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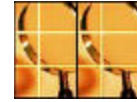
# Policy Note 02/03



## FISHER EFFECT OR FED'S COLA?

BY  
L. RANDALL WRAY

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*Comments for a memorial session for George Brockway, March 15, 2002.*

George Brockway and I carried on a lively correspondence for several years, and I eventually got to know him well through conferences and visits to the Levy Institute. As everyone who knew him can attest, he was generous, polite, gentlemanly, and modest. On Wednesday I pulled out some of his letters. The first letter from him came February 4, 1996. To that point, I had only known of him from the back cover of the JPKE—he was a member of the managing board. I think I may have seen his book (*The End of Economic Man*), but I don't believe I'd ever opened it.

Back to his first letter. It began, “Dear Professor Wray: This is a fan letter.” I can guarantee you that is an effective way to grab a reader's attention. He went on to say that he had meant to write to me in 1991 after he had read some *JEI* article, but, *now*, he emphasized, after reading my piece on the origins of money, “I *must* write you”.

We carried on with a number of other topics. In December of 1996 he wrote “I agree strongly with you that 0% unemployment is the only acceptable goal. Certainly the nearer we get to the goal, the messier it will be. But we have no choice.” Those who have read the last edition of his book know that he supported the employer of last resort program.

Two years ago he wrote that even the Goldilocks expansion aimed too low, arguing “The economy certainly can grow at an annual rate of 10% or 12%. It grew at a rate of 13.5% for three years during the good war.” He went on to add that it is easier to grow fast now than it had been during WWII because half of the wartime output “was just blown away, and about a quarter of the wartime workforce was employed in blowing things a way, while another half was employed in manufacturing things to blow away”. He saw the various natural rate and growth speed limit debates as nothing short of embarrassing.

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We also had a lot of correspondence about my 1998 book (*Understanding Modern Money*), which he had read from the earliest drafts. He tried to use his influence with Norton to get it into the “popular” press, but to no avail. He wrote to me: “You should be very proud of your work, and I am ashamed of my successors.” In typically flattering prose, he went on “This book can change how we think about our world. If we are up to it, we will find it one of the great books of our time. It is a rarity in economics.” I don’t repeat this because I believe any of it, but rather to give a sense of the character of the man.

In December of 1996, George sent to me notes on what he called the Banker’s COLA—that is the addition to the interest rate that is designed to offset inflation. It was of course in his 3<sup>rd</sup> edition and he continually reworked the idea. By the fourth edition of the book, he had extended and refined the arguments as Chapter 19, titled “The ‘real interest’ fallacy and the Fed’s COLA”. As he explained, while he originally called it the Banker’s COLA, it made more sense to attribute it to the Fed since the Fed is responsible for it.

There is so much in that chapter with which I agree, it is tempting to just copy the chapter. I’ll quote liberally. “In trying to adjust interest rates for inflation, economists of almost every school and almost every persuasion routinely commit what may be called the ‘real interest’ fallacy...” by subtracting annual changes of the CPI from the nominal interest rate to obtain a “real” interest rate. As he argued, nothing could be more “unreal”. He demonstrated that real rates were negative in 1979-80, while lending hit new records. If, indeed, lenders were concerned with real interest rates, why would lending be so strong with negative rates?

Not only are economists and others wrong about this—a point to which we’ll return—but, worse, “The fallacy of the ‘real interest’ theory is a single misadventure of thought that has had, and continues to have, appalling consequences for the wealth, health and happiness of the people of the globe.” This is because the Fed jacks up the fed funds rate whenever there is inflation, in an attempt to preserve the “real” returns of lenders. It is as if interest rates have become, through misguided policy, indexed to the rate of inflation. Brockway went on to explain:

Labor and money....are essential to every economic transaction. Unless indexed, wages and salaries are far from uniform. Interest rates, however, being fundamentally set by the Federal Reserve Board....are substantially uniform for comparable risks from coast to coast, and so are in effect indexed to the price level.”

There are two important implications that follow from this. First, each time it raises interest rates, the Fed imposes higher costs on firms and household borrowers. Indeed, later in the chapter he argued that high interest rates set by the Fed helped to multiply Third World debt “a thousandfold in a couple of decades”, leading to IMF imposed

austerity and tremendous suffering around the world. As he correctly argued, the period of active Fed intervention from 1969 to 1983 also coincides in the US with rising trend and cyclical unemployment, with rising poverty, and with soaring business failure rates, and he pointed out that we had four recessions in those 14 years—what he labeled “a dismal record”.

The second implication Brockway read from the theory and evidence is probably more controversial, but no less correct. Raising interest rates is inflationary:

The causation indubitably runs from the price of borrowing money set by the Federal Reserve Board to the prices of commodities set by the firms of the economy. It does not and cannot run the other way. Raising the interest rate cannot cure inflation; it causes it.

As he argued, interest is a cost of doing business, as surely as wages are a cost. Economists recognize that wage hikes tend to be inflationary, even though they are never uniform and can be offset somewhat by increasing productivity and by substitution of other inputs (capital, or nonunion and foreign labor). In contrast, interest rate hikes hit all firms much more uniformly, and they are harder to avoid because money is an essential input into the production process. Brockway did admit that “while the price level follows the interest rate up, it of course does not do so according to a precise formula”. Some firms will cut other costs—downsize the workforce—or will take lower profits. However, to the extent that higher interest costs are not passed along through higher prices, they still impose costs on the economy.

