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Interest-Rate Outlook

Harmful interest rate risk – A modest proposal

*by Joe Cobb**

Consumer Business Compass reports that 88 percent of the business leaders interviewed say interest rates are the primary risk they worry about. This was up from 80 percent in 2014. The category is "Top Spot on Economic Risks List."[1]

Under our system of central bank control of the monetary base and tight regulation of commercial banks, the entire spectrum of financial interest rate opportunities is focused on the Federal Open Market Committee and its periodic meetings. So much discussion on a single factor cannot be a good way to run economic policy. Retailers as well as traders and producers of tangible goods and services are influenced by interest rates and uncertainty is not welcome.

Indeed, there is every reason to think that monetary-policy uncertainty is a significant killer of growth. We can actually quantify a sensitive relationship between interest-rate volatility and subsequent growth in real GDP.[2] Figure One is a chart based on work at HCWE originally published many years ago.

Reading the gossip about the Fed's March meeting, the minutes of which were released in early April, everyone was just *hypnotized* about "when" the central planners will make a critical decision that will affect everyone's fortunes for the next three years. Uncertainty is a big bad policy choice, but nobody who reads the *Wall Street Journal* would ever believe it could be possible for the Fed to declare *never* to raise rates, because its whole reason for being is to centrally plan rates and bail out the payments system.

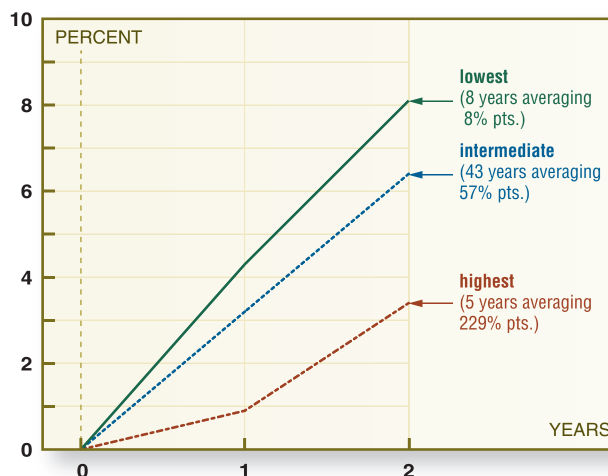
> **A fixed interest-rate rule would eliminate uncertainty surrounding "when" interest rates would begin to rise.**

The Fed is like a church and the Federal Open Market Committee (FOMC) is like a College of Cardinals or governing cabinet of the monetary authority. We avidly follow any news about the Fed for the same reason we would follow any news about President Obama (war/peace) or fire in a house next door. They are all imminent threats to our safety and peace of mind. Thank you, Woodrow Wilson, for giving us central planning for our financial markets. How's that working out? I think about as well as it worked in Russia, East Germany, or Cambodia.

Figure One

Fed-funds Rate Variability and US Real GDP Growth

calendar-year average data from 1956



Data: Calendar-year totals of real gross domestic product (Bureau of Economic Analysis) and calendar-year standard deviations of monthly change in the fed-funds rate.

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1. Consumer Practice Leaders, *2015 BDO Retail Risk Factor Report*, BDO USA, May 28, 2015 at http://blog.bdo.com/index.php/2015/05/28/infographic-2015-retail-riskfactor-report/.
2. See "Would the US be better off without monetary policy?" *Interest-Rate Outlook*, HCWE Inc., October 22, 2013, p.2.

Central planning was a fad that infected the intellectuals of Europe and the US eastern establishment in the 1890-1914 era that led to the establishment of the Federal Reserve. It could even go back to the role for a central bank discussed by Walter Bagehot in *Lombard Street* (1873), who developed the "lender of last resort" argument. Look at the classic literature of the time, such as Edward Bellamy's *Looking Backward* (1888), the third all-time best seller in America, just after *Uncle Tom's Cabin*. Bellamy showed how the benefits of central government economic planning would make everyone happy and prosperous by the year 2000. If you have not read it, do not bother.

