

# Economic Déjà vu

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The recent recession that swept through this and many countries worldwide had many causes, one of which was the low interest rates in the United States. Loose monetary policy pursued by former Chairman of the Federal Reserve Alan Greenspan was a major component of the housing crash and following recession. Furthermore, the Fed's current monetary policy is extremely similar to policy pursued before the 2008 recession. Unless a change takes place, the American economy could experience another — and possibly worse — recession in the near future. The current system of monetary policy implemented in the U.S., necessitating that credit and debt expand forever, is a dangerous and potentially disastrous policy to be pursuing.

Low interest rates are agreed to be a main cause of the housing bubble which burst in 2006.<sup>1</sup> Policy pursued by Greenspan, who chaired the Fed from 1987 to 2006, kept the interest rate too low for too long. These low interest rates enabled Americans to buy houses and accelerated “the housing boom and thereby ultimately [lead] to the housing bust.”<sup>2</sup> Leading up to the boom, many individuals, including subprime borrowers, were able to take out equity in their home to fuel their purchasing passion. The Financial Crisis Inquiry Report

noted, “Homeowners pulled cash out of their homes to send their kids to college,” and “take vacations.” Eventually, however, the delusion of wealth evaporated and millions of individuals were stuck owning houses valued far less than what they owed. This housing bust, which occurred in late 2007, could've been avoided by more closely regulating who lent what to whom, at least according to the Financial Crisis Inquiry Commission. The FCIC claims, “The Federal Reserve was the one entity empowered to [set mortgage lending standards] and it did not.”<sup>3</sup> While this may seem like a nice way to push the blame onto an institution, the real problem lies in the monetary system, whether implemented by the government or not, of the U.S.

Greenspan was praised as Ben Bernanke succeeded him in 2006. However, a few short years later he was despised for his easy monetary policy that helped contribute to the housing boom and bust. After the dotcom bubble burst in 2000, a recession followed which lasted until 2001.<sup>4</sup> Greenspan lead the Fed in its pursuit to recover the economy by lowering interest rates to spur economic growth. The policy worked and Greenspan was praised for his insight and intuition in helping fix the economy. Unfortunately, the Fed continued keeping the interest rate low — too

low, as many argue. Famed economist John Taylor developed a rule, called the “Taylor Rule,” which uses economic indicators to recommend an interest rate level to best control boom and bust cycles.<sup>5</sup> In 2002, when the economy had recovered from the previous recession, interest rates should’ve risen to reduce the possibility of a boom. What actually happened, however, was the *lowering* of the interest rate. The economy was no longer in a recession, so interest rates should’ve begun to rise, as an application of the Taylor Rule would have prescribed. Rates were further reduced until 2004 when the Fed decided it was finally time to slow economic growth.<sup>6</sup> By then, sadly, it was too late. A housing boom had already been created and increasing rates could do little to prevent what already happened.

The American economy is in an extremely dangerous place, and unless something is done, future stability will be compromised. Current economic conditions are at a high plateau and will crash sometime in the future if action isn’t taken.<sup>7</sup> The U.S. needs to change its monetary policy, which has been dubbed by some as a “Ponzi economy,” or one in which Americans are consuming more than their means should allow and where corporations outsource production

and debt to overseas nations. Furthermore, a Ponzi economy deflates the importance of saving and instead looks for a profitable short-term rather than a long term. This system of a Ponzi economy works until many people want to be repaid, at which point the economy comes crashing down.<sup>8</sup>

The American government, more specifically the Fed, is also responsible for perpetuating a Ponzi economy. Its tendency to pursue expansionary monetary policy, regardless of economic conditions, has backed the Fed into a corner. Getting out of the corner requires the Fed to print more money to pay off debt interest. In just five years, from 2008 to 2013, the monetary base tripled.<sup>9</sup> A general economic agreement has been made regarding expansionary monetary policy: an increase in the money supply causes an increase in prices. If money supply tripled in five years yet inflation remained relatively low, then something unusual must have kept prices from rising. An investigation into excess bank reserves reveals that since 2008, excess reserves have increased by *1624 times* 2008 levels. Excess bank reserves, as of October 2014, reach over 2.6 *trillion*.<sup>10</sup> The implication of this colossal increase in excess reserves is the potential for an unexpected increase in inflation. Banks with excess reserves can

lend out money immediately, as opposed to needing to raise funds to finance the loan. An immediate increase in the money supply, even 500 billion, could cause inflation to rise.

