NATIONAL CENTER FOR POLICY ANALYSIS

The Fed Is Holding Rates Down for All the Wrong Reasons

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In September and October, under intense public scrutiny, the Fed passed up another opportunity to raise short-term interest rates. So the guessing game shifted six weeks forward to the next meeting of the Open Market Committee (December 15-16) — or maybe the next meeting after that. But the longer the debate goes on, and the more public it becomes, the more it is dumbed down. In their efforts to focus minutely on the trees, all sides are losing sight of the forest.

Dallas Headquarters:
14180 Dallas Parkway, Suite 350
Dallas, TX 75254
972.386.6272

www.ncpa.org

Washington Office:
202.830.0177
governmentrelations@ncpa.org

Uncertainty Hurts the Economy Worse than Certain Action. It scarcely matters whether or when rates are raised by a quarter-point. Such a rate hike is too small to make a sustained economic difference either way, and would no longer serve even as a clear indicator of policymakers' future intentions. What affects the economy much more is *uncertainty* about what the Fed will do and when. And Fed hesitation has been fostering that uncertainty.

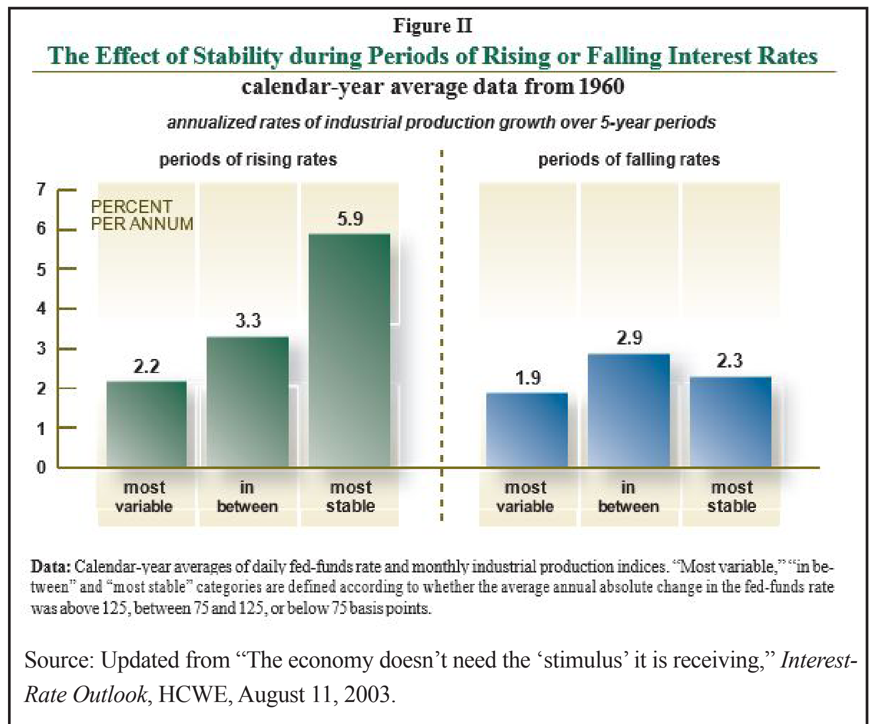
The issue on which the debate ought to be centering is whether or not the monetary system is moving toward some kind of normalcy. Are we getting closer or further way from letting the free market determine how credit is allocated? People ask these questions less and less as the Fed strays further and further from its original mandate. And, as policymakers dither, the long-term supply of debt capital needed to fuel the economy is compromised by arbitrarily low risk-free rates of return from extending credit. Borrowers are not better off if monetary policy denies savers a profit motive to lend to them. Until the authorities relax the stifling effect of near-zero interest rates on both sides of the credit market, the financial system is drifting without the guidance of a natural price mechanism.

Equally damaging is the economic waste that results from unnecessary volatility. The Open Market Committee announced its September decision after what the press rightly called "weeks of market-churning debate at the central bank."[1] Such churning diverts financial expertise from productive employment, enfeebles productive risk-taking and pulls capital into financing frivolous bets about the Fed's actions and intentions.

