Your on the Street Reporter

Uyless Black

Epilogue XIV to *The Nearly Perfect Storm*

The Federal Reserve and Low Interest Rates

Preface

My intent in writing *The Nearly Perfect Storm: An American Financial and Social Failure* and these epilogues is to spark your ire. I am not one to compose inflammatory compositions. I began my studies of the 2008 financial crisis with a neutral view of the subject, perhaps even skewed toward the financial world (specifically, the investment banking industry), reflecting my former employment at the Federal Reserve.

No longer. The more I learned about the institutions and individuals who were involved in the meltdown, the more disgusted I became. I wish this turn of events had not come about. I wish I had found the Great Recession occurred because of a downturn in a conventional business cycle. It did not.

Do not expect this series to be light-hearted, although I will attempt some gallows humor to lighten the load.

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The Nearly Perfect Storm: An American Financial and Social Failure
Epilogue XIV: The Federal Reserve and Low Interest Rates

Ocetober 19, 2015

These epilogues are written on occasion as follow-ups to *The Nearly Perfect Storm: An American Financial and Social Failure*, available online at Amazon, Barnes & Noble, as well as local book stores. As in Epilogue VI, Epilogue XIV discusses recent legal settlements that represent aftermaths of the 2008 financial meltdown. I begin with excerpts from the book about the issue.

Quotes from *The Nearly Perfect Storm* about the issue.

Page 15:
… Goldman and other institutions were granted an amendment to their charter. In one swift move, they were changed from an *investment bank* to that of a *bank holding company*. This latter category describes a non-commercial banking company that owns a bank or banks. This extraordinary grant from Uncle Sam's beneficence allowed these companies to gain access to the Federal Reserve's deep pockets and obtain loans at interest rates that you and I—and Main Street companies—could realize only in our dreams. [Regulators have later claimed this grant was not done for monetary reasons.]

Page 18:
In spite of the complex contract, a prospective homeowner was eager to take on a mortgage because interest rates were very low for many years—another gift from Uncle Sam. The prolonged low interest rates were helping to feed an expanding residential market, which became known as the "housing bubble." The market was booming, resulting in huge increases in the value of homes.

Page 197:
On another matter, from the perspective of an individual citizen, and not financial institutions, how can Uncle Sam preach the goodness and patriotism of savings when the Federal Reserve Board keeps interest rates so low? At a level that a bank depositor's return on a savings account does not even compensate for the rise in gas prices? Low interest rates help borrowers but penalize savers. We are told by the Fed governors that low interest rates—for many years—will be required to aid in the nation's recovery. Meanwhile, Joe the Plumber pays 5 percent interest on a mortgage to a bank, and the bank goes to the Fed's discount window for a loan at less than 1 percent.

Comments on the excerpts:
Three types of interest rates are pertinent to this discussion:

Fed Funds (federal funds) rate: The interest rate at which banks and credit unions exchange their balances (federal funds) in the form of *unsecured* loans held at the Federal Reserve with one another. [Something similar to Barnes and Noble helping out Borders to keep Borders stabilized. Sound strange? It should.] These loans are usually overnight transactions, but the Fedcontrolled interest rate for these exchanges affects interest rates in many parts of the economy, such as CDs and mortgage loans. Currently, this rate is 0.25 percent.

Discount rate: The interest rate charged to banking institutions for loans received from the Federal Reserve's discount window. The word *discount* is apt, because these institutions can borrow money at low interest rates. Currently, this rate is 0.75 percent.

Prime rate: The interest rate that banks charge their best customers, which are usually large corporations and not individuals. The rate is largely determined by the Fed Funds rate. The prime rate affects individual customers, because it determines the rates for mortgages and personal loans. Currently, this rate is around 3.25 percent.

The Fed Funds rate drives the other rates. It is used to make it more expensive (raising the rate) or less expensive (lowering the rate) to borrow. Thus, it controls the supply of available money and helps control inflation.

Hm. 0.25 percent; 0.75 percent; 3.25 percent. Meanwhile, conventional interest rates to Joe Citizen are around 4.0 to 4.5 percent for a conventional 30-year fixed mortgage and at least 5.0 percent for a personal loan to a person with a stellar credit rating. For more risky borrowers, the rate goes beyond 10.0 percent. If you are in financial trouble, and must resort to using credit cards until you find a job or avail yourself to Uncle Sam's unemployment checks, the interest on the first few months of credit card debt might be modest. But prolonged use of a credit card results in interest payments ranging from 12.0 to 20.0 percent.

A skeptic to my leanings in this essay may say, "So what? Lenders must make a profit on their lending. Otherwise, there will be no lenders."

