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The Fed Doesn't Know What Corporate America Needs

Campbell Harvey

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NEW YORK (TheStreet) -- When conventional monetary medicine becomes ineffective, central banks often resort to a dose of quantitative easing (QE) to stimulate the economy. The Federal Open Market Committee (FOMC), a group within the Federal Reserve, will likely agree to another round of QE in one of its next two meetings. But would it work?

Last month's Duke-CFO survey of 450 U.S. CFOs drilled down to the key driver of growth: investment. We find new evidence suggesting that small tweaks in the interest rate would not have a measurable impact on investment.

While consumer spending represents two-thirds of GDP, the key driver of growth is private investment. Consumer expenditures are smooth. For example, in the horrible first quarter of 2009, real consumer expenditures dropped by 1.6% (annualized). In contrast, gross private domestic investment plunged by 43% (also annualized).

The Fed's main levers are interest rates. The short-term rate is already essentially zero. It is unlikely that the Fed would push the short-term rates below zero. Long-term rates are more difficult to control, but at the last FOMC meeting, the Fed extended its Operation Twist by agreeing to spend $267 billion to buy long-term bonds (to reduce yields and borrowing costs) and finance it by selling shorter-term bills.

There are other options. They might include lowering the 0.25% interest rate the Fed pays banks on reserves to prod them to lend money rather than park it with the Fed. It is possible to purchase other (non-government bonds) assets (in an indirect way), which might lower interest rates on corporate bonds. They might even copy the Bank of England's scheme to subsidize bank lending. But the common logic is that, by reducing the cost of borrowing, investment will increase.

While this logic seems sound, there are at least two reasons why investment will not robustly respond to QE given today's circumstances.

First, the cost of borrowing is already amazingly low. The yield on Moody's Baa rated bonds is only 4.8%. The yield on the highest-grade bonds, Aaa, is only 3.3%. These rates are rock bottom -- we haven't seen levels like this in 50 years. Yet investment has not responded.

It is unlikely that lowering the interest rate a little more will produce any measurable effect.

Second, it is crucial to understand the non-residential investment process. Our recent survey found that the average hurdle rate for new investments was 13.5%. That is, firms will not even consider investments unless they have projected returns of at least 13.5% a year. Note that this is sharply higher than their after-tax financing costs (a blend of debt and equity financing costs, which is probably closer to 6% today).

Even the projects that are promising 13.5% returns are not automatically selected. We asked the CFOs about the probability of taking on a project that "fits" company strategy (management time and financing would be available). The CFOs said there was only a 33.2% chance the project would be approved in today's environment.

Given this huge contingency buffer between cost of financing and expected cash flows, it is hard to fathom how fine-tuning the interest rate by a few basis points will spur growth. Indeed, we asked the contra-question: suppose your firm just approved an investment project that exceeded the hurdle rate, but unexpectedly, interest rates increased by 1 percentage point (think of the Baa yield going from 4.8% to 5.8%). What is the chance that you would abandon or delay that approved project?

Only a trivial number of CFOs (3.4%) would reconsider their investment. To be clear, a 100 basis point increase in rates would be massive compared to the most optimistic impact of a further QE. Here lies a fundamental disconnect: The Fed thinks that making small changes in interest rates will drive investment growth. Corporate America operates differently. They build in large contingencies before they make investments.

There is no doubt that if firms pursued all the 13.5% projects, this would drive substantial growth -- but they are not. There is an extraordinary amount of uncertainty due to a number of known unknowns: a slow-moving train wreck in Europe, stubbornly high unemployment in the U.S., four years of trillion-dollar fiscal deficits, Iran and other Mideast hotspots, the stalling of the Chinese growth engine, and the U.S. election.

We asked the CFOs why projects that exceed the hurdle rate are not pursued. The answers fall into two categories.

The first is best summarized by a CFO who wrote us that "we want to maintain a strong cash position in the current economy." Given the risk, corporate America is playing wait-and-see. This applies to investment as well as employment decisions. The second is summarized by another CFO who wrote us complaining about "insufficient capital." That is, even though the firm might have a great project, it can't get funding from the bank.

There are "haves" and "have nots." The haves are cash hoarders who will not pull the trigger on good projects because they are worried about the future and want to conserve cash. The have nots are firms that lack cash and can't get bank loans to finance good projects because the banks want to conserve cash.

The survey evidence suggests that a small tweak in interest rates would not drive growth. It would be far more effective for policy makers to pursue an agenda with the goal of reducing policy uncertainty. After all, the patient will best return to health in a stable environment.

Campbell R. Harvey is a professor of finance at Duke University's Fuqua School of Business. He served as editor of The Journal of Finance from 2006-2012.

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