Facilitating Capitalism — or Running a Command Economy? At one time, the Fed's mandate was to help free markets to do their job; it certainly was never to usurp economic freedoms. But the Fed has taken on the role of a master helmsman who supposedly guides the economy through rough waters, making sure that any first-class passengers who happen to fall overboard are rescued. The helmsperson also has to contend with a large audience of sidewalk superintendents second-guessing every tilt of the steering wheel. No longer do either the Fed or its audience see the objective in terms of facilitating the efficient operation of free-market

capitalism. They see themselves as trying to run a command economy.

It is not that the private sector has lost its ability to move under its own steam. But its velocity and direction are greatly distorted by countless constraints imposed by Washington. And far from a team of far-sighted leaders, the Fed's elite group of decision makers now spends its time bickering over the direction and timing of every small policy step. They are forcing short-termism on everyone. Fed intervention roils the waters, and the economic ship is adrift on a long-term basis. They have lost their sense of direction — and their mission. Over time, that will arouse disillusionment.



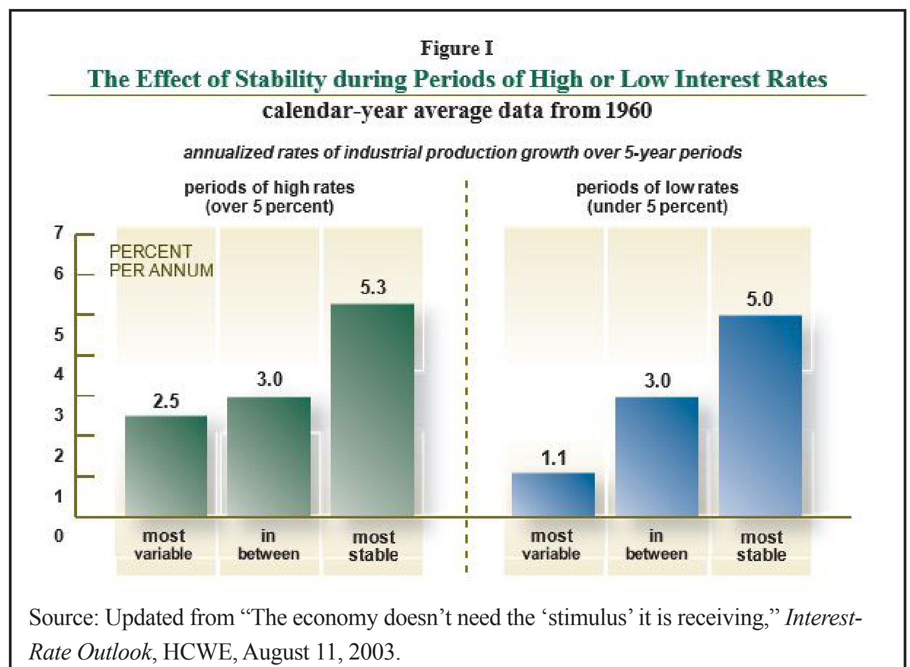
Source: Updated from "The economy doesn't need the 'stimulus' it is receiving," *Interest-Rate Outlook*, HCWE, August 11, 2003.

The many other economic considerations that feature so much in public discussion — inflation, deflation, unemployment, global instability — are fascinating to study, but inconclusive and judgmental. Even where policymakers and outside economists appear to think along similar lines, it is more the result of their collective acceptance of a doubtful doctrine than their reliance on a verifiable body of facts. The Phillips curve theory is a good example of ambiguity. Much cited by Federal Reserve Board Chair Janet Yellen, and still taught in universities, the curve disappeared from empirical view decades ago and has long been discredited. Even inside the Fed it is controversial at best.[2] It is used mainly for dumbing down Fed logic for the benefit of the general public.

