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Fed Still Sowing the Seeds of Uncertainty

By W. Michael Cox and Richard Alm

After months of outsiders speculating and insiders hinting, the Federal Reserve Board finally began undoing the most expansive monetary policy in its 102-year history. In December, the central bank raised its benchmark federal funds rate, which had been at rock bottom since the dark days of the financial crisis of 2008. Fed statements suggested additional rate hikes would follow—but they didn't say when.

For the Fed, December's quarter-point increase in the target federal funds rate was just a first tentative step on a long, difficult journey back to normalcy (*see chart below*). Getting there will require the central bank to find its way along an uncharted path, removing excess money from the economy while avoiding policy miscalculations that could ignite inflation or invite another recession.

The Fed adopted historically low interest rates because it hoped a surge of money would stimulate an economy that had plunged into severe recession—in 2008-09, output fell sharply, stock markets plunged, and the unemployment rate climbed to 10 percent.

The tidal wave of money didn't produce the expected results. Interest rates did indeed come down, but economic growth has been agonizingly slow—at least compared to past recoveries. A low unemployment rate masks continued slack in the labor market, with many workers still sitting on the sidelines, out of the labor force. Despite U.S. history's most aggressive monetary policy, inflation remains persistently low. Stocks rebounded from their 2009 nadir, but they're a mere 28 percent above the pre-recession peak.

New concerns are raising questions about the wisdom of higher interest rates. In the past few months, financial news focused on the bearish stock market, plunging oil prices, China's faltering growth and the strengthening U.S. dollar. A divisive presidential election only adds to the jitters.

Slow growth. A slack labor market. Low inflation. Wobbly stock prices. Global weakness. By the usual playbook of monetary policy, this is an odd time for the Fed to be contemplating higher interest rates.

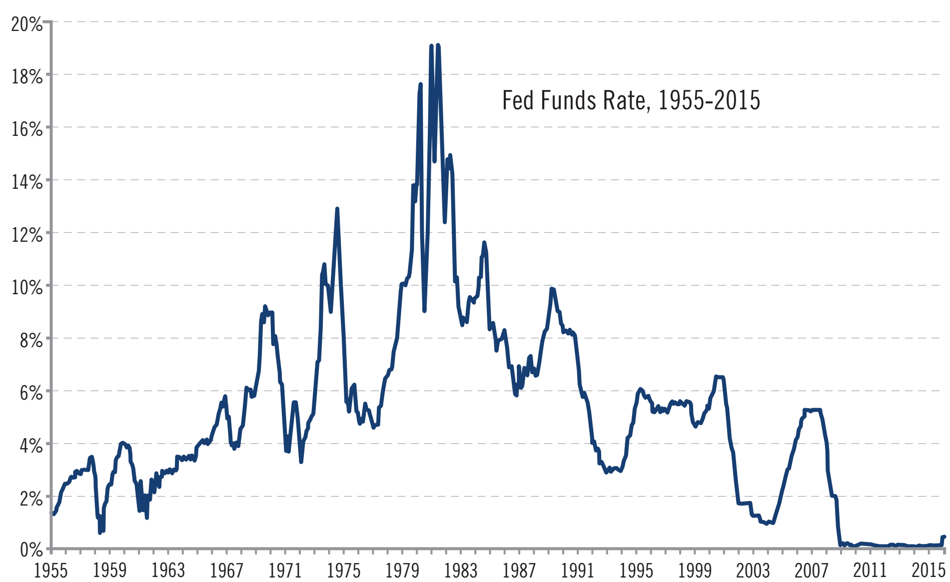
The broad picture suggests the Fed will proceed cautiously in 2016, keeping a wary eye on financial markets and indicators of growth and employment. For businesses, consumers and investors, this will mean another year of speculation about the Fed's intentions, adding even more uncertainty in an uncertain outlook.

CAUGHT IN A TRAP

The irony of the Fed's policy stance under former chairman Ben Bernanke and current chairwoman Janet Yellen lies in this: Going lower-for-longer on interest rates—the supposed remedy for sluggish growth—has become the primary obstacle to the strengthening of the U.S. economy.

To understand why, we turn to the work of Joseph Schumpeter—by our lights, history's most insightful observer of capitalism. The Austrian-born economist emphasized the pivotal role of credit creation in propelling an economy forward. In short, a capitalist system runs on borrowed money.

Long Road to Normalcy—7 Years of Near-Zero Interest Rates



Source: Federal Reserve Board

The Fed hoped low interest rates would encourage businesses to borrow, igniting a new round of credit creation to stimulate the economy. However, the banking sector, facing low potential returns and worried about the risk of losses, has been wary of lending, preferring to hold an enormous stock of excess reserves.

