

DOES THE FED HAVE OMNIPOTENT POWER?

Frequently analysts will refer to the FED “undershooting” or “overshooting” their monetary rate-raising or rate-cutting moves. How misleading...! Let’s explore!

For background, when they are attempting to restrain an overheated economy or prevent an inflationary breakout, they will increase the Fed Funds rate. This move has a direct effect upon short-term interest rates by establishing the all-important target for the Federal Open Market Committee (FOMC). In this case the Operating Committee would sell short-term treasury securities and effectively “mop up” liquidity in the market. With a greater number of securities in the market, demand for each tends to decrease, thus pushing the “market” interest rate up to attract buyers. This maneuver directly soaks up money and will shrink the money supply aggregates (liquidity). Conversely, when reducing the Fed Funds Rate target, the opposite occurs, thus injecting “liquidity” into the markets out of thin air!

So what business does our Central Bank have in messing with interest rates? An unbiased observer would like to think that the sale of goods and services on credit to a willing buyer should involve the seller and buyer negotiating an agreement *between themselves* on credit terms and rates amenable to both. Right? Why should government indirectly want to force a seller of merchandise to accept a lower interest rate, if the seller feels the risk of the buyer warrants a higher rate? Or, conversely why should a buyer have to pay a higher rate than a seller is willing to offer? Central Bank intervention on interest rates and credit availability distorts this all important buyer-seller relationship dealing with creditworthiness risks and trust. Adapting Austrian Economic Theory would have us dramatically reduce or eliminate this role of the Central Bank, if the bank should even exist at all.

The Austrian Economic Business Cycle Theory recognizes the *damage* to the economy is inflicted when a boom is induced by artificially lowering interest rates and flooding the markets with “easy money”. The outcome of an induced boom is invariably the creation of asset bubbles. Once the bubbles have been blown they will burst regardless of whether the Fed “undershoots” or “overshoots” in their rate tightening efforts. If they “undershoot”, then the momentum of the boom tends to continue exacerbating the size of the bubbles they’ve created in the first place. Thus, when the bubbles finally burst, the severity of the bust will be that much larger. If they “overshoot” and raise rates too high and/or too fast, then the economy will bust a bit sooner and less severely.

We are witnessing a slow motion economic train wreck in action today. The aggregate bubble imbalances (stocks, bonds, and real estate) are greater today than at any time in the history of the Republic. The bond market bubble started to grow when we abandoned the Bretton Woods agreement in 1971, which decoupled our currency completely from a gold standard. The stock market bubble grew to the most extreme overvaluation in history by any measure during the late 90’s. As this stock market bubble semi-busted in 2000-2002, the “full speed ahead” opening of the liquidity floodgates and tax reduction schemes in 2003 muscled the stock market back up to exacerbate its overvaluation gap. The result of that subsequent monetary and credit stimulation has now created the largest real estate and bond bubbles in the history of the Republic. So, what has the FED done to mitigate this extraordinary imbalance?

We have since witnessed a very timid fifteen baby-step ¼% rate increases from the low of 1.0% (June, 2004) up to 4.75% (March 28, 2006). Unfortunately, the rate of aggregate monetary expansion further feeding inflation of the bond and real estate bubbles has far outpaced the credit restraining impact of the fifteen timid FED rate increases. In the past 52 weeks alone M-3 has

expanded \$827 billion, or at an 8.7% clip! The comical management of our money reminds me of an omnipotent mastermind, who has the power to control the value of our currency, rapidly cranking on a monetary printing press with his right hand, and at the same time selectively counting goods or services that have inflated very little with the left hand, then declaring inflation is “under control” with a straight face! Give me a break... How dim do we look???

The housing and bond markets are now beginning to suffer. The stock market is topping. In the next few years things will get very ugly, especially when foreign investors and central banks begin dumping our currency and create a “dollar crisis” in reacting to the massive illusions of asset wealth we’ve created.

CONCLUSION:

The problem with the FED’s monetary manipulation is not “over-shooting” or “under-shooting” interest rate adjustment attempts to “fine tune” the economy back to normalcy. The problem is the FED unwittingly creating asset bubble(s) *in the first place* as a result of misdirected monetary policy and selective data manipulation, thus creating imbalances that will be *impossible* to diffuse gracefully. I cringe when “expert” analysts predict a “hawkish” FED raising rates too aggressively may send the economy into a recession. Where were they when the massive bubbles were created earlier? Why fill the swamp with excess water and alligators in the first place creating the need to fight the animals off (wrestle with a recession or depression), and drain the swamp (mop up the excess liquidity unwisely created in the first place) to bring our economy back to normalcy?

Unfortunately, the FED seems to possess omnipotent power to have created the economic mess we experience today, but will only have the power to create further illusions when the bust is upon us. They certainly do not have the power to create real wealth. e.g. food, gasoline, capital equipment, etc. Only entrepreneurs and their employees create real wealth. They do, however, have the power to create yet greater illusions via inflation to disguise the massive bubbles they have so skillfully constructed. How popular they have been and legendary they will be! Or not??

Of course the blame for the upcoming bust will be placed upon capitalism, greed, corporate malfeasance, oil prices, wars, hurricanes, low foreign labor rates, unfair trade, not enough government intervention to protect ourselves from ourselves, etc, etc. NOT!

By Russell Randall, March 28, 2006