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Putting Forward the Case for a "Middle Way" for Long-term Interest Rates

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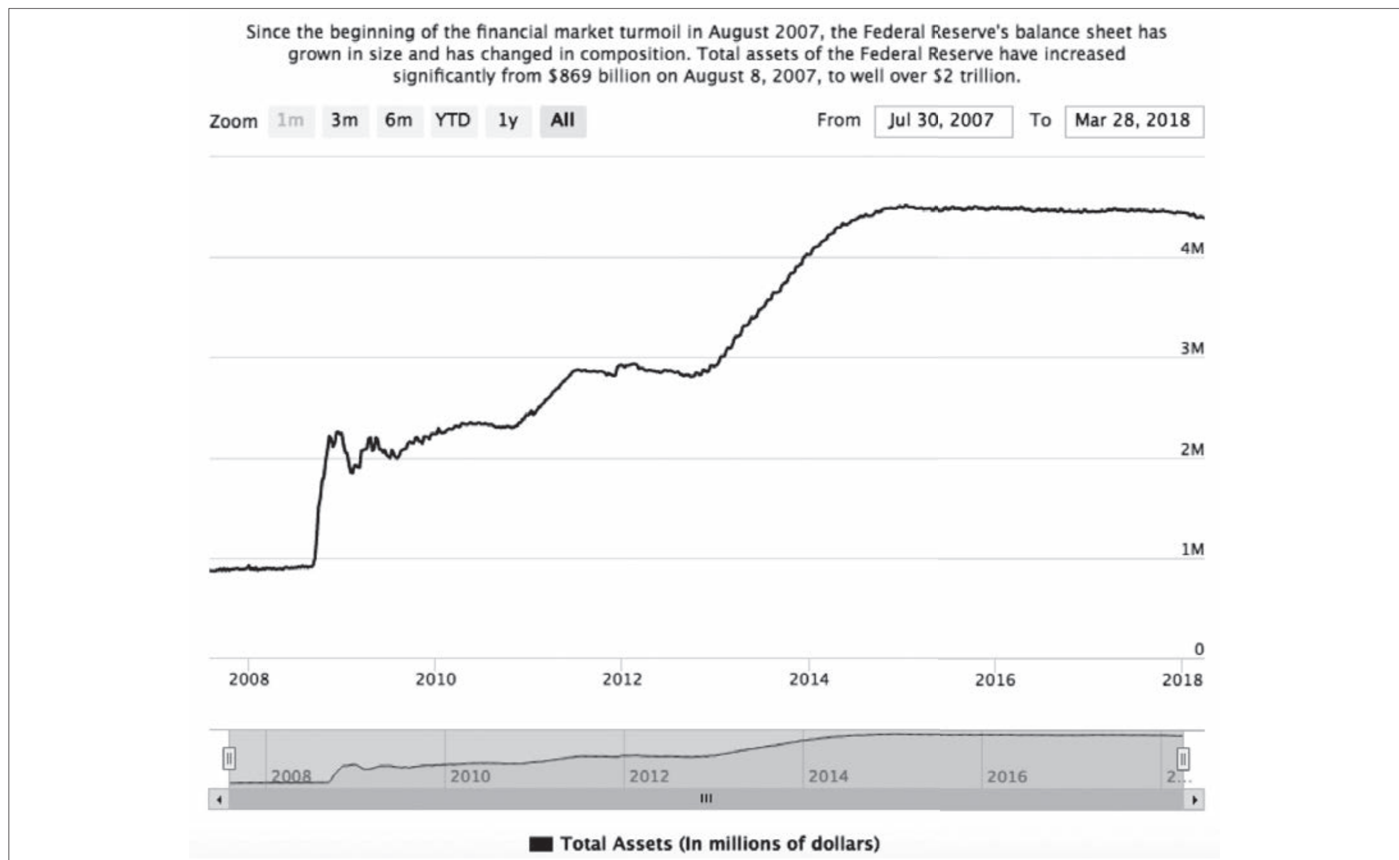
Disclaimer: *Last year, the Investment Section put out a call for essays in a point/counterpoint format, with actuaries arguing opposite sides of an issue. We are pleased to present two pairs of essays in this issue of Risks & Rewards: Joe Koltisko and Suhrid Swaminarayan debate the future path of interest rates and inflation, while John Hegstrom and Jim Kosinski square off over when (or if?) fossil fuels will be displaced by renewable energy. Two more pairs of essays can be found on the section website* https://www.soa.org/sections/investment/investment-landing/, *with Max Rudolph arguing both sides of the efficiency of markets and Nate Worrell arguing both sides of the type of investors that will succeed in the current market environment.*

Please note that this pro/con debate format forces both authors to develop arguments in support of the view assigned to them, even if they hold a differing opinion. The positions expressed in this role-playing setting should not be taken for the view of the authors, their companies, the SOA or any of its affiliate organizations.

