Fed Up, Again

The sun splashes light on the Federal Reserve Building early October 29, 2008 in Washington, DC

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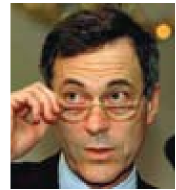
One of the first casualties of a financial crisis is the truth. During times of stress, central bankers embrace a time-honored tradition: they issue anodyne statements that are economical with the truth. Central bankers are also prone to seize upon standard "solutions" that have been congealed into a crust of dogma by endless repetition and obeisance. Today, we are witnessing a well-rehearsed repeat performance.

With the onset of the financial crisis and the collapse of aggregate demand in the United States, the Federal Reserve reached for the standard textbook solution to stimulate demand. Indeed, the Fed pushed short-term interest rates toward zero – a zone in which they have been trapped ever since.

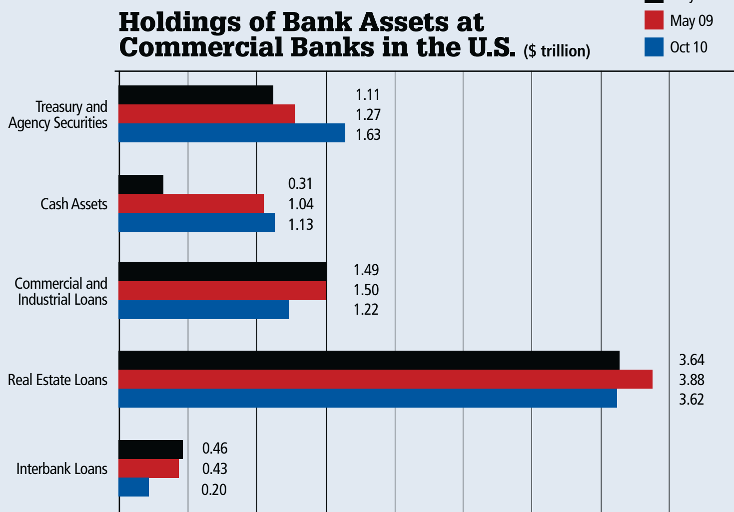
The textbooks tell us that these "low" interest rates should have stimulated investment and given aggregate demand a big boost. The

by Steve Hanke



economy should be in a boom phase. But, it is barely holding its head above water. Why hasn't the economy responded in a textbook fashion to the near-zero, interest-rate elixir?

In the monetary sphere, the Fed has, in a standard Keynesian manner, flooded the economy with high-powered base money since the onset of the crisis in late 2008. But, with the crisis, the money multiplier collapsed and has remained depressed. In consequence, broad money measures, such as M2, have barely budged during the post-crisis period and the economy has continued to disappoint.



Source: Federal Reserve Board

Prof. Ronald McKinnon of Stanford University has analyzed what he has dubbed the zero interest-rate trap. Unlike most economists, Prof. McKinnon can soar to great heights for a global view and also dive to great depths for a micro-market view. In his analyses of the zero interest-rate trap, Prof. McKinnon utilizes both skills. Let's take a look.

While the Fed has pumped huge quantities of liquidity into the economy, the U.S. is paradoxically facing a credit crunch. As the accompanying chart indicates, banks have utilized their liquidity to pile up cash and accumulate government bonds and securities. In contrast, bank loans have actually decreased – a credit crunch. And since credit is a source of working capital for businesses, a credit crunch acts like a supply constraint on the economy. Even though it appears as though the economy has loads of excess capacity, the supply-side of the economy is, in fact, constrained by the credit crunch. It is not surprising, therefore, that the economy is not firing on all cylinders.

To understand why, in the Fed's sea of liquidity, the economy is being held back by a credit crunch, we have to focus on the workings of the loan markets. Retail bank lending involves making risky forward commitments. A line of credit to a corporate client, for example, represents such a commitment. The willingness of a bank to make such forward commitments depends, to a large extent, on a well-functioning interbank market – a market operating without counterparty risks and with positive interest rates. With the availability of such a market, even illiquid (but solvent) banks can make forward commitments (loans) to their clients because they can cover their commitments by bidding for funds in the wholesale interbank market.

