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Perma-ZIRP: Why the Fed Won't "Normalize" Rates in Our Lifetime

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If "normal" means average, let's begin with the fact that the Fed Funds rate averaged 5.90% in the half-century before the Fed adopted its "unorthodox" ZIRP ("zero-interest-rate policy") in December 2008. In our judgment, not only will the Fed Funds rate not come *close* to averaging 5.90% over the *next* fifty years, it won't even reach that *level*. As we surmised in 2010[1], it's likely that the Fed will keep mimicking the low-rate policy launched by the Bank of Japan in March 1999 and keep the Fed Funds rate below 3% *indefinitely*. The policy rate in Japan has been below 3% for more than two decades now (averaging just 0.36% since February 1993) and it too won't rise much in the coming decades.

Table One

U.S. Treasury Yields As Markets Discount Fed Rate-Hiking

June 2013 - March 2015

Date	FF Rate Actual	Futures Market Estimate of the Fed Funds Rate: for Dec 2015	Futures Market Estimate of the Fed Funds Rate: Change	U.S. Treasury Yields: 1-yr. Note	U.S. Treasury Yields: 10-yr. Bond
3/20/14	0.08	0.81	0.73	0.14	2.79
9/20/14	0.09	0.78	0.69	0.10	2.57
3/20/15	0.12	0.45	0.33	0.24	1.93

For three main reasons the Fed won't normalize its policy rate in our lifetime: 1) it believes that doing so will hurt the economy (a falsehood[2]), 2) it worries that higher interest rates on an ever-rising national debt will increase budgetary interest expense, widen the deficit, and further increase the debt (a truth[3]), and 3) for political reasons it much prefers a policy of financial repression (another truth[4]). There's also a good chance that over the next decade another financial crisis or recession will occur in the U.S. and/or abroad, which would give Fed officials a ready excuse to further delay any material rate-raising.

After its latest meeting (March 18th) the FOMC removed language about being "patient" before it would resume rate-hiking, but that doesn't mean it's now "impatient" or eager to raises rates. The language from the FOMC's previous meeting (January 28th) was as follows: "Based on its current assessment, the FOMC judges that it can be patient in beginning to normalize the stance of monetary policy. . . . In determining how long to maintain this target range, the Committee will assess progress--both realized and expected—toward its objectives of maximum employment and 2% inflation."[5] In contrast, the language from the March 18th meeting is thus: "In determining how long to maintain this target range [a near-zero Fed Funds rate], the FOMC will assess progress – both realized and expected – toward its objectives of maximum employment and 2% inflation. . . . The FOMC judges that an increase in the target range for the federal funds rate remains unlikely at its April meeting. The FOMC anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen further improvement in the labor market and is

[1] "Fed Policy Mirrors the Bank of Japan – and Thus Depresses T-Bond Yields," *Investment Focus*, August 20, 2010.
[2] "U.S. Equity and Economy Performance Amid Fed Rate-Hiking," *Investment Focus*, January 5, 2015.
[3] See Douglas Elmendorf, "How Different Future Interest Rates Would Affect Budget Deficits," Congressional Budget Office, March 27, 2013 (http://www.cbo.gov/publication/44024) and Dean Baker, "The Budgetary Implications of Higher Federal Reserve Board Interest Rates," Center for Economic Policy Research, March 2015 (http://www.cepr.net/documents/budgetary-implications-higher-fed-rates-2015-03.pdf).
[4] "Financial Repression: Political Causes & Investment Effects," *Investment Focus*, May 7, 2013. "Financial repression" describes those set of policies whereby a fiscally-reckless government co-opts and/or compels the private sector and/or the central bank to facilitate and finance its deficit-spending schemes at the lowest possible cost (*i.e.*, a cost which would be much higher were the private sector or central bank fully free to avoid financial entanglements with the government).
[5] See http://www.federalreserve.gov/newsevents/press/monetary/20150128a.htm.

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reasonably confident that inflation will move back to its 2% objective over the medium term. This change in the forward guidance does not indicate that the FOMC has decided on the timing of the initial increase in the target range."[6] Upon hearing this announcement, the Fed Funds futures market reduced its estimate of the likely level of the Fed's policy rate over the coming few years, with a reduction of 30 basis points in the estimate for December 2016 (from 1.39% to 1.19%). Table One (page 1) shows how ever-lower estimates of future Fed rate hikes (*i.e.*, expectations of a "perma-ZIRP") tend to *anchor* longer-term U.S. T-Bond yields (even as U.S. public leverage keeps *rising*); a ZIRP makes it profitable, of course, to *borrow short and lend long* on a steeply-sloped curve.

