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Note To The Fed: Bump Up Interest Rates, Then Take A Break

By MIKE COSGROVE

The Federal Reserve needs to change its base for short-term interest rates from near zero to 1% and then take a timeout. Fed policymakers are talking about normalization of interest rates and debating among themselves whether the liftoff should be midyear 2015 or earlier or later. That misses the point:

No one knows what normalization means for this slow-growth economy except that the base for short-term rates is not zero. Near-zero interest rates have resulted in many investors reaching for yield, increasing risk and instability.

Moving short-term rates above zero is essential so that both capital markets and the real economy can adjust. This adjustment process should be orderly if the Fed would talk about moving short-term interest rates to 1% over some time period and then taking a pause.

The movement to 2%, when or if it occurs, may take longer as it may turn out that 2% is the normal for a 2% trend growth economy.

It has to be easier for capital markets and the real economy to adjust to incremental higher stages of short-term interest rates rather than continue this foolish debate about when to start raising interest rates.

An economy going into its sixth year of expansion should not have short-term rates at zero. This zero-interest-rate policy has already gone on for years longer than it should have.

Higher short-term rates of at least 1% would likely be a positive for both capital markets and the real economy as it would lead to improved allocation of capital.

It's hard to believe that Fed officials think it's sound monetary policy to have short-term interest rates pinned to near zero at this stage of an economic expansion. The Fed has been following unconventional monetary policy for nearly six years since QE1 was launched in December 2008. QE is expected to wrap up this October.

Fed policymakers debate the interest-rate lift-off as if there may be a long series of rate moves to return to the old normal of 4% nominal for short-term rates with 2% inflation or some other data dictated point.

Monetary policy has major time lags so a monetary policy geared off incoming data is by definition going to lag. That type of approach makes no sense in today's U.S. economy.

Likewise Fed officials surely can't think it's sound monetary policy to be talking about lift-off and leaving it open-ended as to whether the move up in short-term interest rates will be fast or slow to some unknown level. Capital markets adjusted to the unconventional monetary policy.

But the Fed is so far away from the standard norm of 2% inflation-adjusted short-term rates that the Fed's approach to normalization will likely result in major dislocations in both the capital markets and the real economy.

The current U.S. economic expansion has been weak when compared to prior expansions. But this weak expansion reflects administration fiscal and regulatory policies.

Highly accommodative monetary policy cannot offset fiscal and regulatory policies aimed at redistribution of incomes. Monetary policy is one of the least effective ways for reducing longer term unemployment.

In contrast, faster-trend economic growth is the most effective method for reducing longer-term unemployment and increasing household income. But this administration is focused on redistribution policies.

The redistribution and increased regulation approach has resulted in a major falloff in new business development, and more businesses exit or go out of business than start according to recent studies.

Administration regulatory and fiscal policies have created an economy that can only grow at around the 2% trend growth rate. At least that is what the first five years of this economic expansion tell us. Monetary policy cannot offset this slow trend growth.

A better approach to normalization of interest rates in this slow-growing economy is to think in terms of stages. Stage one can be 1% short-term interest rates and stage two would be 2% short-term rates. Higher short-term interest rates above 2%, if needed, would correspond to later stages that we may never get to in this economic cycle.

Fed officials could debate how rapidly they plan on moving to 1% short-term rates before they take a timeout. Some market mavens such as those at Pimco suggest a 2% benchmark for nominal short-term interest rates may be the new normal. That could be right.

Capital markets and the real economy can cope with the level of short-term interest rates at 1% or 2%. The 2% level could be two years away. Plus it could be that a level of 1% or 2% for short-term rates can lead to a more efficient allocation of capital and trend economic growth could increase. If so, then capital markets would build in higher short-term rates.

• Cosgrove, principal at Econoclast, a Dallas-based capital markets firm, is a professor at the University of Dallas