Before the financial crisis, the U.S. banking system had virtually no excess reserves, so Schumpeter's credit creation was chugging ahead at full force. After the debacle of 2009, the banking system grew cautious and began to pile up excess reserves, which reached a peak of more than 27 percent of deposits in 2014 (*see chart below*).

The economy has been improving, but banks still have little incentive to make the longer-term loans that fuel businesses' growth. The prime rate, charged to top corporate customers, has been at 3.25 percent since 2009—not much of a return at a time of substantial default risks, potentially higher inflation and increasing compliance costs (i.e., the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010).

To make matters worse, just about everyone has been expecting the Fed to raise interest rates, a belief fostered by the Fed's official pronouncements. Why would banks lend at such low rates? Wouldn't it be better to sit on bank reserves and wait until rates move higher, particularly with the Fed now paying interest on those reserves?

One look at the persistently high level of excess reserves tells us how the banking system as a whole has answered these questions. The economy's credit system has become stuck in a liquidity trap—an anomaly, identified by John Maynard Keynes himself, that renders monetary policy ineffective because low interest rates have little impact on lending or real economic activity.

The United States fell into a liquidity trap in the Great Depression of the 1930s; more recently, a liquidity trap has frustrated

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Japan's efforts to lift its economy out of the doldrums that have persisted into a third decade. In both cases, rock-bottom rates did little good.

In a liquidity trap, low interest rates are the problem, not the solution. The path back to prosperity starts with the decision to raise rates, which will encourage a revival of the Schumpeterian credit creation so vital to a vibrant capitalist economy.

WEDDED TO LOW RATES

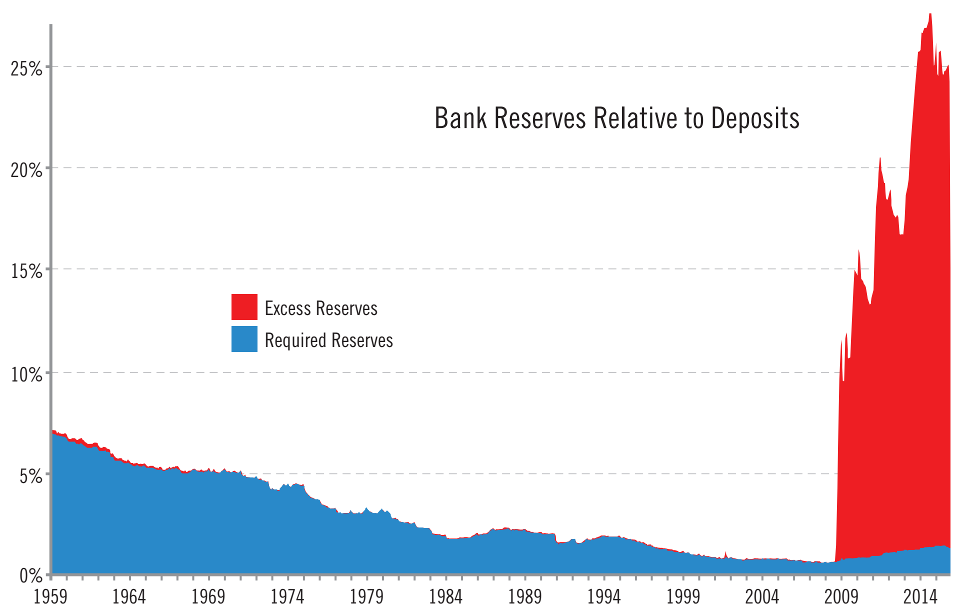
Higher rates would help revive the economy, but the Fed has dithered and vacillated. It's partly a matter of economic doctrine. Led by Bernanke and Yellen, Keynesians have dominated the policy-making Federal Open Market Committee (FOMC), reciting a mantra of stimulating aggregate demand. They cling to the idea that lower rates are better—even if the policy isn't producing the hoped-for results.

At the same time, stock and bond markets greeted every hint of impending interest rates hikes with a panicky swoon. It just added another reason to be cautious for a Fed already jittery over an economy struggling with subpar growth and job gains.

The Fed may have continued to make the familiar policy mistake of low interest rates because it feared the consequences of another kind of policy mistake. With banks holding a mountain of excess reserves, imagine the consequences for inflation if the process of credit creation quickly returned to normal.

Three rounds of quantitative easing—buying securities to put more cash in the economy—left the Fed's balance sheet piled high with assets. The central bank's holdings of Treasury bonds and mortgage-backed securities rose from a relatively stable $900 million before the financial crisis of 2008 to nearly $4

Fed's Challenge: Encouraging the Banking System to Make More Loans



Source: Federal Reserve Board

trillion at the end of 2014.