The relationship between economic performance and the "correct" interest rate is obscure and contentious despite decades of research. It is not even empirically clear that Fed interest-rate adjustments influence economic growth in a sustainable way — although it has long been clear that they destabilize it.[3] Historically, we cannot even be sure we are measuring the effect of Fed policy accurately when we define monetary "tightness" as a matter of whether rates are high or low (see Figure I), or whether they are raised or cut (see Figure II).

And how much does it even matter? Figures I and II show that what influences the growth of the economy is neither the level nor the direction of rates, but whether they are stable or variable. As I have said, "Switching policy from easy to tight and back again tends to reduce economic growth over time."[4] The less action the Fed takes back and forth, the more stable interest rates are, and the better the economy grows.

It is a bad idea to put credit prices at the mercy of a debating society inside the Fed. In a commentary this



Source: Updated from "The economy doesn't need the 'stimulus' it is receiving," *Interest-Rate Outlook*, HCWE, August 11, 2003.

year, former congressional staffer Joe Cobb reports that "88 percent of the business leaders interviewed say interest rates are the primary risk they worry about."[5] He argues that "there is every reason to think that monetary-policy uncertainty is a significant killer of growth."[6]

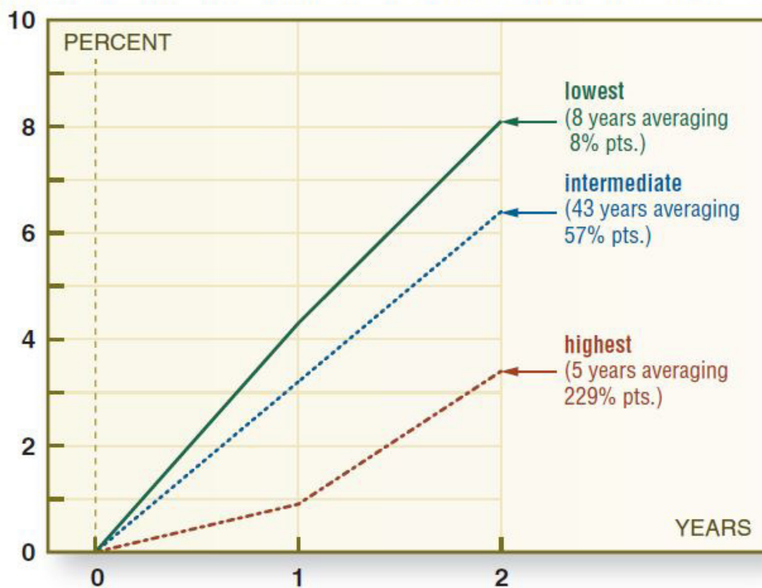
To a degree, the economic damage is quantifiable. Risk is easier to measure than uncertainty, but aspects of both are quantifiable. Figure III shows the consistent inverse relationship between month-to-month volatility in the Fed's target federal funds rate and the subsequent year's growth of real GDP.

Figure III

Fed-funds Rate Variability and US Real GDP Growth

calendar-year average data from 1956

AVERAGE cumulative growth of real GDP following years in which the month-to-month standard deviation of the fed-funds rate was:



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.

Source: Updated from "The economy doesn't need the 'stimulus' it is receiving," *Interest-Rate Outlook*, HCWE, August 11, 2003.

Evidence from implied volatility also suggests that rate uncertainty has a negative effect on growth.

How to Avoid Uncertainty. In the end, central management of the economy does not lend itself to transparency. Ironically, the Fed's policy of "forward guidance" was designed specifically to make interest-rate setting transparent and avoid the chaos created by unexpected rate changes. But one form of uncertainty has been replaced with another. The dilemma is that the more information is made available about the Fed's intentions to change rates, the more the scope (and perceived need) for speculating, gambling and hedging on when the next change might occur. The Fed needs to pay attention to that and make the *timing* of its interest-rate decisions transparent as well.

Cobb therefore proposes a fixed rule: "The interest rate … 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.'" However, this is not something the Fed is likely to consider. The more transparent the Fed became, the more its freedom of action would be curtailed. The trouble is that government discretion is a potent source of superfluous uncertainty. As Cobb puts it, the Fed sees as its "whole reason for being … to centrally plan rates and bail out the payments system."

