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It Is Time To Raise Rates

By Dr. Peter Linneman, PhD
Chief Economist, NAI Global
Principal, Linneman Associates

With quantitative easing behind us, low interest rates are next on the chopping block. If low interest rates and QE are not a serious economic distortion, why is the Fed so insistent that they must eventually be reversed? After all, if these tools are sure-fire creators of economic growth with little or no adverse consequences, just leave them in place. But deep down, Fed members realize that these policies have created serious distortions over the past six years. They simply choose to not state what these distortions are, lest the full damage of their interventionism become too transparent.

The truth is that a slow recovery is the result of a prolonged period of interventionist monetary, fiscal, and regulatory policy. Glib statements that "it would have been even worse" do not stand up to serious theoretical or empirical examination. There is no empirical evidence that low interest rates or budgetary deficits notably stimulate macro economic growth, or that QE exerts any notable positive macro impact. All that the Fed's low rate policies are doing is distorting capital allocation, increasing uncertainty, and massively redistributing wealth and income.

Perhaps the current belief in interventionist policies reflects a desire to "be more like China," and is reminiscent of the bad old days when Soviet-style planning was thought to be an economic cure-all, with perfect policies being set by benevolent and omnipotent policy deities. But China is hardly a great economic model. China's GDP per capita is just 20% of that in the U.S., and their GDP growth per capita in absolute terms is only about the same as ours, despite their advantage of "catch-up" growth.

Interventionists constantly highlight the frequent failures of markets. However, they are silent regarding massive government failures. After all, the Fed that is now "saving the financial system" is the same body that failed miserably at bank oversight prior to the Crisis. They are also the same body that triggered the housing bubble by keeping interest rates far too low for far too long (talk about a lesson forgotten). And Congress is the same body that forced Freddie and Fannie to take on huge amounts of seriously sub-prime loans. Add to this an endless stream of high-profile failures in every branch of the

Table of Contents

government (e.g., Benghazi, the IRS scandal, etc.). Solving market failures by government intervention is simply going from the skillet into the fire.

It is high time to realize that Japan has 25 years of non-growth as a result of policies the U.S. and Europe have pursued for the past six years. Why would we believe that following such interventionism will yield different results for us?

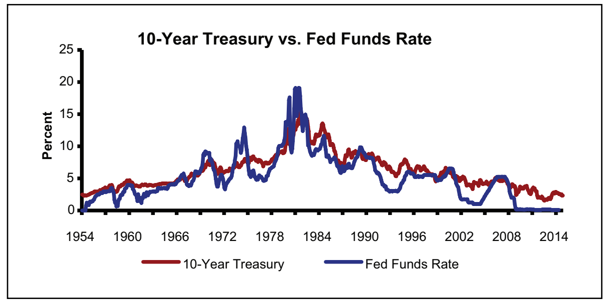
The austerity versus interventionist fiscal policy debate is nothing more than interventionists believing that government policy can solve market failure, while the austerity proponents see nothing but government failure in such spending due to political lobbying, waste, fraud, and abuse.

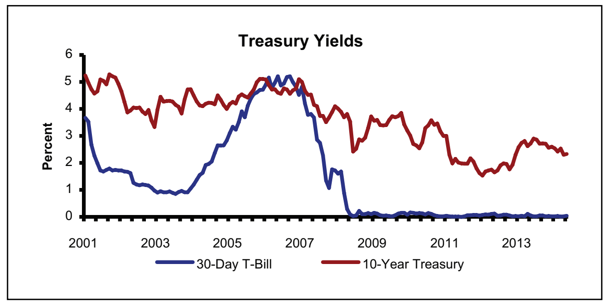
The press and the Left constantly harp on the idea that fiscal austerity is strangling economic growth. While we do not believe that austerity reduces growth, we have yet to see any austerity measures, so we have no way of knowing whether we are correct. For example, Eurozone government spending was 49.8% of GDP in 2013, versus 46.7% seven years earlier (on a lower real GDP). We hardly consider 310 bps of growth in the government sector as austerity. In fact, it is quite a sizable increase by standards of Keynesian stimulative spending proposals. If higher government spending were indeed stimulative, France, Italy, and Japan would be the richest and fastest growing economies in the world.

The simple truth is that moving resources from the private sector to government control moves resources from relatively high productivity sectors to a relatively low productivity sector. This negative arbitrage necessarily reduces growth.

The brilliance of Milton Friedman is succinctly captured by a vignette during a debate about the need for an all-volunteer military instead of a draft. When a draft supporter claimed that Friedman favored an army of mercenaries, he quickly responded (with his characteristic smile), “And you want an army of slaves!” On monetary policy he always favored fixed rules for monetary expansion over unpredictable discretionary interventions by the Fed. His simple insight was that uncertainty kills growth, and the Fed is a master of uncertain interventions. And this was before the unprecedented interventions of the past decade.

He also noted that nine individuals are incapable of correctly establishing interest rates, even (and perhaps especially) if these individuals have impec-cable academic credentials. Instead it takes millions of market participants to accurately set interest rates — and





to adjust them constantly as conditions change. This is the monetary policy equivalent of Hillary Clinton's claim that "it takes a village" to raise a child. Too bad that her Keynesian supporters do not grasp the relevance of this insight to setting interest rates. In fact, interest rates set by nine individuals will always be wrong, distorting capital allocations and reducing growth.

The Fed's zero interest rate policy was supposedly employed to a large degree to spur the housing market. But after six years of unprecedented low interest rates, single-family home starts remain at just 60% of their historical norm, with cumulative production over the past six years 3.5 million below the norm. But if the Fed understood the literature on homeownership, they would have long ago realized that homeownership is all about the down payment, not interest rates. In fact, the Fed's zero interest rate policy is crushing the rebound in single-family housing. Think of a young household saving in order to compile sufficient funds for a down payment. A zero interest rate received on these savings merely extends how long they must save before they can purchase a home. Zero interest rates are also forcing their grandparents to liquidate their life savings in order to live. This has terrified the grandparents (rightly so), discouraging them from giving funds to their grandchildren to help with the down payment.

If the Fed increased the short-term interest rate to the 3-4% range where it belongs, home purchases would rise notably within 18 months, as more households could accumulate the necessary down payment. Thus the unintended consequence of the Fed's low rates has been to destroy single-family housing demand. It is not by chance that the most extraordinary period of low housing demand is also the period of the most extraordinarily low interest rates. This is a vivid example of the self-defeating nature of market interventions.

The Fed Board is filled with economists who are out of touch with reality. They also lack any expertise in housing policy, incorrectly viewing low rates as a housing market cure-all. Interventionist Fed members have been appointed by an interventionist President and approved by an unconcerned Senate. The dissent in the Fed comes from the various regional Reserve bank presidents, who are not selected by the President. In fact, recent 8-2 votes are shocking for a collegial body, underscoring the extent of the gap between the Fed Board and reality.

As a good friend of ours once said, "Determination is fine, but when the horse is dead, dismount!" It is high time for the Fed to dismount, because the monetary interventionist horse is long dead.