> **The vast and unprecedented expansion of the Fed's balance sheet over the past seven years left behind an inflationary time bomb.**

The vast and unprecedented expansion of the Fed's balance sheet over the past seven years left behind an inflationary time bomb. The Fed recognizes that. In September, it laid out its principles and plans for policy normalization, vowing to reduce the excessive securities holdings in "a gradual and predictable manner."

It has taken the first steps. The central bank pared its securities' holdings by $285 billion from October to January—at about the same time it finally began the long process of raising the fed funds rate.

By continuing down this path, the central bank hopes to encourage lending in the economy, pull excess reserves out of the banking system and bring its bloated balance sheet back to normal. If all goes according to plan, the results will be faster growth and a diminished risk of inflation.

An important caveat hangs over this happily-ever-after story: The Fed has never had to pull off anything like this in its 100-plus years. The policies of the past seven years have been so extreme and so unorthodox that the central bank finds itself in uncharted territory.

Risks abound. If the Fed raises interest rates too quickly, it could tip the economy into recession, ending the fourth-longest post-war expansion (*see chart Page 4*). If the Fed doesn't pare its sheet quickly enough, the excess reserves still in the banking system could lead to a nasty bout of inflation, followed by higher interest rates and recession.

A return to normalcy will require the Fed to make a succession of right moves at the right moment. It hasn't publicly addressed the timing or strength of its interest rate hikes and balance-sheet reductions. In essence, the central bank is telling the public: Just trust us.

STILL A MUDDLE

At its January meeting, the FOMC failed to follow up on December's initial move by giving interest rates another bump upward. So Fed policy continues to be enigmatic, suggesting another year of speculation and uncertainty about how fast and how far the Fed will move on interest rates.

The central bank offered general guidelines in its December "Summary of Economic Projections," released along with the FOMC minutes. In the consensus forecast, FOMC members project an increase of about a percentage point a year in the fed funds target rate—from its current 0.25 percent to a little above 3.25 percent in 2018.

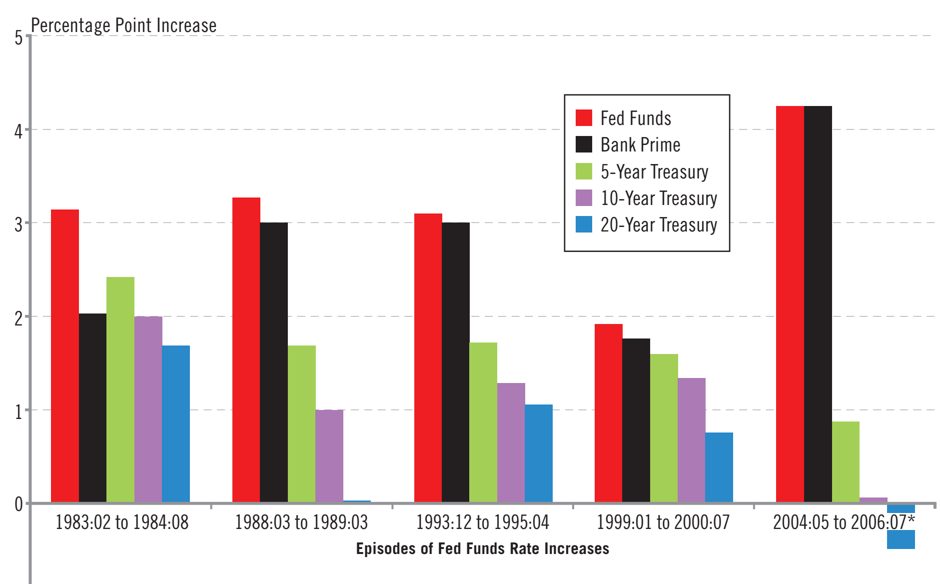
Market interest rates are what matters to businesses and investors—and, ultimately, the economy as a whole. The five most recent episodes of monetary policy tightening show considerable variation in the way rising fed funds rates pull up market rates (*see chart below*).

Aside from the 1983-84 period, the increase in the prime rate closely matches the rise in the fed funds rate. Longer-term rates show greater variation in their responses to Fed actions. The 20-year Treasury rate, for example, rose, did nothing and even declined in these five episodes.

The lessons for market rates are ambiguous at best—and that's in relatively normal times. Today's monetary policy is anything but normal. It differs from the past in the readings on key economic indicators, such as GDP growth (slower), inflation (lower) and levels of interest rates (lower).

