Monness, Crespi, Hardt & Co., Inc.
767 Third Avenue
New York, NY 10017
212 838 7575

Sydney M. Williams

Thought of the Day
"Politicalization of the Fed"
September 21, 2015

"Permit me to issue a nation's money and I care not who writes the laws," so, allegedly, once said Mayer Amschel Rothschild (1744-1812). Last week, Fed Chairwoman Janet Yellen took advantage of falling commodity prices, turmoil in markets, an anemic recovery in the U.S. and weakening economies overseas – especially China – to leave the rate on Fed Funds at the zero to twenty-five basis points where it has been since December 17, 2008. She also cited a lack of inflation and concern that a stronger dollar would further inhibit economic recovery at home.

What she did not mention was the effect of higher interest rates on debt owed by the federal government and, thus, its fattening impact on the deficit. Federal debt is about $18.2 trillion. That number excludes debt owed by state and local governments, as well as funds owed by agencies. And, of course, it does not include future obligations of social welfare programs like Social Security, Medicare and Medicaid. Deficits in fiscal 2015 will add about $400 billion to existing debt. A one percent increase in interest rates would up the deficit by about 40 percent. Should rates revert to normal levels, the deficit would rise to a trillion dollars. Ms. Yellen is surely mindful of the salutary effect low interest rates have had on annual federal deficits.

Connecticut, where I live and which is one of the most profligate of the fifty states, announced last week that $103 million would have to be cut from next year's budget. The headline in my local paper: "Malloy Plans Steep Cuts." Those affected cried foul, even though the cuts amount to one half of one percent of the $20 billion state budget. It would be as though the average Connecticut family, with a house-hold income of $60,000, were told to pare expenses by $300. The explanation for the cuts could have come from the theater of the absurd. Mr. Malloy claimed that stock market losses will cut into anticipated corporate and state income taxes received. (The State had budgeted for a 7.1% increase in income taxes, an unrealistic expectation given that individuals and businesses are deserting the state. His budget still assumes a 4.4% increase in those taxes, which will prove too ambitious.) Low interest rates, without the ability to print money, are not a panacea to the financially promiscuous. They mask the problem.

A little bit of inflation the Fed finds desirable. Am I too much of a cynic if I suggest it is because it allows them to pay back today's loans with tomorrow's less-worthy dollars? Since the Great Depression, politicians have warned of the devastating effects of deflation – an excuse the Fed uses to justify keeping rates low. Deflation, we have been conditioned to believe, leads to Hoovervilles, men selling apples and brokers taking swan dives out of windows on the corner of Broad and Wall. Deflation <u>is</u> bad when incomes fall faster than prices of goods and services. Yet, as James Grant reminded us in his most recent *Interest Rate Observer* that is not always the case: "In England, between 1800 and 1913, real GDP more than quintupled even as consumer prices dwindled; the basket of merchandise that cost £2.25 in 1800 cost £1.60 in 1913. Keep in mind, that period included the Napoleonic Wars, a time that saw British debt soar to 250% of GDP." More pertinently, those years included the Industrial Revolution, which brought disruptive change to millions, costing jobs and driving families off farms and into cities. Yet, employment grew, as did standards of living. Today, technology is changing our lives in similar ways, eliminating jobs in many industries and putting downward pressure on the pricing of goods and services. What we *can see* are the jobs being eliminated due to technology. What we *cannot see* are the jobs that will be created because of technology. Examples are Amazon and Uber, each going after politically entrenched businesses, while providing goods and services that benefit consumers. Consider, as well, the opportunities Charter schools provide inner-city children, despite objections from teachers' unions and push-back from their political gophers.

We cannot plan for every contingency, whether good or bad. Government's response should be to give people more freedom to innovate and experiment, to succeed or to fail. People need confidence, not about the future which is always unknown, but in the belief that their freedom will not be taken away, and that regulation and taxes will not provide too steep a hurdle. The price of money is important, as is knowing that inflation will not diminish its value. At this point in the cycle, it is fiscal reform not monetary ease that is wanted.

The Federal Reserve is supposed to be independent from political interference. It is comprised of twelve Reserve Banks, with a headquarters in Washington. The twelve Reserve Banks elect or appoint their presidents. There are seven members of the Board of Governors who are appointed by the President and confirmed by the Senate. They serve 14-year terms. The President designates and the Senate confirms two members of the Board to be Chairman and Vice Chairman, for four-year terms. The primary responsibility of the Board is the formulation of monetary policy, which is done through a twelve-member Federal Open Market Committee (FOMC). The FOMC consists of the seven board members and five presidents of the twelve Reserve Banks, the latter on a one-year rotating basis. The board sets reserve requirements and shares responsibility with the Reserve Banks for discount rate policy. Those two functions plus open market operations constitute the monetary tools of the Federal Reserve System.

The Fed was critical in 2008, when the credit crisis threatened to undue our financial system. The first quantitative easing program was announced in November 2008; a month later the Fed reduced rates to zero. Then, less than four months after President Obama signed the American Recovery and Reinvestment Act of 2009, the economy came out of recession. What allowed the economy to recover was a combination of Fed actions, coupled with the confidence people felt with Mr. Obama in the White House. The recovery that emerged arrived before the economy could feel the effects of the so-called stimulus plan. In contradiction to the myth that has been told, Mr. Obama inherited an improving economic and financial situation. The mess in which we now find ourselves is of his making, not his predecessors.

Low rates have allowed the federal government to increase its borrowings without the inhibiting effect of normalized interest rates. Since federal government spending accounts for about 23% of GDP, and with state and local spending bringing the total to about 35% of GDP, the question arises: is government too big to tame? We better hope not.

Mr. Obama has put us on the well-trodden path toward democratic socialism and the limit that route brings to economic freedom. We need to get back to the one from which Western democracies have strayed – the path that leads to greater opportunity and reward for individual initiative. One step would be to release the Fed from the bonds of politics.