Bernanke, who was at the head of the Fed from 2006 to 2014, spurred the destructive monetary policy the Fed has been pursuing over the past 10 years. In a speech delivered in 2002, Bernanke identified deflation as posing “special problems for the economy and for policy” because it causes nominal interest rates to drop near zero.<sup>11</sup> Bernanke explained that when interest rates reach zero, the interest paid back equals the rate of deflation because the money borrowed loses value. As a result, businesses reduce investment, homes are not purchased and general spending decreases. Thus the real problem, according to Bernanke, was — and is — deflation. Bernanke argued that any and every measure must be taken to ensure deflation never happens in the American economy. This is the root of current monetary policy that created a serious worldwide recession and caused many to lose their jobs.

Current monetary policy is focused on preventing the deflation Bernanke identified as posing significant threats to the economy. Such policy is typified by excessive money creation in order to raise prices and decrease the value of each dollar. Regardless of economic school of thought, whether Keynesian or Classical, increasing the money supply causes demand for each dollar to fall, and thus the value of the dollar to fall, thereby leading to inflation. Inflation, as mentioned by Bernanke, is preferred to deflation. In almost a humorous manner, Bernanke bragged about the U.S. government's printing press, which allows production of unlimited U.S. dollars.<sup>12</sup>

Quantitative Easing (QE) is an unconventional way of stimulating investment when interest rates have dropped to zero and can't be reduced further. The Fed purchases securities from banks and other financial institutions with money it created specifically for the purpose of buying these securities. Purchasing securities with newly created money is what causes the excess bank reserves mentioned earlier. And, as also previously mentioned, excess bank reserves can cause unpredictable inflation if banks decide to suddenly loan out their excess reserves. However, QE can create economic growth if firms and consumers increase

investment and spending because of new confidence in the banks. Therefore, in the short run, QE can create more successes than failures, but in the long run is a dangerous tool to use because unexpected inflation could occur.<sup>13</sup>

On the surface, the economy appears to be functioning well, but the reality is that an endless issuance of debt is utilized to combat downturns. This debt is created not only by the federal government but also by corporations making risky decisions and investments fueled by debt. Using debt to finance gambling works well if the gamble pays off. If, however, the gamble does not pay off, such as the housing bust of 2007, debt cannot be repaid and instead continues increasing. Thus the current economic situation requires debt and credit to continue expanding forever which is a preposterous notion and a logical nightmare. Something has to change before the Ponzi Economy and our monetary system collapses.

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Monetary policy pursued by the Fed, more specifically low interest rates, must be modified in order to keep the American economy stable in the future. The destructive nature of keeping interest rates too low is still happening. In fact, current policy

regarding interest rates is so dangerous that a recession rivaling that of 2008 could be in

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store for the U.S. When interest rates were initially lowered to spur investment and consumption after the 2001 recession, they fell to a low of .98 percent. Eventually, the rate was brought back up to 5.25 percent in the two years preceding the housing crash. Then, to stifle the extent of the recession, the Fed began lowering the federal funds rate in August 2007 to limit the extent of the recession.<sup>14</sup> The rate was lowered nine additional times until the rate was lower than .2, where it has remained ever since.<sup>15 16</sup> As of October 2014, the rate was .09, essentially zero. As is evident, nothing has been learned from the Greenspan disaster and the housing boom and bust. Rates now are lower than before the housing boom and have been at this low rate for almost six years. Applying the

Taylor Rule to the current situation, rates should be at least above one percent, if not higher.<sup>17</sup>

The current economic situation of the American economy is very similar to the economy after the dotcom recession. Rates are at historic lows while the S&P 500 is at record highs.<sup>18</sup> The same exact thing happened in 2007 when the S&P 500 hit record highs while the Fed simultaneously lowered rates.<sup>19</sup> The Fed hasn't learned its lesson from 2008 and has the potential of jeopardizing future economic stability. As for why rates are so low, the Fed claims GDP isn't growing as fast as it should be and that the recession was so extensive it will take low long-term interest rates to help the economy. These policies appear blind to the past and, in a way, they are. The economy has recovered and now may even be in a greater equity bubble than pre-2007.<sup>20</sup>

To stabilize the economic future of America, a few policy changes must be made. First, interest rates must be raised to Taylor Rule approximation levels, if not higher. This will reduce the potential for future boom and bust cycles. Second, the expansion of money and the "war on deflation" must be reduced because such policy makes debt a controlling factor of the economy. Quantitative easing as well must be stopped because QE is simply

another mechanism to lower interest rates below zero. Third, banks must hold a higher capital stock to reduce risky loans to prospective homeowners. This will serve as an additional safeguard if higher interest rates are ineffective at reducing a dangerous boom cycle.

