

BACK TO THE FUTURE FOR THE FED

RICKARDS' REAL TIME COMMENTARY

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March 4, 2016 marks the sixty-fifth anniversary of the "Fed's Independence Day." It was on March 4, 1951 that the Federal Reserve and the U.S. Treasury reached an historic accord that restored policy independence to the Fed after a nine-year period of fiscal dominance by the Treasury. The question today is whether we are entering a new period of fiscal dominance in which the Fed will have to give up control of its balance sheet and interest rate policy in order to save the U.S. from secular stagnation. The signs are that the Fed will subordinate its policy independence to fiscal stimulus coordinated by the White House and the Treasury. The implications for investors are momentous.

The original Treasury-Fed Accord of March 4, 1951 allowed the Fed to regain control of monetary policy after nine years of Treasury dominance. Beginning in April 1942, shortly after U.S. entry into World War II, the Fed agreed to cap interest rates on Treasury bonds in order to help finance the war effort. The cap meant that the Fed had given up control of interest rate policy. It also meant that the Fed had surrendered control of its balance sheet and the money supply because it might have to purchase potentially unlimited amounts of Treasury debt in order to implement the rate cap. Such asset purchases had inflationary potential, but inflation was managed separately through wartime price controls. It was a wartime economy, and the Fed was drafted to do its part.

After the war, the Treasury was naturally reluctant to give up its fiscal dominance of the Fed. President Truman felt strongly that patriotic investors in U.S. bonds should not have to suffer capital losses as rates rose. The White House insisted that the wartime cap on long-term rates be maintained. The Fed resisted this, but their resistance was soon overcome by the Korean War. This new war was used by the Treasury to continue the rate cap rationale. It was not until 1951, with the Korean War in stalemate and a presidential election on the horizon, that the Treasury and Fed agreed to restore the Fed's independence on interest rates and the composition of the Fed's balance sheet.

Today the Fed's independence is again threatened, not by war, but by secular stagnation. The U.S. economy has grown about 2% per year since 2009; below its former potential growth of 3%, and well below the pace of prior recoveries, which occasionally grew at 5% or 6% before settling back to trend. U.S. debt-to-GDP ratios are the highest since the end of World War II (and much higher if contingent liabilities for entitlements are considered to be debt). While U.S. deficits have declined, they are still adding to the overall debt faster than the economy is growing. This means the U.S. is still on a path to a fiscal crisis and loss of confidence in the dollar.

The Fed has used its independence over the past seven years to pursue unconventional monetary policy to stimulate U.S. growth and return growth to its long-term trend. This unconventional policy has included quantitative easing (QE), forward guidance, currency wars,

Operation Twist, and zero interest policy (ZIRP). Some of these policies may have helped to avoid a deeper depression, but none have succeeded in restoring trend growth.

Some speculate the Fed is out of bullets to deal with depressed growth, but that is not true. Now that the Fed's policy rate is off zero (and likely to go higher with rate hikes in March and June, 2016), the Fed will have room to cut rates late this year or in early 2017. The Fed could return to quantitative easing, but QE4 is unlikely because there's little evidence that QE2 and QE3 achieved much.

The Fed could also go to negative interest rates, although the early evidence from Europe, Switzerland, Japan and Sweden indicates that negative rates don't do any more to help growth than zero rates. In fact, negative rates may be counterproductive to the extent that they signal deflation fears, which can produce even more savings, and less spending based on expectations. It's a vicious cycle that's hard to break.

The Fed might return to the currency wars, and cheapen the dollar as they did in 2010 and 2011. This could give the U.S. economy a short-term lift and import some inflation from abroad. The problem is that U.S. gains come at the expense of trading partners whose growth is either already lower than the U.S. (Japan, and Europe), or dropping precipitously (China). In a globalized world, there is no escape from the global slowdown. What is needed are stimulus policies that don't turn into a negative sum game.

A new global consensus is emerging (from voices such as Adair Turner, Larry Summers, Joe Biden, and Christine Lagarde) that the only solution to stagnation is expanded government spending on critical infrastructure, healthcare, technology, renewable energy, and education. In a Republican administration, more defense spending could be added to the list, but the idea is the same. If citizens won't borrow and spend, the government will. It's the basic Keynesian idea from the 1930s without the Neo-Keynesian and monetarist gloss.

More government spending means more government debt. Who will buy the government bonds? More to the point, how will fiscal officials keep interest rates low so that a death spiral of higher deficits, higher rates, and still higher deficits does not push government finance to the point of collapse?

Enter the Fed (and, central banks around the world). The Fed and Treasury could reach a secret accord under which the U.S. government would run larger deficits to finance stimulus-type spending. The Fed would then cap interest rates in the intermediate maturity sector in order to keep deficits under control. Capping interest rates could have the added benefit of producing negative real rates if inflation emerges as the Fed expects.

The Fed would use open market operations in order to achieve the rate caps. This means the Fed would not only give up control of interest rates, it would give up control of its balance sheet since a rate cap might require a "whatever it takes" approach to Treasury note purchases.

Operationally, a rate cap might resemble QE, but only superficially. The purpose of QE was to achieve a portfolio channel effect driving investors to other asset class (stocks and real estate), to

achieve wealth effects that would increase aggregate demand. This policy failed because the wealth effects were weak and the asset price increases turned into bubbles, which must now be unwound.

The popular name for rate caps to support government spending is “helicopter money.” The more technical names are fiscal dominance and financial repression.

The implications for investors are significant. If deflation persists, rate caps might be imposed at levels much closer to where German Bunds are today. In effect, nominal rates and inflation would be in a race to the bottom in an effort to achieve negative real rates. The big winner in this scenario would be U.S. Treasury notes.

If inflation emerges, the rate cap might be higher in nominal terms, but still low enough to achieve negative real rates. In this scenario, gold would perform extremely well. Treasury note holders would not suffer unduly because the rate cap will put a brake on what might otherwise be large losses if nominal rates were allowed to outpace inflation.

The model portfolio for this Fed back-to-the-future scenario would consist of Treasury notes, cash and gold. The cash would provide reduced volatility and valuable optionality as the nominal rate drama plays out.

Rate caps will not arrive until mid-2017 at the earliest. That’s because the current Fed mini-cycle of rate hikes followed by rate cuts has to play out first. (Fed policy changes apply to the short end of the yield curve. The rate caps discussed in this article apply to the intermediate part of the yield curve. The Fed might end up in the curious position of implementing rate floors at the short end, and rate caps in the intermediate sector).

The last time the Fed lost its independence – in 1942 – the reason was war. Now a new war on secular stagnation may cause the Fed to lose its independence again. As with any war, investors need to prepare before the first shots are fired.