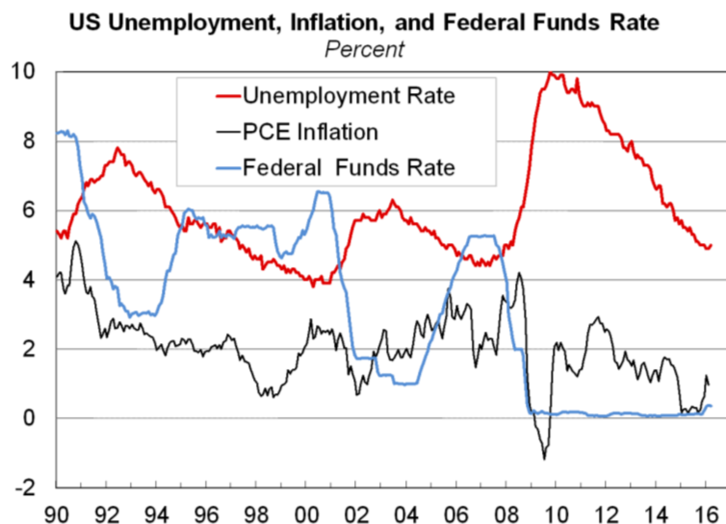
Current Economic Conditions

Robert C. Fry, Jr., Ph.D. April 18, 2016

I'M TIRED OF DEFENDING THE FED

Over the years, several of my friends and former colleagues have taken me to task for not being tougher on the Federal Reserve. In email exchanges with them, I've defended the Fed against attacks that I thought were motivated more by a Jeffersonian/Jacksonian hatred of central banks or by support for a gold standard than by any objection to the Fed's monetary policies. I've also defended the members of the Federal Open Market Committee and economists at the Fed against attacks on their motivations; I don't think they're bad people. I still support the existence of a central bank, and I don't think a gold standard will work in a world where more than a few countries are experiencing economic growth, but I think I need to make it clear that I have serious problems with the monetary policy of the last several years.

Most criticisms of monetary policy center on the current low level of interest rates. The Fed held its target for the Federal Funds Rate in a range of 0-0.25% from December 2008 to December 2015 before raising it by a quarter point to the current level. The Fed followed this Zero Interest Rate Policy (ZIRP) in an effort to return the economy to full employment and get inflation up to the Fed's 2% target. The headline unemployment rate has fallen to a level the Fed deems consistent with full employment, but inflation remains below the Fed's target. If the Fed were concerned only with U.S. economic conditions, it probably would have raised interest rates further, but concerns about slow growth abroad, especially in emerging markets, and about a strong dollar and its impact on U.S. net exports have delayed further rate hikes.



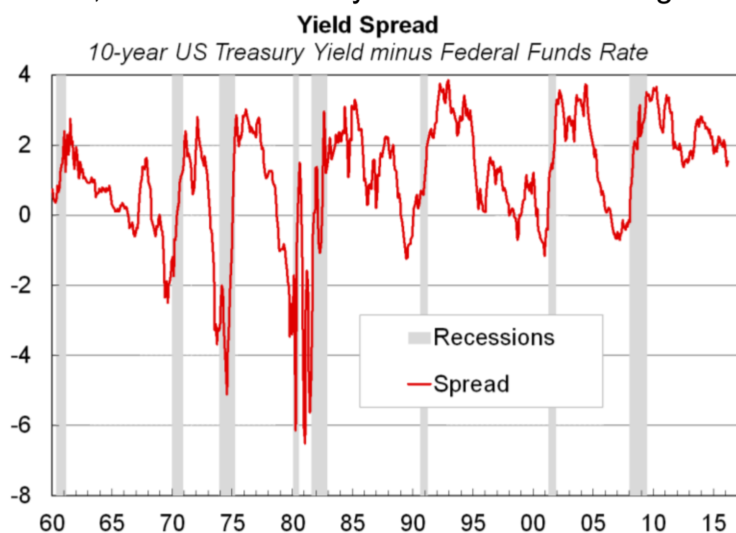
Other criticisms of monetary policy have focused on three rounds of "quantitative easing" (QE), the purchase of long-term treasury securities to put downward pressure on long-term bond yields. QE has resulted in a massive increase in bank reserves and in the monetary base, which can be thought of as the raw material that banks use to create money. Critics of QE call the expansion of bank reserves "money printing" (even though it's done electronically now) and claim it will lead to inflation, but as long as banks hold the reserves as excess reserves instead of using them to support lending, the money supply won't grow and inflation (and growth) won't accelerate. Money-supply growth has not accelerated significantly.