It is hard to find an instance of any government agency drawing back from using its powers or giving them up. The Fed, with an ever broader mandate, is no exception. Instead it is currently intent on expansion, under the slogan of a "macro-prudential" mandate: widening its dominance in banking to cover the entire financial system and capital market.[7] The Fed's decisions are no longer restrained by the inflation-unemployment mandate laid down by Humphrey-Hawkins legislation. Since 2008, with gridlock between the White House and Congress, external control over the Fed has evaporated and it is writing itself a new mandate that will govern "financial prudence" throughout the credit industry.

The latest signs of "mission creep" showed up in chairman Yellen's expressions of Fed concern about instability in China and around the world. Doves in and out of the Fed argue that widespread economic weakness overseas threatens the U.S. recovery, so the Fed must

base its policies on that too. This has brought new criticism. In the words of one commentator, "Fed policy is held hostage by events outside our borders."[8] In yet another irony, making uncertainty about China a reason for the Fed to hold off from taking any action deepens and prolongs U.S. financial-market uncertainty — and the economic drag that results.

An enlarged Fed mandate also further broadens the scope for internal disagreement about monetary policy. The case for or against each little interest-rate step becomes more and more hazy. In one popular press comment, the Fed is said to be "navigating through a fog." Readers are asked to "pity the central banker …" [even when] signals flash red, amber and green at once … central banks must continue to steer the economy."[9]

But this presumption is the over-arching issue. Is it really true that central banks "must" continue to steer the economy? A more thoughtful answer is: No — an economy with the size and sophistication of the United States must never entrust such authority to any unelected group. Least of all should broad powers of economic control be exercised by an elite team of mandarins who are lost in the fog, cannot see further than their noses, and do not remember where they are supposed to be taking us.

In the best of all worlds, what the Fed should do is become more passive and narrow its mandate. Withdrawing gradually but completely from the interest-rate setting business would reduce an important and self-inflicted source of uncertainty and drift. But that would never happen voluntarily. Only the Congress has constitutional authority to restrain the Fed's over-exercise of power.

David Ranson is a senior fellow with the National Center for Policy Analysis and president and director of research at HCWE Inc.

Notes

1. "Economists react to the Federal Reserve's interest rate decision: 'relief,'" *Wall Street Journal* blog, September 17, 2015. Available at http://blogs.wsj.com/economics/2015/09/17/economists-react-to-the-federal-reserves-interest-rate-decision-relief/.
2. Justin Lahart, "Fed rate debate: Twists in an old path," *Wall Street Journal*, October 17-18, 2015.
3. For summary evidence see R. David Ranson, "Would the US be better off without monetary policy?" *Interest-Rate Outlook*, HCWE, October 22, 2013, Figure One, pages 1-2.
4. R. David Ranson, ibid.
5. The survey was conducted by Consumer Business Compass Consumer Practice Leaders in *2015 BDO Retail Risk Factor Report*, BDO USA, LLP, May 28, 2015. Available at http://blog.bdo.com/index.php/2015/05/28/infographic-2015-retail-riskfactor-report/.
6. Joe Cobb, "Harmful interest rate risk — A modest proposal," *Interest-Rate Outlook*, HCWE, June 13, 2013. Available at http://www.realclearmarkets.com/docs/2015/06/IRO-0615.pdf.
7. See Fed Vice-Chairman Stanley Fischer, speaking before the National Bureau of Economic Research, Cambridge, Massachusetts, July 10, 2014. Available at http://www.federalreserve.gov/newsevents/speech/fischer20140710a.htm.
8. Chris Rupkey of Bank of Tokyo Mitsubishi, quoted in "Economists react to the Federal Reserve's interest rate decision: 'relief.'"
9. "The Federal Reserve: False start," *The Economist*, September 12, 2015, page 14. Available at http://www.economist.com/news/leaders/21664137-fed-should-wait-until-inflation-closer-target-raising-rates-false-start.