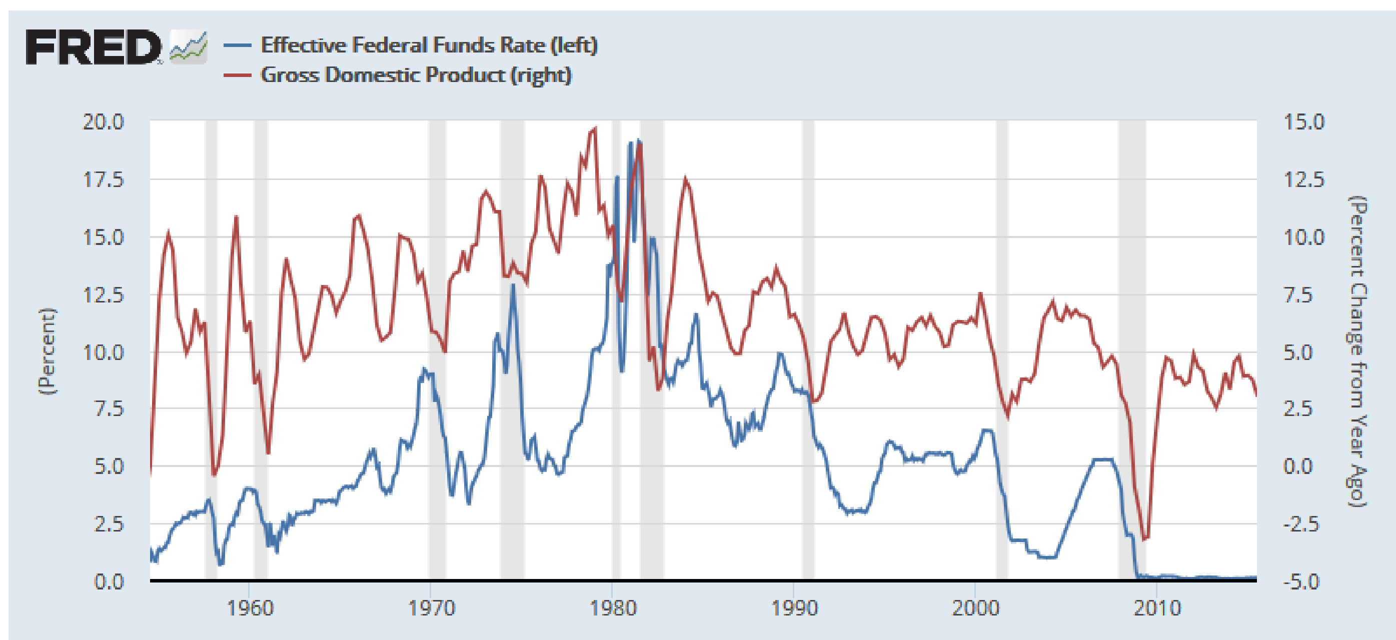
The Fed Has An Irrational Fear Of Growth And Inflation

To support the premise of this article, we need to look back over time to find any periods in modern history when the Fed began raising rates at a time when growth was anemic and inflation was less than 2%.

