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OPINION: The Fed Is A Toothless Tiger, As The Markets Are Learning

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By Bert Ely

WASHINGTON--On July 6, the Federal Reserve's Federal Open Market Committee will announce whether or not it will change its target for the so-called fed funds interest rate.

This rate, currently at 6 percent, supposedly drives all interest rates. In reality, the fed funds rate merely signals what the Fed thinks is an appropriate short-term interest rate.

Scores of articles have reported the debate over whether or not the Fed will cut interest rates.

It almost seems as if the fate of the Western World depends on what the Fed will do, which of course feeds egos at the Fed.

Some people laud Fed Chairman Alan Greenspan for his ability to obfuscate when asked about monetary policy, yet his complex elocution hides the simple fact that the emperor has no clothes.

THE FED'S ALMOST MYSTICAL GRIP on interest rates, and therefore on the economy, is reminiscent of the Wizard's hold on the Munchkins in "The Wizard of Oz."

The Wizard's hold, of course, was broken when Toto revealed him for the snake-oil salesman that he was.

The Fed, too, sells snake oil.

Fortunately, though, the financial markets are steadily pulling back the curtain to reveal the Fed for what it is.

INCREASINGLY, THE MARKETS are determining interest rates independently of Fed actions.

This in turn produces less inflation and smoother economic growth than occurs when the markets follow the Fed's lead.

The Fed in fact does not possess as much control over interest rates or the economy as it wants the public and the financial markets to believe because it lacks the brute force power, through the buying or selling of Treasuries, to move rates.

Instead, its power over interest rates, and therefore the economy, is based almost entirely on the perception that it can move rates.

THE FED, THEREFORE, IS A TOOTHLESS TIGER whose roar the financial markets can and should ignore, for three reasons.

--**FIRST, THE FED'S** discount rate is totally meaningless because the Fed does almost no lending.

Last year, its loans averaged \$258 million, mostly to finance seasonal farm loans extended by small midwestern banks.

This amount equals just 0.002 percent of the \$13 trillion in credit-market debt owed by the nonfinancial sector of the economy.

--**SECOND, THE FED** today effectively controls only a tiny portion of the nation's money supply called excess bank reserves. Excess reserves normally fluctuate within a range of less than \$1 billion.

The Fed passively supplies whatever amount of currency people demand and whatever required reserves the banks need as they expand and contract bank deposits to meet their customers' needs.

The Fed cannot inflate prices by pumping billions of dollars of fresh currency into the economy for one simple reason: The federal government pays almost all of its bills by check or wire transfer.

Consequently, a currency-driven inflation of the type that routinely plagues less-developed countries is nearly impossible in the United States today because neither the Fed nor the federal government can force currency into circulation.

Hence, the quantity of U.S. currency circulating throughout the world is totally demand-driven.

--**THIRD, BANKS PASS THE COST** of holding required noninterest-bearing reserves at the Fed through to their depositors.

Because banks can pass through what effectively is a tax on deposits, reserve requirements have absolutely no effect on bank lending or the total amount of credit available in the economy.

Instead, the quantity of credit supplied to the economy today is entirely a function of interest rates.

An interest rate is an almost-unique type of price in that it largely reflects expectations about future costs, such as the real rate of interest, inflation and credit losses.

Manufacturers and retailers, on the other hand, already have spent, by the time they sell their products, most of what they hope to recover from their customers.

IN THE UNITED STATES TODAY, interest rates largely reflect borrowers' and lenders' expectations about what the future holds.

Fortunately, because competitive financial markets operate most efficiently at zero inflation, borrowers and lenders will find it mutually beneficial to set interest rates that will produce noninflationary credit growth.

That is, interest rates will be low enough to stimulate a reasonable demand for credit, but high enough to keep credit from growing faster than the growth in goods and services available for purchase.

INFLATION THEREFORE OCCURS today when various government policies, notably tax subsidies for various types of borrowing, overstimulate credit growth.

The Fed, which as a central bank represents one of the last vestiges of central planning, periodically damages the economy by using the perception of its power to mislead the financial markets as they set interest rates.

THE FED DID SO IN 1993 when it conned the markets into holding short-term rates too low.

These low rates overstimulated credit growth, and therefore the economy, which the Fed then tried to brake in 1994 by doubling its fed funds rate target.

However, the Fed erred in the opposite direction by effectively pushing rates too high, which is why the fear of another recession grows daily.

Fortunately, the markets have been pushing down short-term rates in recent months despite the Fed's efforts to hold short-term rates at 6 percent.

IN EFFECT, THE FED'S erroneous rate signaling is whipsawing the American economy, to the detriment of real people.

Just as the socialist countries rejected central planning for the superiority of market forces, the time has come to gag the Fed so that the financial markets can set noninflationary interest rates that will permit smoother and therefore greater economic growth than the Fed has been able to engineer.

The FOMC could signal its willingness to stop hurting America by deciding at its next meeting to halt its interest rate signaling.

If it does not cease selling its brand of snake oil, then the media should stop reporting Mr. Greenspan's ego-boosting obfuscations and the financial markets should totally ignore the Fed's roar. End

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