True, but should this idea penalize those people who do not borrow but save? As it now stands, the answer is yes. An individual person is irrelevant to the big picture of companies, businesses, and corporations. It's a macro economics issue. It's a big picture issue.

The gray panther, with her husband pushing up daisies, relies on her precious 401(k), hoping it will stretch out before she is stretched out. At less than one-half of a percent in interest being paid on her 401(k), the long term planning between her and her husband, planning to be able to live out their lives with financial dignity, has been rendered moot.

The skeptic will say, "Yes, but a faltering economy will also hurt Mrs. Gray Panther. So, it is to her benefit that the Federal Reserve holds the line on paying more to her 401(k) in order to protect the economy."

Increased interest payments on her savings would more than offset any increase in prices she might pay because of increased prices from inflation. Plus, she has no loans for which she would be paying more interest payments (older people do not carry as much debt as younger people). As a saver, inflation is a godsend to her, something that is left out of the macro-economic equations.

In addition, low interest rates lead to low inflation and a brake on prices; thus a brake on tax revenue from sales of goods and services. The Social Security system's possible annual raises are based on tax receipts. During times when taxes are not bringing in sufficient money to the government (when inflation is low) it does not raise the annual Social Security pay-out to older citizens.

However, the expenses for older people are more pronounced for health care, which has been increasing well beyond the average inflation rate. Therefore, gray panthers (many who rely mostly on Social Security for their major source of income) find their net income decreasing, income that was low to begin with. For 2016, Social Security payments will not be increased, because of lowered tax receipts.

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Enough of my libertarian thoughts about the individual for now. As for macro-economics, the Fed is following the same practices that helped contribute to the 2008 financial meltdown. A prolonged period of low interest rates encourages individuals and institutions to take on more debt. Some of this debt is for questionable investments or simply to fund profligate spending. Whatever the reason, highly leveraged parties lose flexibility to do their business. Any slight downturn will push them into financial straits.

Last week, the Federal Reserve Board announced it would not raise the Fed Funds interest rate, thus prolonging the availability of cheap money. The reason given by the Fed was that the economy "had not achieved equilibrium and a rise in interest rates would dampen the slowly recovering financial sector and companies" that rely on the financial sector for capital. Figure 1 sheds light on this issue.[1]

The following fact seems to have been lost on the Fed. "In nine of the 12 most recent [financial] cycles, the stock market has risen in the year following the first rate increase."[2] In addition, as Figure 1 shows, manufacturing capacity is at a relatively healthy rate and continues to climb.

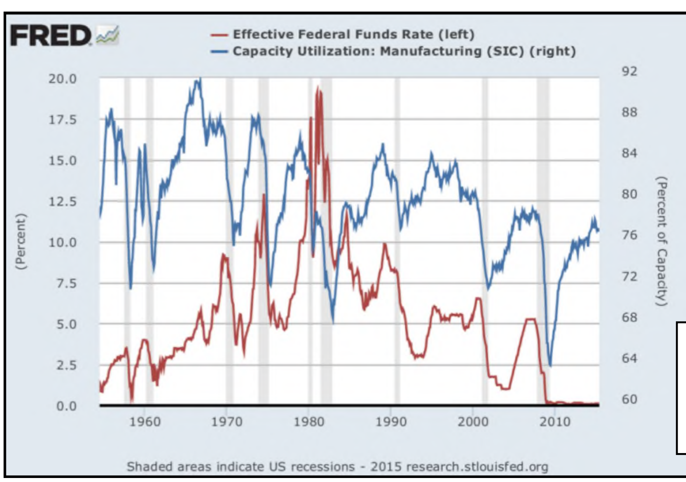

Figure 1. Fed Funds rate and manufacturing capacity utilization.

[1] From the Federal Reserve Bank of St. Louis. See research.stlouisfed.org.
[2] "Tightening Pains," *The Economist*, September 12, 2015, 67.

As stated on page 197 of *The Nearly Perfect Storm*, these periods of low interest rates can prove disastrous to parties who do not use debt to fund their business or pleasure. Uncle Sam no longer encourages its citizens to save. CDs and savings accounts are a joke. Spend! Spend! Spend! Get this consumer-oriented economy moving again.

But what if a citizen does not want to spend? What about senior citizens, who need to succor their savings and cannot afford the ups and downs of the stock market? After all, the market might be down when they go down, leaving little money in their will for their loved ones and former wives.

As they say today, they are SOL (excuse the term, *shit-out-of-luck*, but it aptly describes the situation). Leaving money in CDs, savings, or money markets is not much different than putting it under a pillow.

Let's assume a gray panther has $100 of savings. He puts it in a CD that pays one percent (compound interest, calculated on a daily basis). Alternately, the CD pays five percent. In ten years, the higher rate has yielded over six times that of the lower rate ($64.87 vs. $10.52).