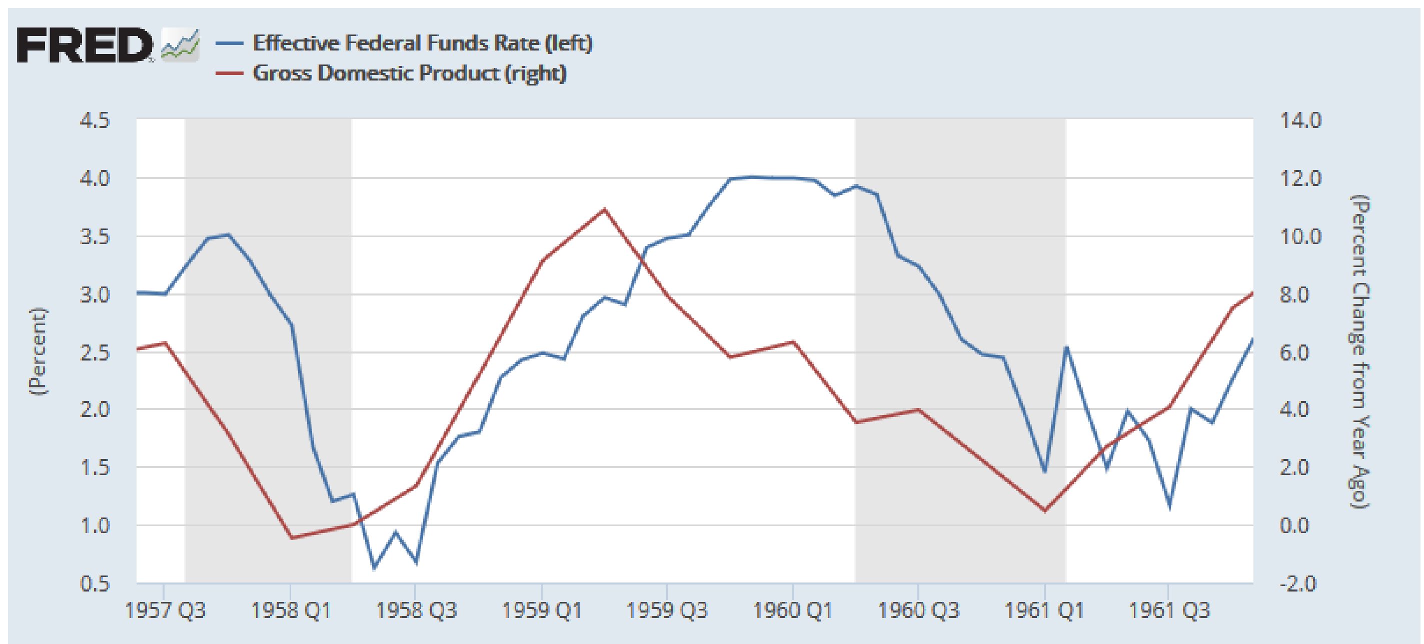


The most similar time in history was the late 1950's early 1960's. During this period there were two recessions with the Fed raising rates just before each recessionary period.

Please indulge the history lesson because at the end, we will determine if "it's different this time", or if the current set of Fed governor's have irrational fears of growth.

During the late 1950′s Eisenhower was President and the mid-term elections did not go well for the party of the sitting President as the Republican's lost a massive 16 Senate seats, at least partially due to the 1957 recession. The US was still on the Gold standard. The country was just coming out of the 1957/58 recession. The Federal Reserve at the time, was totally focused on international money issues, primarily the Balance of Trade payments. The Bretton Woods accord (1944) became fully operational in 1958 as other countries pegged their currency to the US Dollar and the Dollar was pegged to Gold ($35/oz).

But the US was running a Balance of Payments deficit and gold was leaving the US and the Fed had to stem the tide by raising interest rates to attract foreign capital. The goal of increased rates at such a fragile time (GDP had just recently recovered from below 0%) was to reduce the quantity of Money which would cause contraction and ultimately reduce prices of goods (curb inflation). Reducing price levels in the US would make US products cheaper and more competitive internationally.