Not only do higher interest rates tend to raise prices, the Fed’s high interest rate policy is a, and perhaps *the*, major determinant of inflation. While the Fed, most economists, and financial markets believe that the Fed does and should raise interest rates to *fight* inflation, Brockway argued the Fed’s policy *causes* inflation. It is easy to see how the Fed could get caught in a vicious cycle, as Brockway believed it was after it raised rates in 1969 and again at the end of the 1970s—setting off an inflationary spiral both times.

In 1969, despite the first federal budget surplus in nine years...., the Reserve Board raised interest rates, undoubtedly intending by conventional means to avert the inflation conventionally expected as a result of the guns-and-butter financing of the Viet Nam War. The inflation rate increased anyhow, because the increased interest was, of course, an additional cost on top of everything else. This was the start of a fourteen-year run of disastrously misguided central bank policies that, in spite of much insistence on being ‘serious about inflation’, produced a record-breaking 271.4 percent increase in the CPI....

In the 1970s, the Reserve, in a manic resolve to ‘stay the course’, raised interest rates to unprecedented heights, and we were well on our way to a hyperinflation caused by escalating interest rates rather than by wage hikes. In July 1981, when the federal funds rate reached 19.1 percent, the Reserve began a slow retreat, and the inflation rate followed quickly after.

By contrast, the low inflation rates over the course of the Goldilocks boom could be attributed to the Fed’s willingness to allow interest rates to moderate. Indeed, Brockway argued that “What inflation is still in the system is largely due to the Fed’s COLA, which protects lenders from inflation at an egregiously disproportionate cost to the economy as a whole....elimination of the Fed’s COLA will eliminate the subsequent inflation rate.” For further support, he might have turned to Japan, which has the highest budget deficits among the major developed nations. At the same time, it has overnight interest rates at zero (so much for the hoary crowding out argument) and hence has squeezed every ounce of inflation out of the system, indeed, is experiencing deflation. Note that Brockway did not advocate zero inflation—he saw the advantages to low inflation—but he did want to eliminate the inflationary pressure caused by the Fed’s COLA.

What about the so-called Fisher Effect, a notion near and dear to the hearts of most economists, according to which nominal interest rates are increased by the amount of inflation by automatic market forces rather than by central bank policy? Brockway dismissed it. Sure, an individual who lends money would like to have the loan held as an asset produce growing purchasing power in terms of the basket of commodities the individual habitually purchases. And pigs would like to soar through the clouds but are stuck wallowing in mud. Brockway provided an example. Suppose the nominal interest rate is 10.79 percent while the CPI inflation rate is 13.50 percent. A thousand dollar loan returns to the lender \$107.90 annually in the form of interest. However, given the inflation rate, at the end of one year, the principal and interest would have a purchasing power of only \$986.34—or less than what the lender had started with. Obviously, the lender would like a better return. However, the alternative would have been to simply hold cash and earn no interest, in which case the purchasing power at the end of the year would have fallen to \$865.

The result, whereby a ‘negative’ interest rate is greater than a zero rate, is of course in flat contradiction of the laws of mathematics. On reflection, it may seem wiser to retain the laws of mathematics, which have served us so well, and abandon the ‘real interest’ theory, which has been misleading and disruptive...

He went on to point out that because banks are both lenders and borrowers, “If there were a ‘real’ interest rate, it would operate on both sides of their balance sheets and so approximately cancel itself out and affect only minimally the spread between their costs and use of funds.” On the other hand, households, pensions, trust funds, and other unleveraged lenders do not borrow in order to lend. Hence, they “may fuss when the

offered ‘real’ rate is low or ‘negative’. But their existential choice is between actually offered interest or none at all....”

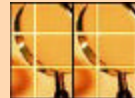
Thus, the Fisher Effect may express the wishes of some classes of lenders, but it has no explanatory power. Any observed correlation between nominal interest rates and inflation (and there is some, although not perfect) results from a policy-induced attempt to maintain the Fed’s COLA. This is against the interests of most of the society, and, indeed, is mostly self-defeating because interest rate hikes simply result in an interest rate-price spiral. Far better to eliminate the COLA and keep the fed funds rate low.

If the economic models of the Federal Reserve Board had been based on a low actual interest rate that the Board itself had set, there would have been no Fed’s COLA; the actual interest rate would not have been kept usuriously high in order to protect an imaginary ‘real’ rate; there would have been little or no inflation; absent the frenzied fear of inflation, there would have been no barbarous practice of a ‘natural’ rate of unemployment; the chasm between the rich and poor would not be deepening as high rates make lenders and speculators ever richer; the Social Security system and Medicare would not need ‘fixing’; there need not have been the sad neglect of our resources and infrastructure and our arts and sciences; and there need not have been the financial ruin and economic waste and personal grief of the nine recessions of the last half of the twentieth century.

Perhaps Brockway has overdrawn the results of the Fed’s mismanagement of interest rates, but I think we can all agree with his policy prescription.

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