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The dangerously low interest rate problem must be addressed before catastrophe strikes. Basic economic principles dictate that low interest rates discourage saving and encourage spending while higher interest rates do the opposite.<sup>21</sup> Keeping interest rates low may be great in the short term because money flows into the economy rapidly. Unfortunately, permanently low interest rates illustrate a lousy plan for the future. Lowered savings ultimately lead to crumbling infrastructure and limited new factories. The solution is to raise interest rates to an adequate level. Difficulty arises, however, in finding the right level. A study cited in *The Economist* revealed higher interest rates have an almost direct correlation with higher returns on equity. In fact, the highest 15 percent of interest rates, sampled out of many countries over a 20 year period, saw the largest increase in equity in the following five years.<sup>22</sup>

Any increase in interest rates by the Fed would be beneficial to economic stability. However, a more precise method of determining what level interest rates should be set at can be determined using the Taylor Rule. As stated earlier, interest rates should currently be set at or around two percent to protect the economy from a disastrous boom and subsequent bust.<sup>23</sup>

QE should be restricted because it's simply another tool to further lower the ridiculously low interest rates. While QE can be effective in some instances, such as drastic economic downturns, it primarily promotes the short run at the expense of the long run. Using this policy after the recession may have been beneficial, but now, six years after the fact, QE needs to be stopped and the interest rate needs to be brought back up to safer levels. Such policy is unbeneficial to a nation seeking to remain globally competitive for decades to come. Recently the Fed has reduced the usage of QE, but should continue reducing until it no longer is a policy option for the Fed.<sup>24</sup> Although QE purchases have thus since been halted, the Fed still holds its assets.

The more capital a bank has, the better. Yet, many banks in America are insufficient in their capital holdings, albeit the requirements banks must hold in capital since the recent recession

has begun to increase. Wisely, the FDIC has required large banks to increase their risk-weighted asset ratio to six percent, an increase over the previous four percent requirement.<sup>25</sup> The total capital to risk-weighted asset ratio was increased to eight percent. Still, a larger requirement can be imposed. Increasing the ratio even further will strengthen banks and pad them against future economic downturns and subsequent losses. The FDIC agrees capital helps pad banks from losses and also notes a larger capital requirement promotes public confidence. An increase from the current ratio of eight percent to a 10 percent total capital to risk-weighted asset ratio would markedly improve the strength of banks and increase protection for these large institutions. The FDIC classifies banks with a total risk-based ratio larger than 10 percent as “well capitalized.”<sup>26</sup> How can increasing capital requirements help current monetary policy? Simply put, an increase in bank capital allows banks to invest using held money instead of customers deposits. Investment, if funneled correctly, can help promote domestic production.

Restrictions need to be placed and monitored on “too-big-to-fail” (TBTF) institutions in order to promote economic stability and security. The top four major banks, JPMorgan, Bank of America,

Citigroup and Wells Fargo hold \$7.88 trillion in assets.<sup>27</sup> That’s more than half of total U.S. banking assets.<sup>28</sup> One of these institutions failing would cause serious repercussions in the economy. Interestingly enough, four out of the first five banks bailed out in 2008 were the four largest banks in America.<sup>29</sup> Changes can be made to prevent this from happening in the future. One way such prevention can be established is by setting a tax on institutions violating an established size limit. A good beginning limit on size is 100 billion dollars in assets. Such an asset limit would keep many banks already over that threshold and would generate a strong source of income for the government. A benefit in taxing TBTF institutions is adjustability if either the tax rate or assets limit needs to be modified.<sup>30</sup> Reducing the size of TBTF institutions would allow smaller businesses and banks to grow in size, consequently increasing the economic stabilization of America.

The recent downturn of the economy hurt many Americans who either lost their job or lost their homes. Destructive policy by Greenspan contributed to the housing bubble, which in turn spawned a recession greater than any since World War II.<sup>31</sup> Keeping interest rates low ruined a decade, yet the same problem is presently happening. Furthermore, monetary

policy now might be worse than before the recession because Bernanke and the Fed utilized quantitative easing to push interest rates to unnaturally low levels. Banks also must be modified to hold more capital stock to reduce the incentive for risky loans to consumers. Creating another housing bubble is the last thing America needs if it wants to remain globally competitive. Nothing will happen overnight, however, and so the government and the American public must be patient in preparing for the future.

