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The Fed and Interest Rates – Into the Weeds

This week's piece is inspired by [Horace "Woody" Brock](#), President of Strategic Economic Decisions. I have followed Dr. Brock's work over the last 10 years and have found his insights to be particularly profound and useful when analyzing major, long-term macroeconomic trends. In "The Fed Funds Rate: RIP", Woody relies on work by Fed Vice Chairman, Stanley Fischer, who is the former governor of the Bank of Israel and first deputy managing director of the International Monetary Fund (IMF). He also cites the work of Professor Benjamin Friedman at Harvard University.

I hope you find my interpretation of Dr. Brock's most recent work interesting.

Wall Street is abuzz with speculation as to if, and when, the Federal Reserve will start to raise short-term interest rates. It appears the Fed's next move is to start raising interest rates following nine years of accommodative monetary policy. **Over the past nine years the Fed has transformed monetary policy in three developments.** The first two developments have been under serious discussion by our nation's economists and investment pundits. The third development currently underway hasn't yet been noticed by the mainstream analytical community. If this view is correct, many on Wall Street, and the capital markets themselves, will need adjustment as this development becomes apparent later this year.

Quick History Lesson – How the Fed Has Worked

From 2008 – 2014 the Fed launched two major initiatives designed to fight against the possibility of the U.S. (and the world's) economy falling into a depression. The Fed lowered the overnight Fed Funds rate to zero percent and has maintained that ultra-accommodative stance to this day. If you look at Fed Fund average rate activity from a historical standpoint over the last 12 business cycles, you will see the Fed Funds rate was less than four percent at this stage of the economic recovery process.

The second development was the Fed launched quantitative easing (QE) operations on three separate occasions over the last eight years. Through these operations, the Fed increased the size of their balance sheet from \$900 billion to \$4,500 billion. How did the Fed do this? In essence, the Fed printed money and then launched massive bond purchasing programs, feeding fresh money into the nation's banking system. Since the world's economy wasn't growing rapidly enough to absorb this extra liquidity (bank loan growth was slow), it found its way into the world's

financial markets. This fueled higher prices in stocks, bonds and real estate while inflation remained at bay.

Now that the Fed's balance sheet has exploded upwards in size (followed by the Bank of Japan (BOJ) and the European Central Bank (ECB)), how are they going to unwind this balance sheet without crushing the markets which they have helped drive to the upside?

The Fed's Next Step

Enter the discussion of the third development – the Fed starting to raise interest rates. One main tool the Fed has used to control short-term interest rates is adjusting the Fed funds rate. ***Federal funds are overnight borrowings between banks and other entities.*** The interest rate earned on these ***deposits at the Fed are controlled by the New York Fed trading government securities which affects the rate earned, or the Fed funds rate.*** ***Since the Fed's balance sheet has exploded in size by five-fold, this method of controlling short-term interest rates has become, according to Dr. Brock and Dr. Stanley Fisher, "unworkable."***

Before the financial meltdown in 2008-2009, the Fed's balance sheet was typically around the \$25 billion range. Reserves were a fraction of what they are today. The level was wholly controlled by the Fed. Minor variations in the amount of reserves (through open market sales/purchases) moved the Fed funds rate up or down as desired. The Fed controlled the supply of reserves the banks were demanding for lending activities. Consequently, through open market purchases and sales of securities, the Fed controlled the Fed funds rate.

With the Fed's balance sheet at \$4.5 billion, ***open market transactions would need to be massive to affect the Fed funds rate.*** This was initially made clear in a Federal Open Market Committee (FOMC) pronouncement in 2014, and then followed up by Stanley Fischer, Fed Vice Chairman. In 2015, Dr. Fischer presented a speech where he stated:

"With the nearly \$3 trillion free bank reserves (up from pre-crisis reserves averaging \$25 billion), the traditional mechanism of adjustments in the quantity of reserve balances to achieve the desired level of the Federal Funds rate may not be feasible or sufficiently predictable."

Two New Tools – Interest on Reserves and Reserve Repo Rate

Given this framework, how will the Fed control demand for capital through interest-rate manipulation? Dr. Brock, and many other well-known economists, believe the Fed will need to design new tools with which to drive interest rates, and consequently demand, for short-term capital by the banking system and others.

1. **Interest Paid on Bank Reserves.** The Fed may control interest rates not through traditional open market transactions, but through declaration of what interest rate they will pay to banks on deposited reserves. The ability of the Fed to do so dates back to legislation passed in 2008. If the Fed decides to pay five percent on such reserves (now at 0.25 percent) banks wouldn't lend money at rates less than five percent. This action directly controls bank lending activities.
2. **Creation of a Federal Reserve Reverse Repo Lending Facility.** The Fed may get heavily involved in the reverse repo market. Not all institutions have access to the Fed's interest rate "targeting" mentioned above. A significant portion of lending activity in the United States occurs within the "shadow" banking system – think money market funds. Historically the banking system comprised the vast majority of liquid deposits from savers and investors. In the 1970's, the proliferation of money market funds drove deposits from the banking system into the fund

complex (called *disintermediation*). The Fed lost direct control over this liquidity. To fully control the money supply, the Fed has been attempting to regain control of these large pools of liquidity. Eligible counterparties (106 money market funds, 22 broker-dealers, 24 depository institutions, and 12 government-sponsored enterprises including several Federal Home Loan Banks, Fannie Mae, Freddie Mac and Farmer Mac). In this action, the Fed will launch a reverse repo agreement facility, acting as guarantor of those transactions and setting the interest rate at which these transactions will occur. This action would set an interest-rate floor as to what interest rate these institutions will be willing to lend.

