NATIONAL CENTER FOR POLICY ANALYSIS

Markets, Not Janet Yellen, Should Set Interest Rates[1]

Issue Brief No. 169 by Richard M. Ebeling August 18, 2015

Federal Reserve Chair Janet Yellen delivered her semiannual monetary policy report to Congress on July 15, 2015. Speaking before the House Committee on Financial Services in Washington, D.C., Yellen said that trends in the U.S. economy suggested it may be the right time for the Federal Reserve to start nudging up the Federal Funds rate – the interest rate banks charge each other – after years at nearly zero.[2]

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In the usual method of Federal Reserve statements, Janet Yellen did not tie a rise in interest rates to any particular period or date before the end of the year. Such a change in interest rates and monetary policy will depend entirely upon how the Federal Reserve policymakers read the trends in employment, gross domestic product and price inflation.

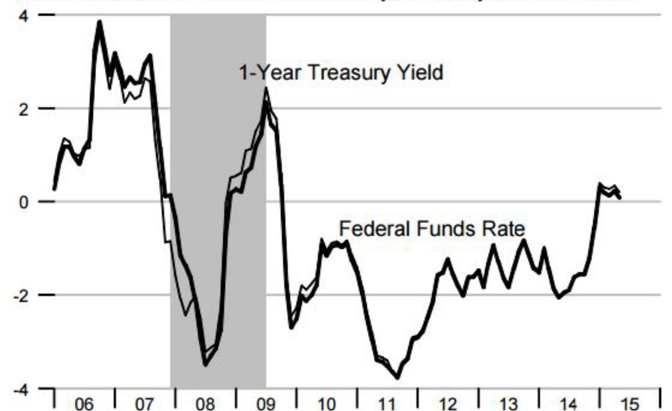
How the Fed Creates Money and Influences Interest Rates. The Federal Funds rate, as Yellen stated, is a key tool of Federal Reserve policy. Federal Reserve rules require banks to maintain a certain amount of cash reserves against outstanding depositor liabilities. On a daily basis, money deposits flow in and money withdrawals flow out of every bank and financial institution. Sometimes banks find withdrawals have exceeded deposits, putting their reserves below the required cash minimum. At other times, deposits exceed withdrawals, resulting in "excess reserves," or cash reserves above the minimum requirement. Banks borrow and lend funds between each other to cover these temporary fluctuations in deposit and withdrawal flows of cash. The rate of interest on the market reflects the availability or "tightness" of such excess funds.

The Federal Reserve can influence this interest rate by purchasing U.S. government securities originating from the U.S. Treasury. However, the Federal Reserve is prohibited by law from directly lending to the U.S. Treasury. Instead, the Treasury borrows money to cover the government's budget deficit by issuing IOUs — short-term or longer-term securities — to financial institutions or larger private lenders. The Federal Reserve then enters the "secondary market" and buys securities held by financial institutions or individuals with newly created money. This cash enters the banking system when sellers of those government securities deposit the payments into their bank accounts. The banks receiving this new money now have larger cash balances with which to extend loans. Banks then lower the rates of interest on loans in order to attract borrowers and lower the rates on short-term Federal Funds for loans to financial institutions under the cash minimum. The result is called "easy" money. A low or falling Federal Funds rate and a banking system awash in new cash allows those banks temporarily short of reserves to meet the requirements.

This process is reversed if the Federal Reserve sells government securities rather than buying them. The purchasers of those Treasury securities from the Federal Reserve's portfolio pay for them out of their bank accounts. This "drains" reserves out of the banking system, tending to push up interest rates, as funds for lending purposes shrink.

Four Trillion Dollars of New Money, but Low Price Inflation. Since 2009, the Federal Reserve has added such a large amount of loanable funds to the banking system (around an extra $4 trillion) that the Federal Funds rate and one-year Treasury securities — when adjusted for the rate of price inflation — have been "negative" virtually the entire time. [See Figure I.] This has resulted in "dirt cheap" interest rates on various commercial and other loans.

