

Rate Hike Fears are Unwarranted

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How often have we heard the phrase “if the Fed hikes rates too early, the economic recovery will be derailed”? It’s ingrained into the Fed’s mindset and statements like it appear frequently in the media. Yet the history of Fed rate hikes during prior economic expansions suggest that such fears are unwarranted, and the current 5 ½ year old expansion is on sound footing and would fare just fine and even be enhanced if the Fed began hiking rates. Normalizing interest rates should be welcomed, not feared by the Fed.

In many key aspects the economy has characteristics that are typical during early-middle stage expansions, and prospects for sustained growth are very favorable. The types of excesses in the real sectors or financial markets that have preceded prior recessions are absent, and monetary policy is aggressively stimulative. Wage and unit labor costs increases are low and inflation is moderate. The stock of capital and the level of employment are not excessive relative to output. Inventories are low. Private sector finances have improved. Households are deleveraging and debt service costs are low. Household net worth is near an all-time high. Profit margins are healthy and business balance sheets are strong. Banks have increased capital and reduced leverage. Virtually all indicators suggest the probability of recession is very low.

Despite these positive aspects, the Fed conveys the image that the economy is very fragile, and its negative real Federal funds rate is increasingly inconsistent with sustained economic growth and moderate inflation. As the natural rate of interest rises with improving economic conditions, the negative real funds rate contributes to mounting distortions.

The Fed’s misplaced fears that any rate hike will upset the economy is the root source of its protracted and increasingly ineffective forward guidance. The Fed’s efforts to be transparent and clear are well intentioned. But in practice they have been muddled and overly complex because the Fed’s monetary policy is misguided. One unintended outcome is mixed signals that undercut public confidence in the economy. The time is appropriate for the Fed to set out a clear and positive strategy for hiking rates, normalizing monetary policy and streamlining its forward guidance.

Observations on the US economy. The economy is in its sixth year of expansion and real GDP is 6.8 percent above its prior expansion peak. Although the 2.2 percent average growth since the deep recession has been slower-than-desired, it’s been consistent with a long international history of slow recoveries following unsustainable debt bubbles and financial crises (Reinhart-Rogoff, 2010 and Reinhart-Reinhart, 2010), and slow US recoveries following housing crises (Bordo-Haugrich, 2012).

The Fed’s unconventional monetary stimulus and forward guidance have attempted to lean against these historic trends, but the US economy continues to be inhibited by real factors and negative influences of government economic policies and related

uncertainties that are beyond the influence of monetary policy. Other policy tools clearly would have been more efficient in addressing specific obstacles to growth (reform of the mortgage market and corporate taxes, for starters).

Lingering labor market weaknesses despite the creation of 9.4 million jobs since the recession trough and the much faster-than-anticipated decline in the unemployment rate largely reflect structural factors that will persist even when the unemployment rate falls to “full employment”. Monetary policy should not be targeting the labor force participation rate or trying to address high unemployment stemming from insufficient education or skills.

Quantitative easing and anchoring the Federal funds rate to zero were emergency policies designed for an economic and/or financial crisis, not current conditions. Such unconventional monetary policies--maintaining the Fed’s excessive \$4.5 trillion balance sheet and its negative real rate policy – are no longer necessary.

The real funds rate has been negative for a sustained period only two other times in recent history, and never as long as the current six year span: during 1975-1977 when monetary policy fueled higher inflation and during 2002-2005 when the Fed’s low interest rate policy contributed to the debt and housing bubble. It is naïve to believe that current policy carries low risks and is not the source of mounting distortions.

Beginning to hike rates consistent with the rise in the natural rate associated with healthy economic expansion and higher expected rates of return on capital would simply maintain the current posture of monetary policy and would not constitute a tightening that constrains aggregate demand and economic growth. That is particularly true now with \$2.7 trillion of excess reserves and extraordinarily low bond yields, and the market anticipating rate hikes.

Historic episodes of Fed rate hikes during expansion. Recent US cycles provide ample support that Fed rate hikes – even aggressive monetary tightening--during early-to-middle stages of economic expansions have little if any short-term economic impact and actually improve the foundations for sustained expansion.

In 1994, in response to stronger economic growth following three years of what was referred to as the “jobless recovery”, the Fed hiked the funds rate from 3 percent to 6 percent while inflation remained stable around 3 percent. Real bond yields exceeded 4.5 percent. The trade-weighted US dollar was strengthening. Growth slowed for two quarters, but then reaccelerated, led by the interest sensitive sectors, and remained strong through the remainder of the decade. This aggressive monetary tightening was considered the Fed’s most successful disinflationary soft-landing, even within the Fed.

During the next expansion, the Fed was very concerned about the negative impact of rate hikes on bond markets and raised rates very gradually, from 1 percent to 5.5 percent from mid-2004 to mid-2006. The real Federal funds rate rose from -1.0 percent to 2.5 percent, while real bond yields hovered between 2.5-3.0 percent and the US dollar weakened. Domestic demand and real GDP growth remained strong through early 2006 and then decelerated as the debt-financed housing bubble began to collapse.