Much like the Bank of Japan in recent decades, the Federal Reserve has become a political whore, accommodating whatever demands are made upon it by a fiscally-promiscuous government.

For a few more years the FOMC also will have a plausible excuse to avoid material rate hiking: low inflation. The first part of its "dual mandate" may justify rate-hiking (the U.S. jobless rate is now 5.5%, down from a peak of 10% in October 2009), but the second part of the mandate does not: the CPI rate has been -0.1% in the year through February, versus +1.6% in the prior-year period, so "headline" inflation is actually *decelerating* (due only partly to the falling oil price, itself the function of an appreciating dollar. The FOMC also monitors a more timely and accurate inflation rate, based on Personal Consumption Expenditures (PCE), but that's even lower (-2.3% for all items in the year through January and +1.3% for the series items ex-food and energy). No FOMC member now foresees a PCE rate above 2.5%; to raise its policy rate in 2015-2016, the FOMC would have to violate the second part of its "dual mandate." Monetarist analysts keep wondering, of course, why a prolonged resort to such "loose" monetary policies as ZIRP or QE doesn't bring higher inflation rates; the main reason is that the demand for money balances (in the extreme, *hoarding*) is usually *high* when interest rates (the opportunity cost of holding cash) are held so *low*.[7]

In fact, a triple mandate. Rarely reported or discussed publically among Fed-watchers is the fact that the Federal Reserve Act (1913, as amended by the Federal Reserve Reform Act of 1977) imposes on the FOMC not a "dual mandate" but rather a *triple* mandate, or set of *goals*. Section 2A requires that the Fed maintain policies consistent "with the economy's long-run potential to increase production, so as to promote effectively the goals of *maximum employment*, *stable prices*, and *moderate long-term interest rates*."[8] This latter mandate is rarely mentioned – and of course Congress doesn't press the Fed to meet it – but obviously it's been violated whenever Fed policy has encouraged *immoderate* T-Bond yields (*i.e.*, when yields have been much too high or much too low). The U.S. 10-year T-Bond yield has averaged 6.7% over the past 50 years, but *immoderately more so* in the seven years of 1979-1985 (11.7%) and *immoderately less so* over the past seven years of 2009-2015 (2.8%).

The latest episode of bond-yield immoderation – amid what some have called "unorthodox" Fed policy – reflects not merely the Great Recession (2007-2009) and the Keynesian hope that low interest rates might boost the economy. The root of this immoderation goes far deeper. The main reason the Fed won't normalize raise rates in our lifetime is the same reason the Bank of Japan (BoJ) hasn't done so since 1993 and won't do so in our lifetime: public debts by now have become so damn high (it is feared) that a rise in interest rates would make budgetary interest expense more onerous, and crowd out more popular government spending.

Eternal stagnation. From the perspective of the supply-side (which policymakers ignore), a ZIRP is *depressive*—on rewards to lending, risk-taking, and entrepreneurialism; a vicious circle develops when, amid the stagnation, central banks keep *extending* rather than *ending* the ZIRP.

For more than two decades in Japan, the BoJ has gifted record-low policy rates and bond yields to the government in Tokyo, which in turn has only *increased* its leverage (public debt/GDP), from 60% to 275%. The BoJ became entrapped willingly: by now it can't raise its policy rate (hence bond yields) without incurring the wrath of budget hawks in the Parliament. The BoJ long ago lost its independence, if it ever had any; it's become a political whore, accommodating the whims of a fiscally-promiscuous state, while its ZIRP precludes real rewards for risk-taking. Slowly but surely, the U.S. Federal Reserve has institutionalized a similar type of monetary-fiscal prostitution; the Eccles Building in Washington, D.C. has become a mere marbled house of ill-repute.

[6] See http://www.federalreserve.gov/newsevents/press/monetary/20150318a.htm.
[7] See "Why Inflation Has Been Low Despite Rapid Money-Supply Growth," *The Capitalist Advisor*, January 31, 2014.
[8] See John C. Williams, "The Federal Reserve's Mandate and Best Practice Monetary Policy," Federal Reserve Bank of San Francisco, February 13, 2012 (http://www.frbsf.org/our-district/press/presidents-speeches/williams-speeches/2012/february/williams-federal-reserve-mandate-best-practice-monetary-policy/).