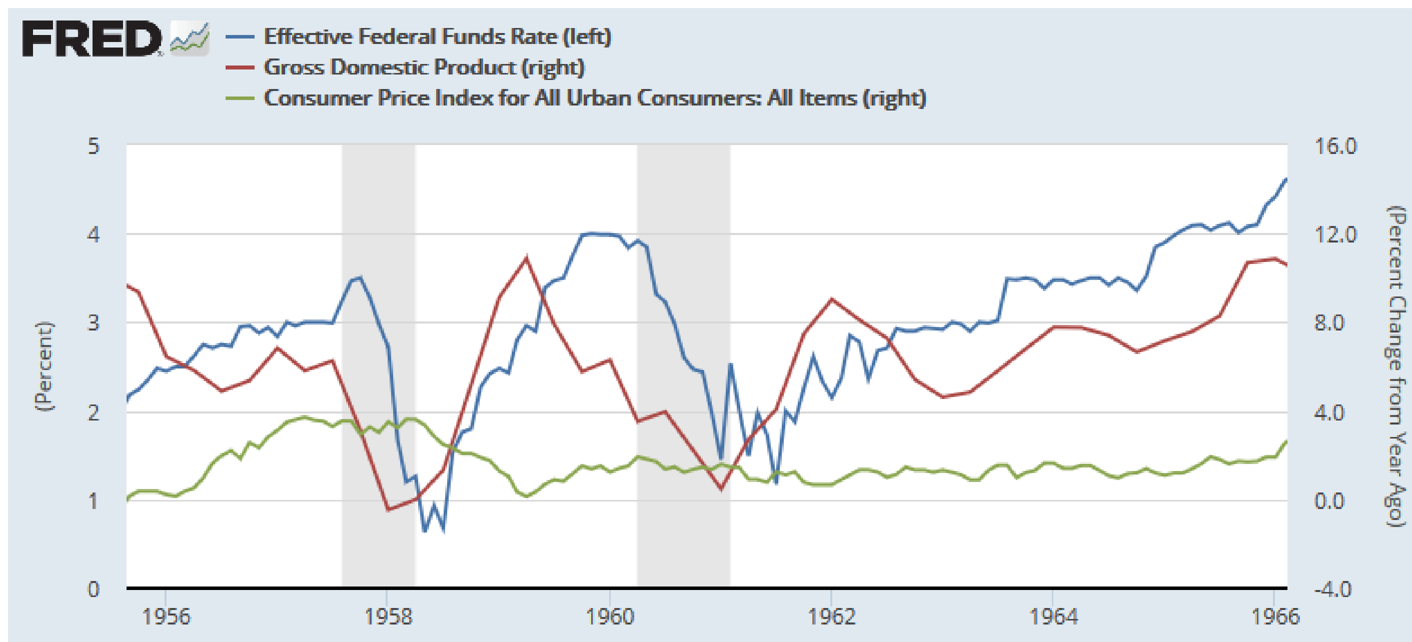


Thus it appears from the literature on the period that there was a lack of linkage between the quantity of Money supply and recession. So, the Fed raised rates just the economy was coming out of recession and kept on raising rates well into 1959 causing another recession in 1960. Coming out of the 1960 recession, the Fed was again raising rates even as the economy was on fragile ground, but this time, the economy won the battle and continued to surge.

The difference between that period and today is the overall strength of the economy. The US was a world dominant economic leader regularly experiencing GDP growth rates north of 5%.

Today the US economy has been severely weakened and has not seen strong year-over-year GDP growth since the 1990′s.

The Fed would not be so important today if the economy were stronger, which argues for a return to US economic dominance which argues for lower taxes and less regulation and stricter trade agreements that favor the US.



Inflation was not a big issue during the late 50's early 60's as GDP was quite a bit higher, which produced "real" GDP growth even with inflation rates as high as 4% during the 1958 recession. The Fed was not fighting inflation as the main enemy, but rather international balance of payments. The Fed did not look at full employment as a goal until Johnson took over for Kennedy in 1963 and after the Kennedy tax cuts had passed in 1964. Full employment became a real goal at this time with 4% unemployment being the universally desired outcome.

Inflation was the enemy, NOT deflation as it is today. In the late 50′s, the rest of world was experiencing inflation in that they lacked the US dollars to import food and energy. Today the world is dealing with Deflation, not Inflation.

Never in the modern history of monetary policy has the Fed tried to raise rates when deflation was the enemy.

One relative advantage the Fed of the late '50's had which does not exist today, is that since currencies were fixed under the Bretton Woods agreement, there was no concern that raising rates would "strengthen" the dollar against other currencies. The Fed of the 50's was free to raise or lower rates to effectively speed up and slow down the economy (manipulating balance of trade payments) without concern for the negative backlash that translates through the currency exchange rates. For example, in June 2015 as the Fed threatened to raise rates (effectively strengthening the US dollar), Emerging Markets convulsed sparking the Arab Spring which began as a revolt over the inflationary price of rice in Egypt. This year as the Fed began to raise rates, China (who maintains a loose peg of the Yuan against the Dollar) decided to devalue their currency rather than let it strengthen with the US Dollar – which in turn supports their manufacturing and exporting economy. Their relative devaluation however, turned out to be a bit extreme causing waves of asset selling emanating from China and resulting in rapid stock price declines in the USA.

The conclusion is that today's modern Fed is overly vigorous in desiring a return to "normal" rates at a time when US economic and world economic growth can not support higher rates and inflation does not warrant higher rates.

Finally, the economies of the world can not tolerate higher rates at this time and the currency effect backlash will continue to slow the over-vigilant US Fed. Naturally, the Fed realizes that when Europe or Japan lowers rates that translates into an effective relative increase of US rates. Thus the Fed can not create a large separation of rates in the US as compared to rates in the rest of the world.

Perhaps most important is that the current environment calls for a global coordination of rates. The Fed can no longer work in a vacuum and must convince Europe, Japan, and China to effectively raise rates along with the USA. Without this coordination, negative currency effects will continue.

Perhaps a better path would be to simply stop trying to raise rates until growth and inflation signal that it's appropriate. An appropriate time for raising rates would not only be "full employment", but growth exceeding 4%GDP and inflation exceeding 2% GDP.

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