The infection, of course, got much worse through the 1920s-30s-40s. But it was really Roy Harrod in the UK and Alvin Hansen at Harvard who pushed the idea of central planning through fiscal policy, with John Hicks' IS-LM model (1937). That was when interest rate manipulation as a macroeconomic tool really came into the mainstream. How to get rid of it? You cannot because it is a religion.

The Keynesian (Neo-Classical-Synthesis) model relies on an exogenous concept of "the money supply." I am thinking that is a flaw in the model, since everything in the payments system today is a variant of credit.

Central planning did not actually come along until after the FOMC act amending the Federal Reserve Act in 1933. According to Benjamin Anderson, the Fed did not even understand how its bond buying in the 1920s was leading to money supply increases, but it figured it out right after the 1921 depression.[3] In the days before 1933, each Fed district bank had its own bond-buying program. Milton Friedman pointed out that the Fed banks followed different bank lending policies after the 1929-30 crashes and the FOMC was intended to centralize that. It was in about 1935 that Congress phased out and stopped allowing the Treasury to issue the special series of bonds to National Banks, which they needed to buy and hold as reserves in order to issue their own currency notes.

Milton Friedman and before him Henry Simons were advocates of "rules" not "discretion" at the Fed, but of course Friedman's rule fell apart when financial services became deregulated, beginning in the late 1970s. With the 2006 amendment to the Federal Reserve Act allowing payment of interest on reserves, a bank's opportunity cost of funds is determined by the Fed. In essence, today the U.S. banking system has achieved the old "Chicago School" idea from the 1930s of a 100% reserve "run-free" banking system: It is called Quantitative Easing. If Prof. Friedman were alive today, I believe he would be advocating a rule for monetary policy that keeps interest rates stable.

Thank you Woodrow Wilson, for giving us central planning for our financial markets. How's that working out?

Central bank policy has lost its direction. We hear some theories about unemployment rates and growth rates in nominal gross domestic product, but nothing timely and nothing that points to movement of interest rates in the near future. Why is there such uncertainty? As suggested by Figure One, US economic growth is affected by interest rate uncertainty. Investment in tangible plant and equipment is particularly susceptible. Policy makers are worried, we are told, about low growth rates, but it is not clear macroeconomic policy has much to offer. Nobody will believe the FOMC has finally found the magic method to keep price stability "stable" and live with very low (nominal) interest rates.

Milton Friedman used to teach that if a rule fixed the rate of increase in the monetary base, everything would settle down and the real economy could avoid major business cycles. During the period he studied, floating exchange rates were not common and international capital markets were not efficient. His measurement of the appropriate "monetary base" does not apply with the same fixed parameters as his 1867-1960 studies showed, but the principle is the same.

In this short essay, I want to propose a new, modest Fixed Rule for the Federal Open Market Committee to adopt and follow as consistently as possible. During the early days of the "Chicago School" from which Milton Friedman emerged, Henry Simons had been an advocate of a fixed monetary rule, as opposed to the "omniscient" method preferred by Keynesians. My modest proposal for a fixed interest rate rule for the FOMC and the whole payments system is the same. A fixed interest-rate rule would say that every month at a fixed time the interest rate the Federal Reserve will pay on the reserves held on behalf of banks will increase by a fixed amount. Every month, for example, the fixed rule could be an increase of 10 basis points. The claim here is that this fixed rule would eliminate uncertainty surrounding "when" interest rates would begin to rise (and whether they would ever be targeted below zero).

So the interest rate paid by the central bank for reserves on deposit will begin to increase by 10 basis points every month on a set day at midnight in Washington and New York. It will continue to increase at this fixed rate until such time as the FOMC decides it should stop and hold steady, based on "economic conditions." This should bring more certainty and reduce uncertainty for a few years.

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3. James Grant has a great new book about that depression, *The Forgotten Depression: 1921, The Crash that Cured Itself*. See also Benjamin Anderson, *Economics and the Public Welfare: A Financial and Economic History of the United States, 1914-1946* (1949).

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