In mid-1983, when the economy was only two quarters into recovery from the severe back-to-back recessions of 1980-1982 and the unemployment rate was 10 percent, the Fed began tightening from an already very high real funds rate. The real funds rate rose from 6.5 percent in June 1983 to 6.9 percent in July 1984 and real bond yields averaged 8.4 percent. Despite these high real interest rates and a strengthening US dollar, real growth remained robust through 1984Q1 and then decelerated, but still grew 4.25 percent in 1984 and 1985.

Fed rate hikes in earlier expansions tell a similar story. The current perceived costs of hiking rates are dramatically overblown.

Current concerns about the negative impacts of the moderately stronger US dollar and weak global economies are overstated, and they ignore the positive boost from dramatically lower oil and energy prices. During prior Fed rate hike episodes, the US dollar was strengthening (with the exception of the 2004-2006 period, when oil prices nearly doubled), and global economic growth was moderately stronger than currently. In each episode, the US net export deficit widened, reducing domestic production relative to demand, but strong domestic final sales in the face of Fed rate hikes and high real interest rates sustained solid growth.

Failing to raise rates appropriately during prior expansions has proved costly, in different and unforeseen ways. Inflation tends not to be forecast until it accelerates and becomes undesirable. That was certainly the case in the late 1970s. Financial and real distortions that result from keeping real rates artificially low too long tend to be understated because initially they feel good – higher housing and asset prices, etc. That was the case during the debt and housing boom of the 2002-2007 expansion. Higher real interest rates would have resulted in a better balanced and more sustainable economic expansion with fewer financial distortions and long-run costs.

The Fed is ignoring these lessons from history. Its continuous fine-tuning of its forward guidance in an attempt to sustain artificially low interest rates has involved frequent adjustments to its labor market guidelines/objectives, excessively nuanced language changes in its Policy Statement, and switching back-and-forth on whether monetary policy is time dependent or data dependent. It has also involved making some public statements that are truly confusing: “the Fed may need to keep its federal funds rate

target below its longer-run normal rate even when the economy reaches full-employment because the economy may still be facing headwinds.”

The Fed seems to have lost sight of the basic issue: Is economic performance best served by the current monetary policy of anchoring the Federal funds rate to zero and maintaining a massive excess bank reserves?

Even on this basic issue, the Fed gives mixed messages: while it forecasts stronger economic growth in 2015-2016 as it gradually raises rates (along the path it currently deems appropriate), its forward guidance and public statements convey the image of a very fragile economy – one that may not be able to withstand a hike in rates, even if real rates remain negative. The Fed’s carefully crafted forward guidance to financial markets of its intentions to keep rates artificially low conveys a distinctly negative tone to nonfinancial businesses and households suggesting that this may not be the right time to spend, invest or take risks. The Fed understates this negative impact on confidence.

Data dependence and recent trends. If the Fed were truly data dependent, it would have already begun hiking rates or be very close to doing so. The rapid decline in the unemployment rate, even as the Fed has lowered its longer-run potential growth, suggests the Fed is quickly approaching its objective. And core inflation has edged up toward the Fed’s 2 percent long-run target, consistent with the Fed’s earlier forecasts.

But the Fed urges patience and stretches out its zero interest rate policy. This is very risky. Adjusting policy to the latest high-frequency data assumes no lags between monetary policy, economic performance and inflation. This is absolutely inconsistent with historical experience.

As the unemployment rate has fallen rapidly, the Fed’s shift to emphasizing wages as a measure of labor market conditions is even more problematic. Wages lag economic conditions and in some instances wages lag inflation. Basing monetary policy on a notoriously long cyclical laggard is backward-looking and prone to policy mistakes. In light of the Fed’s long-run unreliable forecasting track record, moving up its rate hikes would be wise and prudent.

Market-based measures of inflationary expectations have declined approximately 50 basis points since mid-year. The Fed should not use this as an excuse to delay hiking rates. The decline in market-based measures reflect three factors: 1) the sharp decline in oil prices, 2) the market response to Europe’s economic downturn and threat of deflation (German market-based inflation expectations have declined and led the US forward curve down) and 3) the global stretch for higher yielding instruments in response to aggressive global central bank monetary easing and the relative

attractiveness of US dollar-denominated assets. Surveys of US inflationary expectations have moved down only modestly.

Lower oil prices will have a one-time impact on the general price level with little lasting impact on the underlying rate of inflation, but they will provide a significant positive boost to economic performance. The US and Europe have diverged: the US's economic expansion is solid and factors are pointing toward a rise in core inflation, whereas Europe's economy has stalled, in need of further reforms and faces a legitimate threat of deflation. The US dollar appreciation reflects the relative strength of US economic performance and should not deter much-needed normalization of monetary policy.

References

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