Business Forum

Cash hoard

U.S. capital spending this year is up 6% compared with the comparable time in 2007, but corporations' internal cash flow is up 32%.

"The four worries unnerving business are the eurozone crisis, upheaval in the Middle East, a possible recession in China, and America's economic health and 'fiscal cliff'— the combination of tax increases and spending cuts scheduled to occur at the end of this year."
THE ECONOMIST

LONG-TERM RATES | Future credibility at risk

FED'S CURRENT STANCE IS TRAGICALLY WRONG

WILLIAM A. BARNETT

COMMENTARY

A deeply troubling concept in economic theory, "time inconsistency" of policy, has become highly relevant to recent Federal Reserve policy. It's not being disclosed, and the public has a right to know.

Before the current recession, the traditional approach to monetary policy operated through purchase and sale of Treasury bills to influence short-term interest rates and the money supply.

The Fed avoided intervening in the market for long-term bonds. Long-term interest rates were freely determined in bond markets, except during a brief period of experimentation with "twisting" the intertemporal distribution of interest rates (the "yield curve") in 1961. Bond markets set long-term interest rates to provide adequate compensation for expected changes in future short-term interest rates. Fed intervention in long-term bond markets seeks to undermine the market's determination of that compensation. "Operation Twist," named after the famous Chubby Checker song, was widely viewed in 1961 as inappropriate and a failure.

Fed policy in the recent crisis has diverged dramatically from its past conventions in two aspects. First, the Fed has intervened aggressively into the market for long-term Treasury bonds and long-term mortgages, buying more than one-quarter of outstanding Treasury debt and almost all newly issued mortgage bonds backed by conventional fixed-rate mortgages.

Second, and more importantly, the Fed has sought to amplify the effects of its actions by intervening in the formation of public expectations about future interest rates through statements providing "forward guidance," intended to "manage expectations." The combined policies of suppressing long-term interest rates while lowering expectations about future interest rates produce a dangerous game between the Federal Reserve and the public. When the unemployment rate declines to normal levels, the Fed will increase short-term interest rates to meet its target of price stability. Long-term bond prices will unexpectedly drop dramatically. The potential adverse consequences of the Fed's gamble need to be understood by the public, which is an unwitting player in the complicated game.

Private ownership economies operate at their best in "reputational equilibrium," under which the public dependably believes the government is telling the truth. Large or frequent changes in policy do not produce suspicions among the public about the motives for previous governmental statements or actions. Policy changes are viewed as resolving honest mistakes or responding to differing conditions, rather than reflection of prior misleading policy.

In contrast, if governmental policy is shortsighted and "time inconsistent," private sector confidence in the credibility of governmental statements and motives is lost, and private sector behavior becomes defensive. The economy sinks into a stagnation trap, causing long-term economic damage. The world's weakest economies are often caught in the resulting trap, which is the cause of those economies' stagnation.

The complicated phenomenon of time inconsistency in central banking is defined and well known in macroeconomic game theory and occurs if the central bank appears to have an incentive to mislead the public about its intentions, under the belief that it is in the best interests of the public to be misled. A government which behaves in that manner has been called a "benevolent dissembling government" by Stanley Fischer, governor of the Bank of Israel.

Time inconsistency does not

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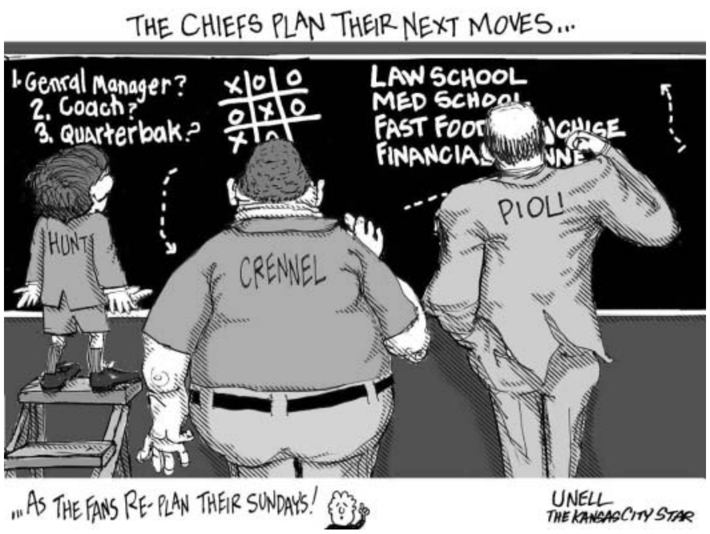
PANEL DISCUSSION



LETTER

Obamacare benefits

Just two years ago, the greatest potential health crisis facing those on Medicare was the impending bankruptcy of the Medicare fund, which covered hospital costs. That fund was due to run out of money in 2016, after which seniors presumably would have had to pay their own hospital bills.

The Affordable Care Act, or Obamacare, saved the Medicare hospital fund from imminent bankruptcy, extending its life to 2024. That's not perfect,

but it's a good start.

If Obamacare is repealed, the Medicare hospital fund will return to the brink of bankruptcy in 2016. Citizens with Medicare need to ask themselves whether they can really cover their own hospital bills starting a little over three years from now.

If the Affordable Care Act is repealed, we seniors will need to really start saving our money. Opening up the doughnut hole again will require us to spend hundreds of dollars.

Paying our own hospital bills may cost us tens of thousands of dollars. Repealing that law doesn't make any sense for seniors.

We need to keep the Affordable Care Act and work to make it better.

Gail Ahumada
St. Louis

COMMENT: Fed's big error

FROM C10

require the central bank actually to misrepresent its intentions, but an incentive to mislead must be evident. With the currently high ratio of national debt to national income, there is the appearance of a Fed incentive to bias downward expectations about future interest rates as a means of helping the Treasury with its debt service. When the economy recovers and interest rates rise, bond prices will drop and bondholders will be likely to wonder whether they were intentionally misled to keep down long-term debt service costs to the Treasury. Historically, losses of central bank reputation through time-inconsistent policy have been very difficult to reverse and have characterized troubled economies throughout the world and throughout history.

Regardless of whether Fed policies are currently influenced by Treasury debt service, the appearance of such a potential linkage cannot be denied. It should be emphasized that the problem is not the combination of Operation Twist with forward guidance. The problem is adoption of those policies at a time of high national debt. The need to finance high national debt produces the conditions for time inconsistency of a policy designed to suppress long-term interest rates and future interest rate expectations.

The time inconsistency of current policies might be a contributing cause of the economy's slow, weak recovery. But far more ominously, the Fed risks serious future reputation loss and consequent major economic damage when long-term rates increase and U.S. Treasury bondholders, both domestic and foreign, take unexpected large capital losses. The Fed's well-intentioned policy game is not likely to end well.

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