's interest expense is someone else's interest income.* Low absolute yields and negative real yields each penalize lenders and savers. If banks, insurance companies, pension plans, retirees, savers, and moneymarket funds can't earn a decent return on short-term investments due to subsidized low yields, they either live with lower earnings and consumption, in the case of retirees, or take more risk to reach for yield. The result is again the artificial and ultimately unsustainable compression of quality risk spreads and the allocation of too much investment to inappropriately high-risk investments. The Fed increases the risk of the next financial crisis by pursuing policies that distort normal market function of allocating credit risk.

So if Chairman Yellen and the voting Fed governors had begun the process of restoring the normal pricing of credit risk by raising short-term rates by 25 basis points, would we have seen the opposite effect on stocks and bonds? The answer, perhaps counter-intuitively given recent precedents, is likely to be "Yes." **Historically there is a clear cut contemporaneous relationship between rising rates and rising economic activity, not an inverse correlation**. It should take quite a few quarter-point rate increases to begin to have any negative impact on Main Street or Wall Street, even if bond markets do in fact temporarily freak out.

Yet there's another aspect to why the Fed should not sit pat waiting for more "data" before beginning to normalize rates. Real interest rates, the difference between the nominal T-bill rate and the expected rate of inflation, should not be negative, even with today's benign inflation rate and even if low yields help the federal government fund its deficits. Monetary policy can't solve current long-term structural problems, but restoring a positive real short-term interest rate of at least 50 basis points would at least be a step in the right direction. All of the Fed's near-term increases in short-term interest rates are likely to come in the form of real interest rate increases. Higher real interest rates are "good" for economic growth and are historically associated with attractive stock returns. For example, real rates hit their highest level in the late 1990s as both the economy and the stock market boomed. Today's suppression of real interest rates suppresses the incentive to make real, non-financial investments. Letting real interest rates rise would be consistent with a rise in return on investment in the real economy. The Fed has the problem backwards in suppressing rates in order to stimulate investment in the real economy. It's time to restore positive real interest rates to the short-end of the yield curve and end the Fed's ZIRP factor holding back the real economy.