Following three programs of quantitative easing (QE), the Federal Reserve began the next phase of its interest rate policy in October 2017—a process of "normalization" involving a reduction to its balance sheet to move it to more normal levels. Precrisis, the Fed's balance sheet stood at 5.5 percent of U.S. gross domestic product (GDP); now it is approximately 25 percent of U.S. GDP, or approximately $4.5 trillion (Figure 1). The natural question is with this (almost) unprecedented

Figure 1
Total Assets of the Federal Reserve



Source: Board of Governors of the Federal Reserve. 2018. "Recent balance sheet trends: Total assets of the Federal Reserve," *https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm*.

buildup in the Fed's ownership of Treasury bonds, will a deluge of bond sales not only end the bull market in bonds (dating back to 1981), but also usher in a period of rampant inflation?

WHY RATES ARE UNLIKELY TO SPIKE

Unless there is unrestrained mismanagement of the balance sheet runoff, it is unlikely that long-term rates will spike. We have only one prior example of the Fed balance sheet rising above 20 percent of GDP (approximately 23 percent in the aftermath of the Great Depression and World War II). In that case, through the emergence and firm demonstration of Fed independence, long-term interest rates were successfully guided above 2 percent without the emergence of inflation for the better part of two decades. Yes, in that environment there was greater scope to increase interest rates without worrying about follow-on economic drag from the debt overhang that is pervasive today in most of the developed world. The article will revisit the implications of a debt overhang later when it discusses whether we will see further QE programs from the Fed in the near future. But for now, let's at least point to the 1950s as a time when interest rates were successfully raised from near today's levels.

While the Federal Open Market Committee (FOMC) has not defined a specific balance sheet target as the outcome of the normalization process, it is safe to say that the Fed will manage the runoff cautiously so as not to boost bond yields unexpectedly. The Fed has provided guidelines, including a consensus path of deliberately sluggish balance sheet reduction based on a reduction in the reinvestment of proceeds from maturing Treasury and mortgage-backed securities (MBS) bonds rather than active bond liquidation. Estimates project that $180 billion will run off in the next 12 months, with $360 billion each year thereafter. And while the Fed has been an important buyer of Treasury debt during its QE programs, foreign and institutional financial sector buyers have actually dominated the market. Low inflation, a forward guidance commitment from the Fed toward stable rate movement and deleveraging in the household and banking sectors all provide anchors to prevent global rates swiftly lifting off from low yields. Let's also not forget the aged and aging populations in Europe and Japan who would be loath to see any inflationary reduction in their purchasing power and who add to the overall global demand for long-term bonds.

THE BASE CASE AS A "MUDDLE-THROUGH" TO NORMALIZED INTEREST RATES AND INFLATION MODERATION

The Fed is moving slowly for fear that raising interest rates too far too fast may halt the postcrisis economic recovery. Macroeconomic measures, including unemployment (at a 49-year low) and the modest, positive level of real GDP growth, together with common economic principles such as the Taylor rule suggest that monetary policy should be much tighter and the federal funds rate should be hiked aggressively to prevent potential inflation. Tayyeb Shabbir, an adjunct professor at

Wharton Business School, confirmed that he sees a normalization of monetary policy in terms of the current functionality of the economy, although there "may not be an exact reversion to precrisis level(s)." He observes that the deep structural changes to the labor market in the United States from the financial crisis—such as the unprecedented, lengthy average duration of unemployment—have dented the traditional Phillips curve relationship between wage inflation and unemployment. Shabbir argues that "(the) last time the unemployment rate hovered around the current levels, wage growth was 4 percent vs. the present 2.3 percent."

Longer-term interest rates can also typically be expressive of inflation expectations. With that in mind, the case against out-of-hand wage growth leading to both unchecked inflation and long-term interest rates is strong. In addition to the demographic anchor to inflation highlighted earlier, commodity inflation and wage pressures are weak (these were both unchecked drivers of the uncontrolled inflation of the 1970s).

The danger of debt deflation caused by public and private indebtedness may also be overblown. The case for public indebtedness leading to stunted GDP growth has not been proven, with historical data suggesting that moderate growth is the average case even for indebtedness in excess of 90 percent of GDP.[9] The current U.S. economy also seems to be adhering to that historical average. In terms of fighting off a future stumble back into persistent meager growth territory or recession, the economist Christine Romer suggests a more flexible approach than the norm in terms of using fiscal programs or revising inflation tolerance (for example, changing inflation targeting to 3 percent rather than 2 percent).

In summary, both inflationary and deflationary risks are overblown and overly pessimistic, and the most likely base case for future interest rates and inflation is a return to moderation. ■

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ENDNOTES

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5 Fed nominee Powell, once hawkish, now champions Yellen's focus on jobs.

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9 Thomas Herndon, Michael Ash and Robert Pollin. 2013. Does High Public Debt Consistently Stifle Economic Growth? A Critique of Reinhart and Rogoff.

10 Andrea Pescatori, Damiano Sandri, and John Simon. 2014. "No magic threshold." *Finance & Development* 51(2): 39–42.

11 Federal Reserve's Fred database/Bank of England data

12 "Will the Fed and U.S. monetary policy ever get back to 'normal'?" 2017. Wharton School of the University of Pennsylvania, *http://knowledge.wharton.upenn.edu/article/will-fed-u-s-monetary-policy-ever-get-back-normal/*.

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