

Why interest rates aren't going higher any time soon

By: Steve Hanke
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Former Fed chief Paul Volcker was let down by inaccurate money supply gauges, which continue to mislead economists. Photo: Reuters

Financial markets have been primed for about a year now to expect higher US interest rates. They haven't arrived yet and probably won't until well into 2016.

Don't be fooled into thinking that the tapering of the Federal Reserve's massive asset purchase programme heralds the imminent normalisation of monetary policy.

The massive distortions created by the Fed's interest rate manipulations will be with us for far longer than most analysts anticipate.

Why? Because the United States is still in the midst of the Great Recession.

Recent data looks encouraging, but the US economy remains weak and vulnerable. Aggregate demand, as measured by final sales to domestic purchasers, tells the tale.

The annual trend rate of growth in nominal aggregate demand has been 4.95 per cent since 1987. At the depth of the Great Recession, that metric plunged to an annual rate lower than minus 4 per cent.

Aggregate demand almost reached the trend rate of growth in late 2011, but since then it has slumped to its current 3.19 per cent annual rate.

And the reason why nominal aggregate demand is so weak is because money supply is tight.

Economists might believe the Fed's monetary taps are wide open, but they are looking at the wrong indicator when making that assessment.

A lesson from 1979 makes the point perfectly. That was when Paul Volcker took the reins of the Fed with the annual rate of inflation running at 13.3 per cent.

He immediately saw that restoring the economy to good health meant wringing inflation out of it and that killing inflation required tight control of the money supply.

By 1982, inflation had dropped to 3.8 per cent, but Volcker's squeeze triggered a relatively short recession that started in January 1980 and lasted less than a year, only to be followed shortly afterwards by a more severe slump that ended in November 1982.

Volcker's problem was that the monetary speedometer he watched was defective. Each measure of the money supply – M1, M2, M3 and so on – was shown on a separate gauge, with the various measures being calculated by a simple summation of their components.

The components of each measure were given the same weight, implying that all of the components possessed the same degree of usefulness in immediate transactions where money is exchanged between buyer and seller.

The Fed's gauges seemed to be saying its policy mix was the equivalent of tapping the money-supply brakes with just the right amount of pressure, when in fact it had effectively slammed them on from 1978 until early 1982.

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A different measure of money supply, the Divisia metric, would have revealed the flaw in the Fed's reliance on a conventional measure.

The Divisia metric reflects that money takes the form of various types of financial assets that are used for transaction purposes and as a store of value – or its “moneyness”.

Money created by a monetary authority – notes, coins, and banks' deposits at the monetary authority – represents the underlying monetary base of an economy. This state money, or high-powered money, is imbued with the most moneyness of the various types of financial assets that are called money.

The monetary base is ready to use in transactions in which goods and services are exchanged for “money”.

In addition to the assets that make up base money, there are many others that possess varying degrees of moneyness – a characteristic that can be measured by the ease of and the opportunity costs associated with exchanging them for base money.

These other assets are, in varying degrees, substitutes for money. That is why they should not receive the same weights when they are summed to obtain a broad money supply measure.

Instead, those assets that are the closest substitutes for base money should receive higher weights than those that possess a lower degree of moneyness.

So when the Volker Fed pushed interest rates up, the opportunity cost of holding cash increased. In consequence, retail money market funds and time deposits, for example, became relatively more attractive and received a lower weight when measured by a Divisia metric.

Faced with a higher interest rate, households had a much stronger incentive to avoid cash and chequing account balances.

The higher Fed interest rates went, the greater the divergence between the simple-sum and Divisia measures of money supply.

When measuring money supply, the broadest measure is always best, and Divisia measures are the best of all.

The US is fortunate to have Divisia M4 available from the Centre for Financial Stability in New York, and when you look at that data, it becomes clear why US nominal aggregate demand and the wider economy have followed the course that they have – the annual Divisia M4 growth rate is an anaemic 2.6 per cent.

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Since bank money accounts for 80 per cent of the Divisia M4 measure, its decrease has dragged down the overall money supply growth rate.

Tougher bank supervision, stricter prudential bank regulations and higher bank capital requirements explain the drop, and these pro-cyclical squeezes are unlikely to be released any time soon.

In consequence, the Fed will probably be forced to keep official rates at the zero bound much longer than most think – perhaps well into 2016.

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