The Importance of Stability

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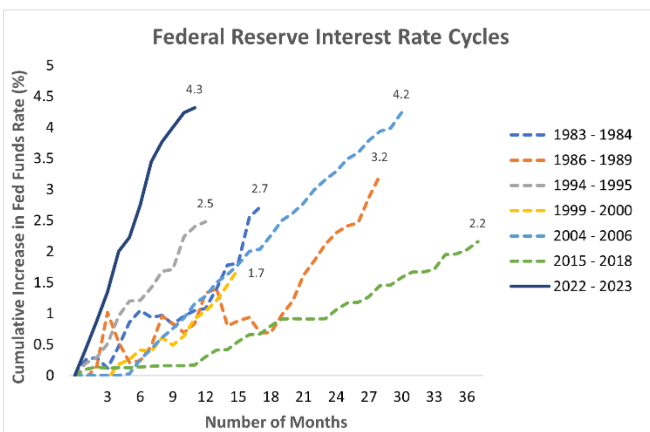
Many years ago, an economist wrote about the importance of stability in the factors that drive the economy. His name is Jude Wanniski and he wrote a seminal research book ("The Way the World Works") on how the economy functions. A critical point that he made was that stability is an essential element in keeping the economy on a growth track. His example highlighted what would happen if the Bureau of Weights and Measures changed the number of inches in a foot, either gradually increasing or decreasing the twelve inches. His point was that the uncertainty surrounding such changes would lead to a dramatic decrease in the production of goods that are affected, thus leading to a decline in economic activity. Imagine building a house and having to deal with the changing measurement of a foot!

Over the past year, the Federal Reserve has, once again, produced a dramatic change in interest rates that have had the effect of sending several regional banks into the arms of the Federal Deposit Insurance Corporation (FDIC) and the need for a rescue plan for virtually all banks that invested excess deposits in long-term securities. The exhibit below illustrates the radical action by the Fed to drive interest rates up by record amounts over short time periods to reverse the mistakes of the pandemic monetary bubble. We have used this chart before because the dark blue line shows just how rapidly the federal funds rate has risen since last year.



As Mr. Wanniski pointed out, such changes can have devastating effects on segments of the economy, in this case, the banking sector. Even though the FDIC and the Treasury have stepped up and guaranteed virtually all deposits of any size, savers are still pulling billions of dollars out of regional banks and going to the very big banks that appear to be secure. How will the economy fare when loans from such banks that experience shrinking deposits offer competitive loans to traditional borrowers? The policy of tight money may succeed in lowering inflation but the unintended consequences of this decision may truncate economic growth and produce the recession that so many economists have been predicting. Stay Tuned!

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