At present, the major problem facing the interbank market is the zero interest-rate trap. In a world in which the risk-free Fed funds rate

Real Interest Rates Around the World

Country	3-Month Interest Rate	Consumer Prices (% YoY)	Real 3-Month Interest Rate
Singapore	0.44	3.50	-3.06
India	7.23	9.80	-2.57
Hong Kong	0.30	2.60	-2.30
Philippines	1.00	3.00	-2.00
China	3.42	4.40	-0.98
United States	0.22	1.20	-0.98
Thailand	2.15	2.80	-0.65
Korea	2.80	3.30	-0.50
Taiwan	1.03	1.50	-0.47
Japan	0.17	0.20	-0.03
Mexico	4.16	4.00	0.16
Turkey	7.87	7.30	0.57
Colombia	3.46	2.60	0.86
Malaysia	2.97	2.00	0.97
Chile	3.60	2.50	1.10
Indonesia	8.54	6.30	2.24
Brazil	10.66	5.60	5.06

Source: The Economist

is close to zero, banks with excess reserves are reluctant to part with them for virtually no yield in the interbank market. Accordingly, the interbank market has dried up – thanks to the Fed's zero interest-rate policy – and, with that, banks have been unwilling to scale up their forward loan commitments.

In short, the Fed's zero interest-rate policy has created a credit crunch that is holding back the economy. The only way out of this trap is for the Fed to raise the Fed funds rate to, say, two percent.

The Fed's interest-rate strategy is not the only thing holding back the U.S. (and international) economy. Regime uncertainty is so thick that you can cut it with a knife. The Fed – by embracing more quantitative easing – has generated uncertainty. Bond market participants, among others, anxiously ponder how and when the Fed will eventually drain liquidity from the economy. Bankers are also nervous. They have been called on to beef up their banks' capital positions. This they have done. But, will there be more mandates to increase bank capital? And, if this wasn't enough, the all-important bank regulations that will accompany the new Dodd-Frank bank legislation will take years to be written and finalized. It's not surprising that bankers, instead of making loans, are piling up excess reserves.

Exchange Rates Around the World

Country	Currency per USD (Dec. 31, 2009)	Currency per USD (Dec. 8, 2010)	Year-to-Date % Change (Appreciation)
Singapore	1.41	1.32	6.82%
India	46.40	45.10	2.88%
Hong Kong	7.80	7.80	0.00%
Philippines	44.15	43.80	0.80%
China	6.83	6.66	2.55%
United States	-	-	-
Thailand	33.36	30.10	10.83%
Korea	1166.00	1146.00	1.75%
Taiwan	31.99	30.20	5.93%
Japan	93.08	84.30	10.42%
Mexico	13.08	12.40	5.51%
Turkey	1.50	1.49	0.67%
Colombia	2042.90	1889.00	8.15%
Malaysia	3.42	3.15	8.57%
Chile	507.36	477.00	6.36%
Indonesia	9425.00	9020.00	4.49%
Brazil	1.74	1.69	2.96%

Source: The Economist

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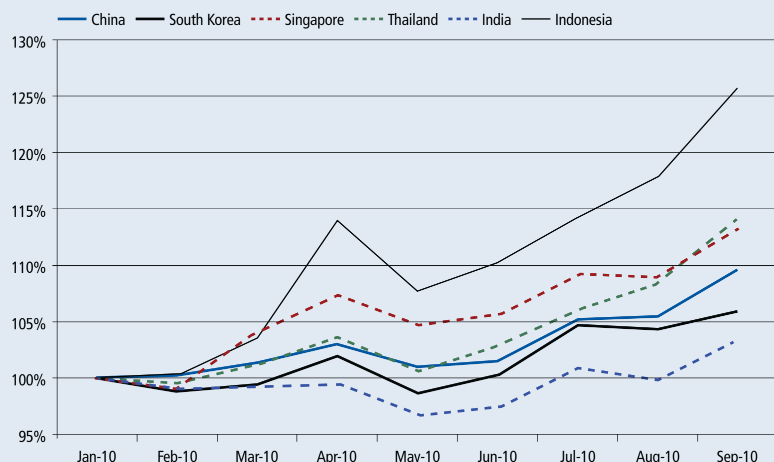
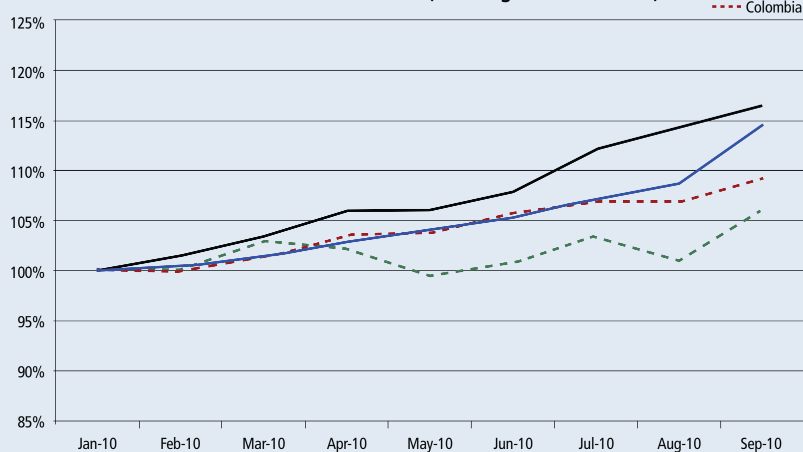