(The Federal Reserve did not keep interest rates low for ten years. This example is hypothetical. However, the Fed dropped its Fed Funds rate to less than 2.5 percent at the beginning of this century and it has been near zero for several years.)

If the gray panther has been counting on getting even a modest return on her money (the five percent) to take care of her later days, as said, she is SOL.[3] She's running short of money before she runs short of breath, so she borrows $100 from the local bank. She pays 3.86 percent on the loan. The bank obtains this $100 from the Fed (at the discount window, because the bank decided to become a bank holding company), or from another financial institution. Currently this rate is 0.75 percent, which reflects a difference of over three percent between the gray panther's interest rate to the bank and the bank's interest rate to the Fed.[4]

As mentioned, the Federal Reserve uses its power to regulate interest rates to combat inflation, to keep it from being too low or too high. The Federal Reserve Board chairperson, Janet Yellen, said in a recent speech, "…inflation is now much more stable than it used to be, and that it is currently running at a very low level. …the Federal Reserve should try to keep inflation close to 2 percent."[5]

Figure 2 shows the relationships of the Fed Funds rate, unemployment, and personal consumption expenditures (PCE). The PCE is "…the primary measure of consumer spending on goods and services in the U.S. economy. It accounts for about two-thirds of domestic final

[3] So is any saver. My example of an older person accentuates the problem.
[4] A critic may claim my example is faulty, because dscount window borrowings are short term. During the financial crisis, the Federal Reserve not only resorted to longer term lending to financial institutions, it actually purchased many of their mortgage-backed securities to get them off the hook. Many were laden with toxic, sub-prime loans.
[5] Janet Yellen, "Inflation Dynamics and Monetary Policy," Speech, Sept. 24, 2015, http://www.federalreserve.gov/newsevents/speech/yellen20150924a.htm.

spending, and thus it is the primary engine that drives future economic growth."[6] It is a measure of price changes of (principally) consumer goods.

What can be gleaned from this data? Inflation is under control, the unemployment rate is manageable, the prices for consumer goods are low, and interest rates for savers are low. Meanwhile, the gray panther's savings wither on the micro-economic vine.

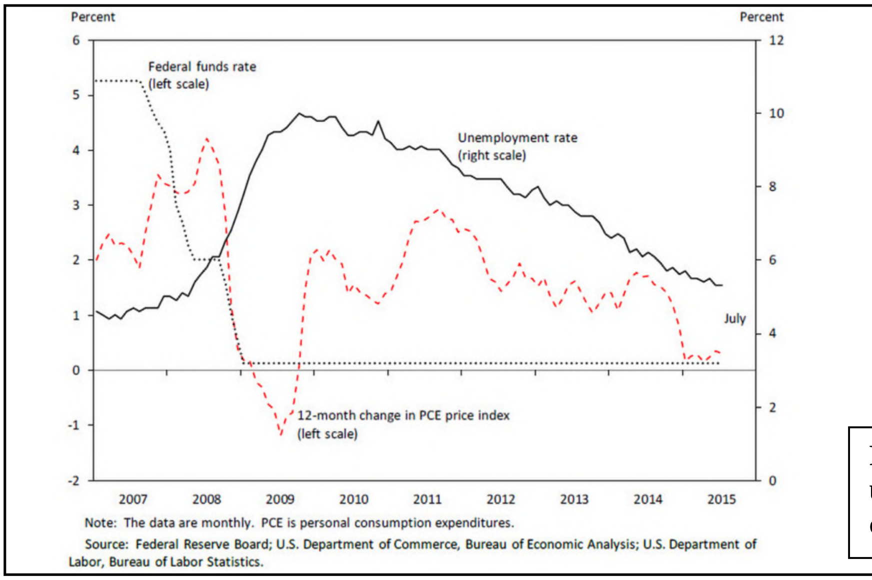

Figure 2. Fed Funds rate, unemployment rate, and consumer spending (PCE).

Protect the economy. It's fragile. Hold those interest rates down so that borrowers can borrow even more. The gray panther also joins the borrowing crowd. If the gray panther could avail himself of the Fed's discount window or the Uncle Sam's loans to banks during the crisis (see TARP), she might have a chance of staying out of the bread line before she joins the queue at the local funeral home and her deceased husband at the cemetery.

Protect the worker. Get him a job and lower the overall unemployment rate. Ms. Gray Panther does not work.

Well, that's macro-economics for you: Take care of the big picture and the big players. Take care of the borrowers. For the micro-world of those gray panthers, it's SOL time.

[6] https://www.google.com/webhp?sourceid=chrome-instant&ion=1&espv=2&ie=UTF-8#q=personal+consumption+expenditures.