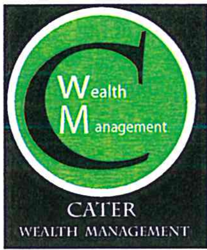

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So the Federal Reserve is Finally Going to Raise Rates.

Really?

Why and How?

Prior to the Great Recession of 2008, standard monetary policy dictated that the Fed would raise or lower the target rate for Fed Funds to either stimulate the economy or slow it down. Investors always ask "W**hy?",** when they should be asking **"How?"** The first question is unanswerable. Everyone seems to have a different opinion regarding why/if the Feds should raise their target rate. The radical opinions and judgements of Doves and Hawks rule over the facts. Each camp is entrenched in its own belief and the truth is, well, we just don't know for sure.

If they do decide to tighten, the real question is "**How?"**

Prior to the Great Recession, changing the interest rate was relatively easy. Banks are required to hold a certain percentage of their outstanding loans in a special reserve account at the Fed. These **Reserves** were a high opportunity cost for the banks because they earned 0%. By law, banks had to be adequately reserved, but because reserves earned 0% they managed them carefully. Back then, it was easy for the Fed to make **Reserves** scarce. If the supply of **Reserves** decreased, banks were forced to bid more for the **Reserves** they needed to support lending. Interest rates would rise both for **Reserves** and for the **Private** bank loans that the **Reserves** supported. The key point here is that the higher rates were being paid by the **Private Sector.**

When the cost of capital for the **Private Sector** goes up economic activity goes down, as least that's the plan.

Oh! How Times Have Changed

Commercial banks have accumulated $2,500,000,000,000 in Excess Reserves. That's 2 ½ Trillion. The Fed has lost its ability to simply make **Reserves** scarce. This glut of **Reserves** in the system is why interest rates are close to zero. Money is, after all, a commodity. If the supply goes up, the price goes down relative to demand. The price of money is reflected in the cost to borrow it (interest rate). This is where we get the Zero in **ZIRP** (Zero Interest Rate Policy).

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BACK TO THE SECOND QUESTION, HOW?

If the Federal Reserve decides that it's time to raise rates (question #1), the easiest method is for the Fed to pay the higher rate themselves. They are actually doing this today in the form of **IOER** (Interest On Excess Reserves). The Fed is currently paying .25% interest directly to all commercial banks holding Excess Reserves, which adds up to more than $6,000,000,000 per year. This money is going directly from the Fed to the private sector banks. Directly to their bottom lines. The only expense they have is perhaps a new hire to count it.

Some, (mostly bankers) suggest that the "normal" Fed Funds rate is closer to 2% than it is to 0%. If the rate hits 2% and the Fed has to pay it on $2 ½ Trillion, that's $50,000,000,000 directly to the banks bottom line. Of course they may have to hire a few more counters! And by the way, who do the Central Bank presidents talk to every day? Hint; they regulate banks.

Today, the Fed pays .25% IOER. Most days, the Fed Funds trade at .13%, and even .07% trades are not uncommon. If the Fed ups the rate to .50%, and Fed Funds don't move, that could prove embarrassing.

Let's return to question # 1 for a minute. If the reason the Federal Reserve decides to raise rates is to combat future inflation, isn't taking a dollar currently at the Fed (or $50,000,000,000) where it can't be spent and transferring to the Private Sector, where it can be spent, inflationary? Fighting potential future inflation with a policy that causes inflation...well you get my point.

We don't know what the Fed will do in December. I'm guessing whatever they do won't have much of an effect on **Private Sector** borrowing costs.

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