Through these actions (and not open market transactions), the Fed would control what interest rate the banks and a major portion of the shadow banking system would be willing to lend, setting the floor for risk-free short term interest rates on which other rates will be built.

Unwinding the Balance Sheet

As mentioned above, the Fed's balance sheet (assets) has expanded by five times since 2007. This has been purposeful as the Fed wanted to literally flood the financial system with liquidity. By lowering interest rates to zero percent, and flooding the banks with liquidity, the Fed was attempting to kick-start economic activity by spurring risk-taking. The BOJ (Japan's central bank) and the ECB (Europe's central bank) are currently undergoing the same type of balance-sheet expansion.

The main goal of QE actions was to spur overall economic growth. QE's impact on the stock market was the most measurable of all four economic/capital market impacts (stock market impact, interest rate impact, currency impact and GDP growth impact). On average, the S&P 500 rose by 30.6 percent in value while the three separate QE actions were ongoing. Measurable GDP growth was less than an increase of one percent during the 12 months following QE actions as compared to concurrent GDP growth while QE actions were undertaken.

So, were the actions which led to the Fed increasing their balance sheet by five times worthwhile? The "Main Street" positive impact was questionable, at best.

Nonetheless, the fact that the Fed increased the size of their balance sheet by five times is a fact, irrespective of the overall economic impact of those actions. Now, how is the Fed going to unwind its balance sheet? How will they eventually return to a more normal environment?

Dr. Fischer provides the following answer to this question, which many astute investors are currently curious:

"With regard to balance sheet normalization, the FOMC has indicated that it does not anticipate outright sales of agency mortgage-backed securities, and that it plans to normalize the sized of the balance sheet primarily by ceasing reinvestment of principal payments on our existing securities holdings when the time comes...Cumulative repayments of principal on our existing securities holdings from now through the end of 2025 are projected to be \$3.2 trillion. As a result, when the FOMC chooses to cease reinvestments of principal, the size of the balance sheet will naturally decline, with a corresponding reduction in reserve balances."

The question then arises – ***since the U.S. federal deficit still needs to be financed, what will happen when the largest purchaser of U.S. Treasury debt "leaves" the market?*** As a businessperson, if the largest purchaser of your product threatens to go elsewhere, what are you

going to do? Make your product more attractive to keep that purchaser – in the Fed’s case they may need to raise interest rates to attract capital.

Closing Thoughts and Market Ramifications

According to Dr. Brock and Dr. Fischer (along with others) the Federal Reserve will be ***forced to abandon the traditional open market transaction method of controlling short-term interest rates. They argue the absolute size of the Fed’s balance sheet makes this type of action unfeasible. To most Americans, these actions may seem somewhat byzantine and obscure.***

If these new forms of money supply manipulation (control of demand for short-term capital by the public markets) come about, ***the new actions could rather dramatically affect shadow-banking activities and heretofore private transactions between private lenders and borrowers.*** The Fed would be viewed by the money market fund complex as the arbiter of reverse repo rate (since the money market funds could deposit money directly at the Fed with no risk) and consequently, ***the Fed would more directly control not only short-term government rates, but also commercial paper lending rates.***

Additionally, as in any major methodology change, ***unknown consequences may occur.*** If the Fed indeed changes their method of controlling short-term interest rates – through reserve rates and the reverse-repo market – ramifications to other less-controlled markets may occur. ***The predictability of these possible ramifications is not currently known. Currently, the Fed’s open market transaction activities are rather transparent. Investors and others can view the Fed’s intentions through open market transaction activities conducted by the Fed in New York. Apparently, the current level of transparency may be altered to become more obscure, leading to a higher potential market surprise factor.***

But perhaps the major change which will occur is one of Federal Reserve control. The process of reversing the disintermediation of deposits away from direct Federal Reserve control continues.

I refer to Dr. Brock’s work extensively in my piece today. As mentioned, I have been following Dr. Brock’s work for some time, and have conversations with him regularly. Highlights from Dr. Brock’s resume read as follows:

Dr. Horace “Woody” Brock is one of the world’s foremost economists. As the founder and president of Strategic Economic Decisions, a renowned economic think tank, Dr. Brock has spent more than 25 years counseling global corporations and other institutions who benefit from his in-depth analysis of ongoing structural changes in the global economy. He earned his B.A., M.B.A. and M.S. from Harvard University, and his M.A. and PhD. from Princeton University (mathematical economics and political philosophy).

Woody is one of those people who we all understand exist – but are hard to find – a true economic genius.

We will be back next week.



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