These differences are significant, but we can't ignore the ultimate wild card—all the money sloshing around the banking system. As interest rates rise and banks start to lend their excess reserves, the money supply could expand rapidly, with potentially dire consequences for inflation. Collectively, banks are sitting on enough excess reserves to expand the money supply and price level by a multiple of three.

Once Fed Starts Raising Rates—Uncertainty for the Economy



*Period end is average of rates from 2006:7 to 2007:7.

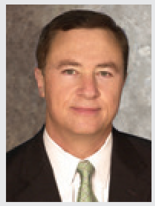
Source: Federal Reserve Board

The Fed has two policy options to stop it. First, it can raise the interest rate it pays on bank reserves, giving banks greater incentives to continue holding excess reserves. Second, it can engage in a massive, prolonged quantitative tightening, reducing the central bank's securities holdings to extract bank reserves—in essence, putting the quantitative easing of a few years ago in reverse.

Looking at the months ahead, the Fed's progress in restoring some semblance of normalcy to its balance sheet will be as important as getting the fed funds rate off the floor. Yet, the Fed's securities holding will not be as closely watched as the highly publicized decisions on interest rates.

The monetary policy environment, stuck in low-rate stasis for so long, has finally begun to change in the past few months, with December's rate hike and three months of shrinkage in the Fed's balance sheet. Yet in another way, the situation hasn't changed that much at all. The Fed remains opaque and enigmatic, a source of uncertainty in an economy facing plenty of other potential obstacles to strong growth and stable prices.

Note: In 25 years at the Federal Reserve Bank of Dallas, Dr. Cox rose to chief economist and senior vice president, advising the bank president on monetary policy and other issues.



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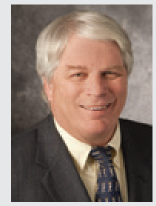

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CHARTING THE ECONOMY

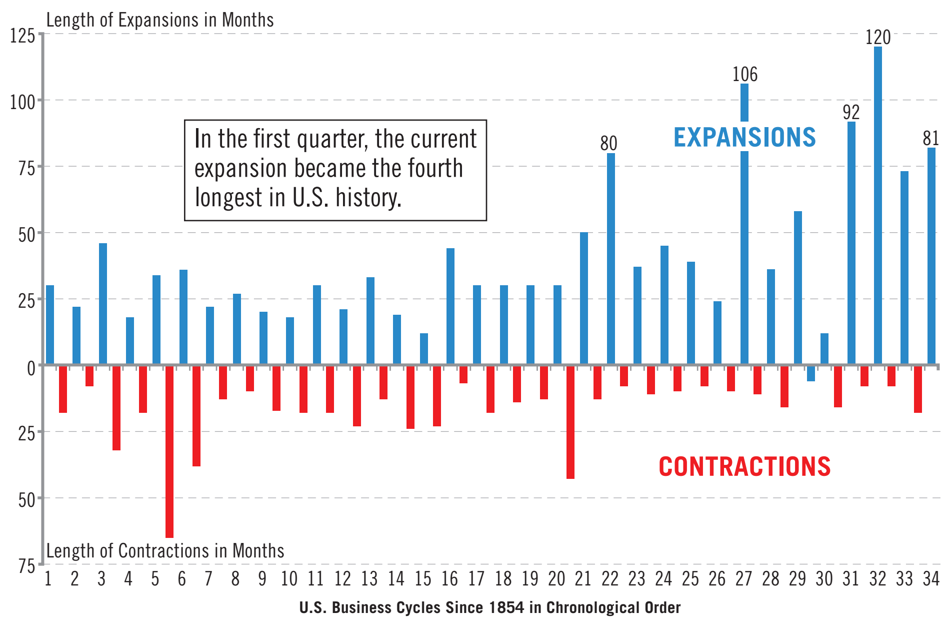
Our Current Expansion: Long Lasting, Not Particularly Strong

A financial crisis plunged the U.S. economy into recession in December 2007, and the National Bureau of Economic Research, the official arbiter of recession and recovery, decreed that the United States didn't start growing again in July 2009.

The current growth spurt will reach 81 months in March, making it the fourth longest in U.S. history.

Up ahead on the longevity list: the 92-month expansion from December 1982 to July 1990, the 106-month expansion from February 1961 to December 1969 and the 120-month expansion from March 1991 to March 2001.

The celebration for this expansion's milestone should be muted. Long it may be, but it lags previous recoveries in terms of GDP growth and job gains. For the three other long expansions, job growth was between 22 percent and 33 percent. This expansion has seen net employment growth of just 9 percent.



Source: National Bureau of Economic Research