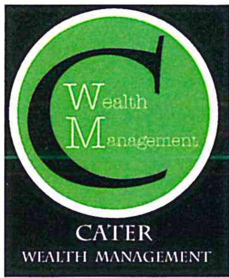

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WHAT IS "NORMAL" ABOUT INTEREST RATES?

Almost every day on CNBC and in financial publications like the Wall Street Journal we hear "experts" predicting when the Federal Reserve will begin the process of "normalizing" interest rates. This leads most of us to believe current rates are not normal. It's assumed to get to normal rates must go up.

ARE YOU SURE?

First let's discuss what interest rate everyone is talking about and then we will discuss the concept of "normal".

Most agree the interest rate the Fed targets is the Fed Funds Rate, the overnight rate banks charge to lend reserves to each other. This rate, also known as the "policy rate", directly influences other rates throughout the financial system. Interest rates influence economic activity. Higher rates tend to slow the economy and lower rates tend to stimulate. So the question is "how does the Fed raise or lower interest rates?" They do it by adding or taking away reserves.

Prior to the 2008 financial crisis banks had little incentive to hold "excess reserves". Large excess reserve balances cost them money because they earned no interest. It was more efficient to manage reserve balances close to the required levels and periodically borrow when necessary. With reserve balances close to required minimums it was relatively easy for the Fed to influence them through standard monetary tools. If they could influence reserve levels they could influence rates. After QE1, QE2, Operation Twist and QE3, commercial banks have trillions of dollars of excess reserves. This changes everything. If the Fed can no longer influence reserves, how can they influence rates?

If everyone has more of something than they need the price of that thing will go down, in the extreme it will go to zero. Most banks have more reserves than they need so absent some outside influence the cost of borrowing reserves should drop toward zero. This is in fact what has happened. Most believe the Fed is taking extraordinary measures to keep rates low when in fact they are taking extraordinary measures to keep rates above zero. Ever hear of IOER (Interest On Excess Reserves)? The Fed is currently paying banks that have excess reserves .25% interest on those reserves. This is extraordinary indeed. Interest On Excess Reserves is the only thing keeping the Fed Funds Rate positive. If the Fed decides to increase rates they will have to increase what they pay on excess reserves, in other words they will have to pay the higher rates themselves. This is a whole new ballgame. No longer can the Fed "nudge" rates toward their target by influencing reserves, expecting the private sector to adjust to the new target. Given the current environment of trillions of dollars of excess reserves:

"NORMAL MAY EQUAL ZERO"

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