The Bleeders

August 8, 2022

According to history.com, in medieval Europe, bloodletting became the standard treatment for various health conditions, from plague and smallpox to epilepsy and gout. Practitioners such as barbers, typically nicked veins or arteries in the forearm or neck of the patient, sometimes using a special tool featuring a fixed blade known as a fleam. Today's barber pole harkens back to the bloodstained towels that would hang outside the offices of "barber-surgeons."

On December 13, 1799, George Washington awoke with a bad sore throat and began to decline rapidly. A proponent of bloodletting, he asked to be bled the next day, and physicians drained an estimated 5 to 7 pints in less than 16 hours. Despite their best efforts, Washington died on December 14, leading to speculation that excessive blood loss contributed to his demise! Beware politicians' opinion about health cures.

Today's monetary policy harkens back to those procedures as raising interest rates seems to be the supposed cure for inflation no matter what the source of that inflation. In the old days, the Fed had various tools to suppress one or more parts of the economy. When the Fed limited the level of interest rates on savings accounts through "Regulation Q," this limit imposed in the mid-60s caused a crisis in homebuilding and an interest rate recession. The Fed had other tools that limited interest charges on various consumer products, but they have disappeared. If rising prices continue, the Fed will continue to raise interest rates until the patient requires a reversal in monetary policy to survive. Just like we have come to realize that medical procedures that lasted for thousands of years were virtually useless, we may find that a commitment to monetary "bleeding" that is designed to lower inflation but results in higher unemployment and economic downturns has a similar ending.

As the economy is returning to reasonable equilibrium, fiscal policy is ready, willing, and able to step in and take blood from the patient. The recent announcement of an agreement among Democrats on spending and tax increases is no different from raising interest rates. In other words, tax increases act as a brake on the economy while spending increases aggravate inflation as they pressure the supply side of the economy. Just at a time when the Fed is rushing to commit to more interest rate increases, the federal government is enacting another big tax increase even though federal tax revenues are surging!

The economic "bleeders" may be leading us into an environment of unintended consequences. As was the case with President Washington, those unintended consequences could have a painful outcome. Hopefully today's policymakers will recognize this risk before it is too late.