Aggressive interventionism and regime uncertainty are, of course, not limited to the U.S. A great deal of this interventionism is flying under the flag of harmonization. It is asserted by the interventionists that taxes and regulations worldwide should be harmonized to insure stability. What nonsense. Never mind. The European Union recently came close to demanding that Ireland increase its "low" corporate income tax rate, so that the Irish rate would be harmonized with other European rates. Brussels is also annoyed with the Swiss, and Switzerland isn't even a member of the European Union. According to reportage in *Le Figaro* (15 December 2010), the E.U. claims that "low"



Source: International Monetary Fund, International Financial Statistics, December 2010

tax rates in some Swiss cantons amount to "tax dumping." The E.U. is determined to put a stop to this "outrage."

And that's not all. Recently, the World Bank released its *Doing Business 2011* report. In terms of the ease of doing business (economic freedom), Georgia is ranked 12th best overall (Singapore, Hong Kong and New Zealand command the top three spots). Among the former communist countries, Georgia commands the top rank. Only days after the report was released, the European Commission indicated that it was not yet ready to sign a free trade agreement with Georgia. Apparently, Georgia is too free-market and must make greater efforts to harmonize its taxes and regulations with those in the E.U. This push to harmonize amounts to a race to the bottom.

One of the leaders in this race to the bottom is French President Nicolas Sarkozy. Indeed, *Le Figaro* of 14 December 2010 reported that a delegation of international union leaders, including Mr. Bernard Thibault of the communist-friendly CGT, recently met with President Sarkozy and together they hammered out an agenda for the G-20 meetings that will take place during the first quarter of 2011. Surprise – harmonization of labor laws will be a top priority. The diversity (competition) of labor market regulations is frowned upon. Georgia beware.

Back in the U.S. and the zero interest-rate trap, we must not forget that the Fed's ultra-low interest rates have not only produced a U.S. credit crunch, but also picked the pockets of prudent savers. For example, with "low" returns (and "low" discount rates), the unfunded liabilities of state pension funds in the U.S. have exploded and are estimated to reach $1 trillion by 2013. In the United Kingdom, actuaries are also having sleepless nights because of "low" yields (and "low" discount rates). Over half of the companies in the U.K. are projected to face bankruptcy if government bond yields remain at current levels.

The distortions created by the Fed in the U.S. don't stop – contrary to Chairman Ben Bernanke's assertions – at the U.S. borders. The Fed-created excess liquidity does not stay put in the U.S. It chases yield. This hot money floods into emerging-market countries and international commodity markets via so-called carry trades in which U.S. dollars are borrowed at "low" rates and invested in asset markets with higher prospective yields. The hot money carry trades weaken the U.S. dollar. This makes the repayment of U.S. dollar loans even less costly and creates inflationary pressures outside the U.S. – most notably in emerging-market countries. The hot money flows also fuel commodity price surges.

The hot money flows from the U.S. are associated with distortions: consumer prices around the world are elevated; real interest rates are depressed; and foreign currencies are "strong" relative to the U.S. dollar (see the accompanying tables on real interest rates and exchange rates).

In an attempt to tame the appreciation of their currencies against the greenback, foreign central banks intervene in the foreign exchange markets and accumulate U.S. dollar reserves (see the two accompanying charts on foreign reserve accumulation). But, absent huge amounts of sterilization – selling domestic bonds and bills to mop up the liquidity created by foreign exchange intervention – domestic inflation and asset bubbles in the countries that are hot money destinations spiral upward. In the end, capital controls – which are permitted under the International Money Fund's rules (Article VIII) and represent a residual influence of John Maynard Keynes who was obsessed with hot money flows and carry trades – become more-and-more inviting.

By employing a faulty economic model at home and by being internationally insular, the Fed has merrily entered into a zero interest-rate trap. At home, a debilitating credit crunch ensued. And abroad, hot money has reared its ugly head, distorting markets far and wide and inviting the use of capital controls. The only way for the Fed to exit the trap is for it to begin to raise interest rates.

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