
Which Way Out?

By Virginia M. Citrano *Wed, Mar 3, 2010*

With the worst of the Crisis apparently over, Fed watchers are wondering about Chairman Bernanke's exit strategy from a low interest rate environment.

In 1939, near the end of the Great Depression, Virginia Lee Burton published “Mike Mulligan and His Steam Shovel.” As any well-read child can tell you, Mike could excavate a basement in just one day. But he and “Mary Anne”—the steam shovel in the storybook’s title—dug so fast that they forgot to leave themselves a way out.

For the last 18 months, Federal Reserve Chairman Ben Bernanke has been trying to dig the U.S. economy out of a hole much deeper than a basement. Now, with the worst of the Great Recession apparently over, economists and financial industry pundits are wondering what Bernanke has in mind for an exit strategy.

Is Bernanke’s new foundation solid enough for him to stop shoring up the walls and put his tools away? Does the Fed chairman know a way out?

Dropping interest rates to the floor is, of course, a classic strategy for combating a recession. While low rates may keep government borrowing costs down and the stock market humming, however, they can be deadly to retirement savers, insurance companies, pension funds and annuity providers.

On the other hand, a return to “normal” rates can pose its own dangers. The Fed has to craft an exit strategy that doesn’t trigger new problems—like falling bond prices, a new spike in unemployment, defaults on real estate loans or another serious stock market correction.

Advertisement In remarks prepared for the House Committee on Financial Services on February 10 (a hearing waylaid by snow), Bernanke described the steps the Fed has taken to prepare for an [exit strategy](#), but indicated that the central bank was not ready to act just yet.

“The FOMC anticipates that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period,” Bernanke’s testimony reads.

Then, eight days later, on February 18, Bernanke surprised everyone by raising the rate at which the Fed lends to banks, known as the discount rate, by a quarter-point. Was this the first move toward the exit?

“It’s a start,” says Rutgers University economist Michael D. Bordo. “I was surprised that they did it so quickly, so maybe they will get it right.”

What Fed watchers say

The Fed hasn’t always done a good job with its exit strategies, write Bordo and Rutgers colleague John Landon-Lane in a recent paper for the National Bureau of Economic Research. Since 1960, the Fed has

generally waited to tighten rates until unemployment peaked—after inflation had already begun to rise.

Bordo does not believe this exit will turn into a double-dip recession. But he frets that the lingering high unemployment rate could put political pressure on the Fed and cause it to repeat the multiple mistakes of the exit from the 1990-1991 recession.

Unemployment from that downturn peaked at 7.7% in July 1992, and inflation began to rise in the first quarter of 1993. But the Fed waited until early 1994 to raise rates, and then did so very rapidly. “It broke the back of inflation here, but it also led to the Latin American debt crisis,” Bordo noted.

But interest rates have to rise at some point. Otherwise they end up damaging insurers. When Japan dropped its interest rates to zero in the 1990s, for instance, it nearly killed its insurance companies, which were still legally obligated to pay 4% on whole life policies.

U.S. life insurers learned from Japan’s experience and lobbied for lower guaranteed rates in this country, said Daniel E. Winslow, a financial planner in Lake Forest, Illinois, and a former chairman of the American Council of Life Insurers’ actuarial committee. Statutorily guaranteed rates in the U.S. are now 3% or less, depending on product or state.

While those reductions help insulate U.S. insurers from the impact of today’s low interest rates, they affect only those contracts issued since the state requirements were reduced. No one knows the size of the old book of business because the information is proprietary.

“My educated belief,” Winslow said of the low interest rate environment, “is that it is bearable as long as it doesn’t last more than a few years.”

As for the prospect of rising rates, “banks should be more concerned than insurance companies because a lot of them are still in shaky condition,” he said. “They have been feasting off lending at 6% or 7% and borrowing at zero percent. When rates go back to normal it will make it that much harder for them to rebuild their balance sheets.”

Unprecedented risks

While many observers grant that Bernanke is a well-schooled student of the Great Depression, some people note that he faces risks that were not even imagined in that period. Take, for instance, the large portfolio of mortgage-backed securities that the Fed has taken on, and the assets it shouldered as the U.S. financial system melted down in 2008.

Ricardo Reis, a professor at Columbia University, believes that the Federal Reserve System and the conduct of U.S. monetary policy have changed more in the past two years than in any period since the system was founded in 1913.

“[The Fed] made loans to a myriad of different institutions,” he wrote in a recent paper on possible exit strategies that will be published as part of a book this spring. “It started buying securities directly like a regular investor, and it found itself supporting failed companies like Bear Stearns and AIG.”

Because the Fed is now such a big player in the housing market, Reis worries, it faces new rivals. For instance, the still-powerful triumvirate of Fannie Mae, Freddie Mac and the mortgage brokerage community could make it hard for the central bank to sell its vast cache of mortgage-backed securities if they perceive the sell-off as a threat to their own finances.

“The big danger in holding all of these assets is that you can lose money on them,” Reis said in an interview. “If the Fed loses, it could lose its independence.”

The shape of the yield curve, others say, matters as much as the rates themselves. If the yield curve flattens again, as it did when the Fed raised rates in 2005, that scenario might be worse for the insurers than low rates, noted Viral V. Acharya, a professor of finance at New York University’s Stern School of Business.

“I expect the yield curve to flatten a bit to reduce the benefits to bank from borrowing short and lending long,” he added.

Acharya says the U.S. has a slightly higher risk of borrowing than it has in the past, and a reduction in the credit risk of the government should flatten the yield curve. He estimates that 40 to 50 basis points of the longer maturity U.S. borrowing rates reflect the risk that the U.S. has taken on. The unwinding of that risk should lower the cost.

The highest priority, he believes, should be to contain the over-lending and over-heating in the economy—a condition fostered by the ultra-low interest environment.

“In a low interest rate environment, the long-term yield on assets is not good,” he said. “Then everyone has to start searching for yield, and that forces people to load up on riskier assets. A rise in interest rate environment will in the long run be better for the insurance sector because it will allow them to be concentrated in lower-risk assets.”

In “Mike Mulligan”, the crowd cheered for Mike and his steam shovel to dig as fast and as deep as they could. But Fed-watchers want Chairman Bernanke to find the nearest exit ramp. “The sooner they get out [of low rates],” says Bordo, “the better.”

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