The Fed has also used "forward guidance" to hold down long-term interest rates and bond yields. Since long-term interest rates can be thought of as a (geometric) average of expected future short-term interest rates (plus a risk premium), promising to keep short-term rates low in the future holds down long-term interest rates. I actually object more strongly to forward guidance than to ZIRP or QE. Promising to keep interest rates lower for longer encourages potential borrowers/homebuyers/investors to sit on the fence and wait. If the Fed had instead allowed fears that rates might rise, potential borrowers might have been more inclined to pull the trigger, and home sales and housing starts would have been higher. But

the Fed shouldn't promulgate fears of higher rates. When Fed officials suggested in late 2015 and early 2016 that there might be four interest rate hikes in 2016, U.S. stock prices fell by more than 10%. Reducing uncertainty about interest rates might help Wall Street banks make money, but it's **not** good for the economy. When I was in graduate school, "rational expectations" was the big thing in macroeconomics. In simple rational expectations models, only unanticipated monetary policy matters; if a central bank wants to either stimulate growth or slow inflation, it has to surprise the economy. In the real world, anticipated monetary policy matters, but I believe that unanticipated monetary policy matters more. Fed policies that have failed to stimulate growth and boost inflation wouldn't have been so impotent if they hadn't been telegraphed. Monetary policy would be more effective if Fed officials would stop giving speeches!

ZIRP, QE, and forward guidance are the result of mistaken assumptions about the economy. First, the Fed significantly overestimates the impact of interest rates on the economy. Thirty-one years as a real-world economist have convinced me that except for housing, autos, and perhaps small privately held businesses, interest rates have essentially no impact on investment and consumer spending. Investment by large publicly traded companies is especially insensitive to interest rates. If low interest rates reduce the interest income of (older) people who keep most of their wealth in savings accounts and certificates of deposit, low interest rates can even **slow** the economy. An economist I know has done research that finds that because of the aging of the population, lower interest rates are now contractionary in Italy.

The Fed especially overstates the impact of long-term interest rates on the economy. Textbook models imply that companies fund long-term investments with long-term bonds. That makes economic sense, but it isn't the way the world works. Big companies fund investments with retained earnings; they issue debt mostly because interest is tax-deductible and dividends aren't. Small companies borrow at the prime rate (or prime-plus), which is tied to the Federal Funds Rate, the ultimate short-term rate. Even in the housing market, where many homebuyers still use 30-year fixed mortgages, short-term rates matter much more than long-term rates. The **marginal** homebuyer, the one on the edge of being able to afford a home, uses an Adjustable Rate Mortgage, which is tied to a short-term rate like LIBOR or the yield on one-year Treasury bills. Economic forecasters have long known that an inverted yield curve (short rates above long rates) is a signal of an impending recession while a steep yield curve (long rates well above short rates) is a leading indicator of growth. That wouldn't be the case if economic growth weren't more sensitive to short-term interest rates than to long-term rates. Long-term interest rates matter for stock valuations; they have very little impact on the real economy.



The Fed also errs in setting its inflation target at 2%. For those of us with defined-benefit pensions not indexed for inflation, an inflation target above zero is tantamount to theft. (I think this is the real reason my retired former colleagues hate the Fed!) Perhaps worse yet, trying to push inflation up to 2% in today's economy is likely to set off a series of harmful asset bubbles long before inflation reaches the Fed's target.

To the extent the Fed's monetary policies have boosted stock prices, they have enriched financially-astute people who already own stocks at the expense of younger people who want to buy them and less-financially-astute older people who have their wealth in bank accounts rather than stocks. The latter have been devastated by the Fed's policies. This redistribution of income has boosted the populist candidacies of Bernie Sanders and Donald Trump. The Fed needs to realize that it is the central bank of the United States of America, not just of financially-astute investors and financial institutions in lower Manhattan.

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