

Adviser Soapbox

Credit 'Black Out' Brightens Up[John Rutledge, Rutledge Capital, 08.31.05, 11:58 AM ET](#)

The news is full of economists wringing their hands over what the Fed is going to do with the federal funds rate: Whether they have tightened too much or too little, and just what level of the "real fed funds rate" would be "neutral." Meanwhile, the economy keeps growing. What gives?

NEW YORK - Monetary policy is a lot more than the fed funds rate. What really matters is whether the network of bank and non-bank lenders to businesses that make up the country's credit markets are functioning or not. As the chart below shows, business loans are growing like crazy.

That's important because credit markets don't work like the textbooks, and macro models would have you believe they do. In the textbooks, investors compare the interest rate with projected returns on projects. Raising rates causes them to trim marginal projects, investment spending falls and output contracts. The real world is not like that.

In 30 years of investing and owning companies, I have never seen an investment project accepted or turned down because fed funds rates were 1% higher or lower. But I have seen plenty of projects canceled, and businesses shrunk because the credit markets imploded. It is the availability of loans--not the posted interest rate--that matters.

Monetary policy has its principle impacts on the economy--not by moving the economy from one equilibrium point to the next, like in the textbooks, but by causing sudden, discontinuous changes, or "blackouts," in credit availability.

The credit market is a communications network, no different from an electricity grid. Normally, credit markets function well. But, from time to time, a policy disturbance causes the network to "black out." During these times, the credit market is far away from equilibrium, and recorded prices (interest rates) are not a good metric for incremental borrowing costs.

Example: From November 2000 until May 2004, during which time business loans contracted from \$1,104 billion to \$870 billion, fed funds rates were pushed lower and lower, but total costs increased to borrowers, as evidenced by the land-office business being done by mezzanine lenders during the period. This blackout was the principle reason that economic performance lagged forecasts during much of that period--one to which many referred as the jobless recovery.

Small businesses, which make up more than half the economy and nearly three quarters of hiring, have few alternatives to banks for working capital. When the credit market blacks out, they lay off their workers and output shrinks.

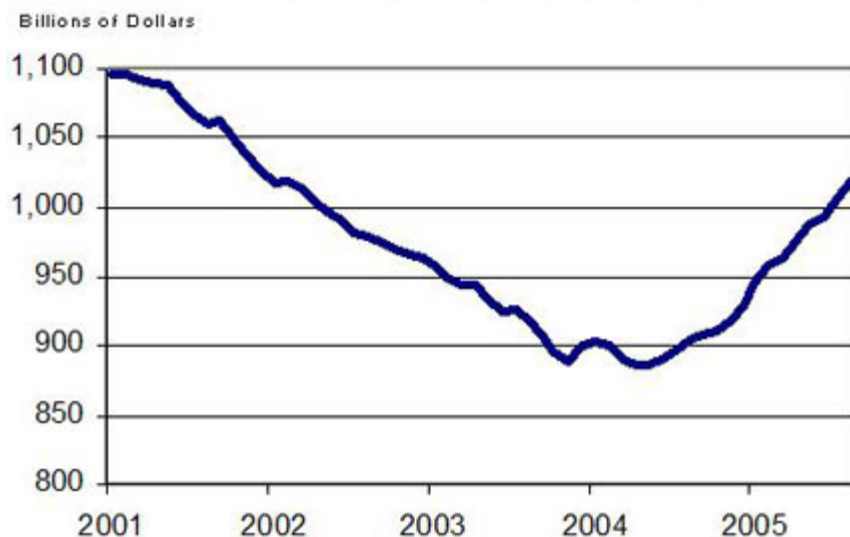
The credit blackout ended in May 2004. Since then, business loans have increased by \$148 billion to \$1,018 billion (as of Aug. 17). This gusher of credit has driven borrowing costs sharply lower for the average business borrower as banks, mutual funds and hedge funds competed for business, even though the federal funds rate increased the entire time. That's why growth and profits keep surprising economists. This is particularly true for bank-loan dependent small companies. This is why small- and mid-cap stocks have outperformed their big brothers and will continue to do so.

Network theory tells us that networks characterized by super-connectors--a small number of actors that are connected to many others--are especially prone to failures. The Fed and Treasury, sitting atop the credit system, are both super-connectors of the first order. The result is on-again, off-again, monetary policy.

We would be better off having a more stable economy with a distributed processing system that pushed policy making out into the network, rather than controlling it from the center, for the same reason our flexible labor market works better than the centrally controlled labor markets in Europe.

The great economists of old knew this. That's why **Wicksell**, **Keynes** and **Irving Fisher** wrote about credit collapses. It's worth reading them again.

Commercial & Industrial Loans



Excerpted from the Rutledge Blog, accessible at [Rutledge Capital](http://RutledgeCapital.com). Dr. John Rutledge is a leading economist who has advised several presidents, including President George W. Bush's Administration. A former Forbes Magazine columnist, he also advises multinational corporations, financial institutions and investors.