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Interest Rates Have Fallen And Can't Get Up!

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Some of us suffer from Fed head: we have allowed anger at the Fed to infect our brains to the point that we blame it for everything from flat tires to broken bed springs. George Selgin, an Austrian friendly economist at the Cato Institute, says take two aspirin and read his blog in the morning:

> The view that the Fed might have raised interest rates long ago, had it only wanted to, became notorious during the presidential campaign, when Donald Trump publicly accused Janet Yellen's Fed of keeping rates low for political reasons. But Trump was merely embroidering a belief common among many (mostly conservative) Fed critics...
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> The unvarnished truth, I hope to persuade you, is that interest rates have been low since the last months of 2008, not because the Fed has deliberately kept them so, but in large part owing to its misguided attempt, back in 2008, to keep them from falling in the first place.

Selgin argues that the Fed was a couch potato when the recession landed on the US economy in 2008 and by trying to keep rates from falling made the recession worse and caused the "natural interest rate" to fall:

> That market rates were in decline before the Fed lowered its policy target is only one of several reasons why it makes little sense to attribute their decline, or their initial decline at least, to "easy" monetary policy. A second is that an easy policy stance ought, ipso facto, to have led to an eventual increase in nominal spending, if not in the rate of inflation. Yet, as everyone knows, neither of those things happened...
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> The alternative explanation - that natural rates have themselves fallen - is supported by a mass of empirical studies, showing that all of the principle determinants of "natural" nominal rates, including expected inflation and total factor productivity, have been trending downward since long before the Fed's first large-scale asset purchases.
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> As we've seen, rates originally crashed, not because monetary policy was too easy, but because it was too tight. The Fed erred, in other words, not by pushing rates down but by trying to prop them up in the months leading to Lehman's collapse.

> The switch to unconventional policies resulted in a substantial increase in uncertainty concerning the future course of interest rates, which served in turn to keep rates low by further dampening an already dampened appetite for investment. Although some of the Fed's later interventions, and especially its attempts at forward guidance, were aimed at quelling this uncertainty, their success was quite limited.

The Wall Street Journal complained about the Fed's fixation with organic banking:

> Central bankers respond that their policies are merely tracking changes in the so-called natural rate, an interest rate determined by powerful economic impulses. They contend this rate has fallen precipitously over the past 30 years as the result of tectonic shifts in the global economy, such as aging populations, a rising glut of savings and slowing productivity growth. This decline, they say, is the primary driver of collapsing borrowing costs across the advanced world.
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> Low policy interest rates are not the caprice of central bankers, but rather the consequence of powerful global forces, including debt, demographics and distribution," Bank of England Gov. Mark Carney recently told British lawmakers.
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> Officials at the Bank for International Settlements take a different tack, saying they worry that central bankers' estimates of the natural rate are too low and may fuel financial problems for the future by encouraging risky borrowing. In a speech in November, BIS general manager Jaime Caruana also warned that investors could be vulnerable to sudden swings in bond yields if they placed too much weight on natural-rate explanations instead of policy and market dynamics.

Mark Spitznagel, founder and Chief Investment Officer of Universa Investments and author of the very popular book, The Dao of Capital: Austrian Investing in a Distorted World, set the amateurs straight on the topic of the natural interest rate:

> Much of this neutral rate talk at the Fed is supposedly supported by the work of Swedish economist Knut Wicksell (1851-1926), who argued that the "natural" interest rate would express the exchange rate of present for future goods in a barter economy. If in practice the banks actually charged an interest rate below this natural rate, Wicksell argued that commodity prices would rise, whereas if the banks in practice charged an interest rate above the natural one, then commodity prices would fall. But that's where Wicksell - often associated with the free-market Austrian school of economics - would cease to recognize his own ideas in current central bank thinking.

The best way to think about the natural rate of interest is the way that Mises, and all good economists, taught it: the origin of interest lies in "time preference," which means that people prefer a bird in the hand to two in the bush. It's a variation of opportunity cost. If you want to use someone else's stuff, including money, you have to compensate them for their lack of use of it. My brother-in-law may want to use my chain saw for a year, but he will have to give me something in return to persuade me and he must return my chain saw in perfect condition. Time preference can change, but because human nature doesn't, the natural rate of interest changes very little as well.

On the other hand, market rates change a lot because of many variables. But let's consider one: the productivity of investments. If business people see little prospect of profit in their investments, the demand for loans will shrivel and interest rates will decline. They will collapse further if banks try to entice businessmen to invest with ultra-sexy rates. If that doesn't work, and it hasn't, then the problem most likely lies in the investment arena. What could make businessmen not want to invest?

Some answers include regime uncertainty, which means large and rapid changes in the law such as Obamacare and Dodd-Frank, high taxes, and massive increases in regulations, such as the 3,000,000 plus pages added to the Federal Register of new regulations since 1970.

Wicksell and Austrians were thinking of a free market. In a free market the natural rate reflects how much people are willing to save for the future instead of living for today and the market rate will be closer to the natural rate. In a socialist economy such as ours, regulations, taxes and uncertainty about the future make the investing for the future much less attractive. It makes sense to live for today if the future looks bleak. That's why corporations are buying back their stock and hanging onto piles of cash.

Hayek may have agreed with Selgin that the Fed isn't totally to blame for historically low interest rates in an "expansion." In his books Monetary Theory and the Trade Cycle and Profit, Interest and Investment, he demonstrated that business cycles can happen without central bank money manipulation. In fact, that happened through all of the 19th century. So what is the point of central banks like the Fed?

The Fed's part in the business cycle comes at the middle of the expansion. Market interest rates begin to rise after the expansion has taken hold, inventories shrink and excess capacity disappears. At that point, the Fed should allow rates to rise and throttle back on economic growth, but it rarely does because the long lags in its data, discussed last week, make it think the economy is still in bad shape. So it tries to force market rates down. That causes an unsustainable expansion. The real economy ends it and there is little the Fed can do about it.

What does this mean for investors? Don't look for the Fed to rescue the economy if it falls and can't get up this year. Fed officials, like all good politicians, takes credit for all things good and blames someone else for all of the bad. Pay more attention to the real economy, especially near the end of a long expansion.