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The Fed's H- Curve

Is it possible that there exists a specific threshold that when exceeded central bank accommodation becomes counter-productive and begins to restrict growth?A level beyond which material long-run costs exceed short-term benefits?

Let's picture a graph, where the x variable is a central bank's official interest rate and the y variable is the resulting economic benefit. Let's call the graph "The H-Curve".

The line is curved, or non-linear, because the 'economic benefits' slope will differ at every point along the curve. This is somewhat obvious as a slope measures the rate of change and central bankers admit that their effectiveness weakens over time and with each successive ease.

This admission though suggests that marginally declining utility will eventually cause the slope to flatten to a point at which further accommodation will simply provide no economic benefit. However, the broader truth more likely is that central bank stimulus is actually a parabolic function, whereby the slope goes negative at a certain point. The parabola's vertex peak point signifies the optimal level of stimulus and anything further is a cost or negative benefit.

Central banks seem to be operating by a different function. It's rhetoric and ideology suggests belief in a perpetually positively sloped line, whose worst-case slope is simply one that is less positive (flatter) over time. In other words, a belief that accommodation always helps but in lesser amounts over time. Such simplistic and narrow-mindedness ignores too many variables.

There is plenty of evidence to suggest that too much accommodation can cause long-run damage and risks to financial stability. Certainly, history is riddled with fed-induced boom-to-bust cycles. Quantitative Easing (QE) was intended to distort asset prices higher, but what's exceptionally troublingly is that in the process it destroyed price discovery and the ability to access risk.

One reasonable way to visualize the 'H-curve' might be to picture the Laffer Curve. This upside-down U-shaped curve represents the relationship between rates of taxation and the resulting level of government revenue. Bear with me. The curve simply shows how taxable income changes in response to changes in the rate of taxation. It theorizes that no income

would be raised at the extreme tax rates of 0% and 100%. The optimal tax rate, therefore, is the one that maximizes revenues and is found at the hump of the curve.

Unlike on the Laffer Curve, however, the H-curve y-axis can fall well below zero. In other words, negative economic benefits can occur with the wrong amount of central bank stimulus, i.e., when there is too much. In other words, there is a level of accommodation beyond which the Fed itself becomes a source of financial instability.

Certainly, savers, pension funds, and insurance companies have been punished since 2008 by low interest rates. In addition, speculation has run amok, asset prices have soared arguably to bubble valuations, debt levels have ballooned, and unproductive zombie companies have been propped-up.

Interest rates below a certain level also hurts lending, because low margins dis-incentivizes lenders who might feel margins do not adequately compensate them for the risks. It is likely one reason why the velocity of money has collapsed and the economic recovery has been tepid.

Central bank policy is supposed to work on a long lag, yet markets have come to expect Fed action for every ebb in economic activity, or with each dip in the stock market. Central banks have self-created these dangerous expectations and its new mantra of 'patience' and 'data dependency' make it worse. The 'Fed put' is alive and well. Fed officials should stop promising more than they can deliver. After all, the H-curve, if correct, suggests a negative impact whenever interest rates fall too far below the Wicksellian Natural Rate.

Following the debt-induced financial crisis, Fed officials frequently said, "we are the only game in town". This arrogant proclamation encouraged political polarization. Since elected officials are primarily reactive, aggressive Fed actions took away any urgency of targeted fiscal action.

Monetary policy does not have the proper tools. Prolonged negative real rates and central bank asset purchases and market manipulation provides some short-term financial market relief, but it is at the expense of long-run costs that continue to aggregate over time.

Why the letter "H"? Because in order to implement such aggressive unproven policy experimentation requires great hubris. The H-curve is short for 'Hubris-Curve'.

The Fed is at war against economic and financial market weakness. In the movie "War Games", the military super-computer was programmed to predict possible outcomes of nuclear war by playing tic-tac-toe against itself. In the end, it learned that not only are there no winners, but "the only winning move is not to play". Zero and negative rates and further QE could be the Fed's nuclear war. Let's hope hubris stays in check at FOMC meetings in 2019 and beyond.