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<sup>2</sup>John Taylor, "The Financial Crisis and The Policy Responses: An Empirical Analysis of What Went Wrong," *Nber Working Paper Series*, January 2009, Internet (Accessed September 17, 2014).

<sup>3</sup>Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, Wendy Edelberg et al., Washington, DC: Government Printing Office, 2011, Internet (Accessed September 17, 2014).

<sup>4</sup>Andrew Beattie, "Alan Greenspan: 19 Years in the Federal Reserve," *Investopedia*, n.d., Internet (Accessed November 15, 2014).

<sup>5</sup>Hussman Ibid.

<sup>6</sup>*Federal Reserve Board's semiannual Monetary Policy Report to the Congress Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate*, 108<sup>th</sup> Cong. (2004) (Statement of Alan Greenspan, Chair, Federal Reserve, Washington D.C.), Internet (Accessed November 15, 2014).

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<sup>8</sup>"The Ponzi Economy," Hussman Funds, September 22, 2014, Internet (Accessed September 21, 2014).

<sup>9</sup>"Excess Reserves of Depository Intuitions," St. Louis Federal Reserve, October 2014, Internet (Accessed November 8, 2014).

<sup>10</sup>Marc Labonte, "Monetary Policy and the Federal Reserve: Current Policy and Conditions," Congressional Research Services, July 1, 2014, Internet, (Accessed November 8, 2014).

<sup>11</sup>Ben Bernanke, "Deflation: Making Sure 'It' Doesn't Happen Here," (speech, Washington D.C., November

21, 2002), Federal Reserve, Internet (Accessed November 15, 2014).

<sup>12</sup>"Deflation: Making Sure 'It' Doesn't Happen Here"

<sup>13</sup>R.A., "What is Quantitative Easing?," *The Economist*, January 14, 2014, Internet (Accessed November 8, 2014).

<sup>14</sup> *Semiannual Monetary Policy Report to the Congress Before the Committee on Financial Services, U.S. House of Representatives*, 110<sup>th</sup> Cong. (2008) (Statement of Ben Bernanke, Chair, Federal Reserve, Washington D.C) Internet (Accessed November 15, 2014).

<sup>15</sup>Kimberly Amadeo, "Fed Funds Rate: Definition, Impact and How It Works," About.com November 14, 2014, Internet (Accessed November 16, 2014).

<sup>16</sup>Board of Governors of the Federal Reserve System, *Effective Federal Funds Rate [FEDFUNDS]*, retrieved from FRED, Federal Reserve Bank of St. Louis, November 15, 2014, Internet (Accessed November 15, 2014).

<sup>17</sup>Brian Twomey, "The Taylor Rule: An Economic Model for Monetary Policy," Investopedia.com, n.d. Internet

<sup>18</sup> William Cummings, "S&P 500 Bumps Up to Another Record Close, Dow Slips," *USA Today*, November 14, 2014, Internet (Accessed November 15, 2014).

<sup>19</sup>Alexandra Twin, "Dow, S&P Break Records," CNNMoney.com, October 9, 2007, Internet (Accessed November 15, 2014).

<sup>20</sup>"Yes, This is an Equity Bubble," Hussman Funds, July 28, 2014, Internet (Accessed November 15, 2014).

<sup>21</sup>Michael Sivy, "Is the U.S. Waging a War on Savers," *Time*, October 23, 2012, Internet (Accessed September 26, 2014).

<sup>22</sup>Buttonwood, "The Impact of Low Interest Rates," *The Economist*, February 5, 2013, Internet (Accessed September 26, 2014).

<sup>23</sup>Taylor, Ibid.

<sup>24</sup>Hibah Yousuf, "Here Comes the End of QE," *CNN Money*, January 7, 2014, Internet (Accessed November 8, 2014).

<sup>25</sup>Department of the Treasury, *Federal Register*, by Office of the Comptroller of the Currency, Washington, DC: GPO, 2013, Internet (Accessed September 26, 2014).

<sup>26</sup>Federal Deposit Insurance Corporation, *DSC Risk Management Manual of Examination Policies: Capital*, Washinton DC: GPO, 2004, Internet (Accessed September 26, 2014).

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<sup>30</sup>Congressional Research Service, "Systemically Important or 'Too Big to Fail' Financial Institutions," by Marc Labonte, Congressional Research Service, 2014, Internet (Accessed September 26, 2014).

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