Rodney's Take

June 20, 2022

Call Me When the Fed Gets Serious

The central bankers on the Federal Reserve Open Market Committee voted last week to raise the federal funds rate (FFR) from a range of 0.75% to 1.00% to a range of 1.25% to 1.50%. The financial world shook with fear over what this means for the U.S. and the world, while higher rates crash through the domestic and international economies like a bull in a china shop. Clearly, some things will get broken. It's just a matter of how much damage the central bankers inflict.

Maybe, but maybe not.

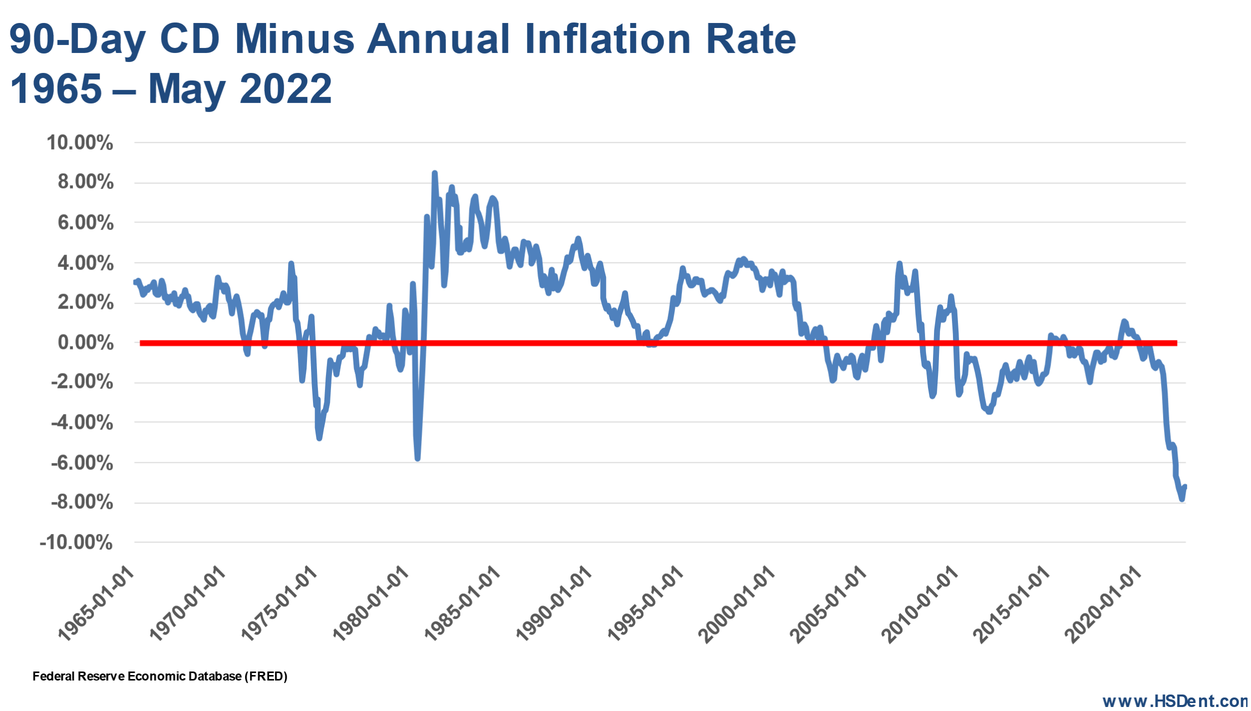
We've been so focused on the "stick" of higher rates that are supposed to curb demand by weighing on borrowed cash that we've forgotten the "carrot" of rising returns. When we look at what the Fed has done from the standpoint of enticing us to save instead of spend, their actions seem more like a slap on the wrist than a punch to the gut. To really change the economy, they'd have to raise rates to a lot higher than they are today.

In the *Rodney Johnson Report* published last week, I pointed out that the national average savings deposit interest rate is 0.07%, even though the FFR was 0.75% before the Fed meeting and 1.25% after. This isn't a new thing. The savings deposit rate has been less than 0.20% for more than a decade. The Federal Reserve Economic Data (FRED) database tracked the average national savings deposit interest rate only from May 2009 through March 2021. The interest rate started at a paltry 0.14% and fell to 0.03% over the course of 12 years. Anyone who has been holding money in cash since the

Great Financial Crisis not only has missed out on market returns, but also has gotten crushed by inflation, even when prices only rose by 1.5% or so. But this was part of the plan.

We think of the Fed raising interest rates to destroy demand by making borrowing more expensive, but that's only part of the equation. The Fed also wants to motivate people to keep money in their savings accounts instead, to earn higher interest, rather than spending it. With short-term interest rates essentially at zero, few people were motivated to sit on cash. To make this work, short-term interest rates must be lower than the inflation rate. Conversely, to entice consumers to save more, rates must be higher than inflation.

To get a better look at how this has played out over time, we can look at the interest rate on 3-month certificates of deposit minus inflation. When the rate is positive, consumers are earning money even when accounting for inflation. When the rate is negative, consumers are losing purchasing power when they hold cash.



The comparison went negative during the mid-1970s, but that wasn't because the Fed wanted people to spend more money. This was during rising inflation when the Fed dragged its feet on raising rates. When Chair Volcker dramatically raised rates in the early 1980s to fight inflation, the 3-month CD rate far outpaced inflation and more or less stayed above inflation until the mid-2000s. Compare that with the last 14 years. We've seen the 3-month CD rate pop above inflation only a few times. For more than a decade, consumers *lost* purchasing power by holding cash. Today, we're not just losing purchasing power, we're getting creamed! At -7.83%, consumers holding cash in a 3-month CD are losing the most purchasing power because of inflation in the history of the data, back to 1965.

With cash as "trash" today, losing purchasing power by the minute, few people are enticed to bulk up their savings by putting off purchases. Instead, they're looking to buy whatever widget or experience they can get before prices march even higher.

Personally, I'm not holding cash at the expense of buying something; I've got money on the sidelines waiting to pounce on the next investment opportunity. Even with that as my motivation, I'm still painfully aware that I'm losing purchasing power every day, although I try to minimize the loss with short-term Treasury bonds.

If the Fed wants us to put off spending in favor of holding more cash, it's doing a lousy job of making such a thing look inviting.

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Got a question or comment? You can contact us at info@hsdent.com.