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Interest Rates and the Federal Reserve

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On June 30, 2004, the Federal Reserve Open Market Committee announced it was raising the targeted federal funds interest rate from 1 to 1.25 percent, to begin to prevent a possible future price inflation. Then on August 10, the Fed announced it was raising the federal funds target rate once again by a quarter point, from 1.25 to 1.5 percent.

Nearly all the commentaries that either preceded or followed the Fed's announcements focused on what impact these decisions will have on investment and consumer spending, and whether they will fuel higher price inflation in the future.

What was ignored is the more fundamental question of whether the Fed should be attempting to set or influence interest rates in the market. The presumption is that it is both legitimate and desirable for central banks to manipulate a market price, in this case the price of borrowing and lending. The only disagreements among the analysts and commentators are over whether the central banks should nudge interest rates up or down and by how much.

In the free market, interest rates perform the same functions as any other price: to provide information, to serve as an incentive, and to bring supply and demand into balance. Market prices convey information about what goods consumers want and what it would cost for producers to bring those goods to the market. Market prices serve as an incentive for producers to supply more of a good when the price goes up and to supply less when the price goes down; similarly, a lower or higher price influences consumers to buy more or less of a good. And finally, the movement of a market price, by stimulating more or less demand and supply, tends to bring the two sides of the market into balance.

Market rates of interest balance the actions and decisions of borrowers (investors) and lenders (savers) just as the prices of shoes, hats, or bananas balance the activities of the suppliers and demanders of *those* goods. This assures, on the one hand, that resources which are not being used to produce consumer goods are available for future-oriented investment, and, on the other, that investment doesn't outrun the resources available to support it.

Interest rates higher than those that would balance saving with investment stimulate more saving than investors are willing to borrow, and interest rates below that balancing point stimulate more borrowing than savers are willing to supply.

There is one crucial difference, however, between the price of any other good that is pushed below that balancing point and interest rates being set below that point. If the price of hats, for example, is below the balancing point, the result is a shortage; that is, fewer hats are offered by suppliers than the number consumers are willing to buy at that price. Some consumers, therefore, will have

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to leave the market disappointed, without a hat in hand.

Out of Thin Air

In contrast, in the market for borrowing and lending the Federal Reserve pushes interest rates below the point at which the market would have set them by increasing the supply of money on the loan market. Even though savers are not willing to supply more of their income for investors to borrow, the central bank provides the required funds by *creating them out of thin air* and making them available to banks for loans to investors. Investment spending now exceeds the amount of savings available to support the projects undertaken.

Investors who borrow the newly created money spend it to hire or purchase more resources, and their extra spending starts putting upward pressure on prices. At the same time, more resources and workers are attracted to these new investment projects and away from other market activities.

The twin result of the Federal Reserve's increase in the money supply, which pushes interest rates below that market-balancing point, is an emerging price inflation and an initial investment boom, both of which are unsustainable in the long run. Price inflation is unsustainable because it undermines trust in and the value of money. The boom is unsustainable because the imbalance between savings and investment will eventually necessitate a market correction when it is discovered that the resources available are not enough to produce all the consumer goods people want to buy and all the investment projects borrowers have begun.

Thus the expansionary monetary policy that the Fed has been following for the last three and a half years, and which has kept interest rates artificially low, is finally starting to bring about the price inflation that the Fed now says it must prevent. How expansionary has Fed monetary policy actually been? A frequently used measurement of the money supply in Federal Reserve publications is known as M2, composed of currency, travelers' checks, demand deposits, savings deposits, small-denomination time deposits, and balances with retail money-market funds.

If we use this as an indicator of Fed monetary policy, we discover the following: From 2000 to the middle of 2004, M2 increased by more than 30.5 percent. In 2001, M2 rose by almost 9 percent; in 2002, by over 7.5 percent; and in 2003, by almost 7 percent. The Federal Reserve's semiannual report to the Congress, released in the middle of July, reported that for the first half of 2004, M2 increased at a 6.5 percent annual rate. But for some months in the first half of 2004, the monthly increases in M2 were at annualized rates near or over 9 percent. In May alone, M2 increased at a 13 percent annual rate. It should not be surprising that interest rates have been pushed down to levels not seen since the 1950s.

In other words, the Fed says it must combat the very problem its own monetary policies have created, while all the time publicly warning about the inflationary effects they have caused. And all the while the Fed worries about dampening the investment boom and consumer spending its own artificially low interest-rate policies have brought about.

Rather than continuing to manipulate interest rates, the Federal Reserve should simply stop creating money. That would bring an end to any danger of price inflation, since there would no longer be any monetary expansion putting upward pressure on prices in general in the American economy. And by ending any further monetary expansion, interest rates would be free to tell the truth: how much savings is actually available for investment purposes, and therefore how many and what types of investment projects can be undertaken without a future artificial investment bubble having to burst.

It is really that simple. Unfortunately, the Federal Reserve is not willing to give up its monetary mischief. And commentators in the media seem to be obsessively focused on looking at the interest-rate symptoms rather than at the monetary disease. □