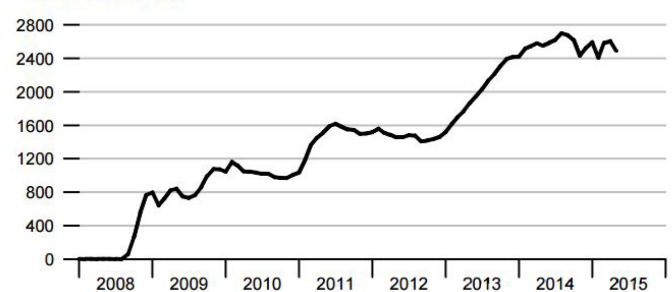
Figure I



Source: *Monetary Trends*, Federal Reserve Bank of St. Louis, July 2015.

Why then has price inflation not risen higher than 2 percent a year, less than the Consumer Price Index (CPI) measured rate of price inflation, with $4 trillion of extra loanable funds in the banking system? The reason is that the Federal Reserve fears that its own "easy" monetary policy might cause price inflation. The Federal Reserve pays banks not to lend a sizeable portion of that $4 trillion by offering them an interest rate slightly above what they could earn by lending to consumers. Thus, nearly $3 trillion of the $4 trillion sit in the banks as un-lent, "excess reserves." [See Figure II.]

Figure II



Source: *Monetary Trends*, Federal Reserve Bank of St. Louis, July 2015.

Treating interest rates as "policy tools" to influence the general levels of employment and prices in the economy, the Federal Reserve prevents interest rates from doing their "job" in a functioning market economy.

Market Interest Rates Have Work to Do. In the free market, interest rates perform the same functions as other prices: to provide information to market participants; to serve as an incentive mechanism for buyers and sellers; and, to bring market 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 product 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. Finally, the movement of a market price tends to bring the two sides of the market into balance.

Market rates of interest balance the actions and decisions of borrowers, or investors, and lenders, or savers, just as the prices of shoes, hats or bananas balance the activities of the suppliers and demanders of those goods. This assures that resources that are not used to produce consumer goods are available for future-oriented investment, and that investment does not outrun the saved resources available to support it. Interest rates higher than those that would balance saving with investment stimulate individuals to save more than investors are willing to borrow, and interest rates below that balancing point stimulate individuals to borrow more than savers are willing to supply.

Central Banks Cause Imbalances and Distortions. 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, suppliers offer fewer hats than the number consumers are willing to buy at that price. Some consumers, therefore, will have to leave the market disappointed, without a hat in hand.

In contrast, the Federal Reserve pushes interest rates below the point at which the borrowing and lending market would have set them by increasing the supply of money on the loan market. Even though savers are unwilling 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 then exceeds the amount of savings available to support the projects undertaken. Investors who borrow the newly created money hire or purchase more resources, and their extra spending eventually 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 Federal Reserve's increase in the money supply leads to price inflation and an initial investment boom, both of which are unsustainable in the long run. Price inflation reduces the value of the money in everyone's pockets, and threatens trust in the monetary system. The boom exposes an imbalance between savings and investment, requiring a market correction since there are not enough resources to produce the consumer goods people want to buy. Moreover, investment projects started with the newly created money falter since real savings do not exist to complete or fully sustain them.

Federal Reserve Policies Bring About Booms and Busts. The most serious consequences of monetary expansion and interest rate manipulation are those distortions and imbalances brought about in the underlying supply and demand relationships between savings and investment in the economy. Price inflation, as measured by such statistical methods as the CPI, may seem moderate or even near zero, but the effects of manipulation exist beneath the surface of the macroeconomic aggregates of total employment, total output, or the "general price level" of goods and services.

Janet Yellen and the other members of the Board of Governors may wait for price inflation to reach 2 percent a year (their desired "target" for inflation) before becoming concerned about their easy money policies. But by that time, the macroeconomic statistical aggregates and averages beneath the surface, including savings and investment patterns, the use and allocation of labor, and other sectors in the economy, will have been given a "wrong twist." Consequently, Yellen's monetary and interest rate policies meant to assure full employment and stable prices could set the stage for another "bust" following another unsustainable "boom."

Conclusion. In an address at the Greater Providence Chamber of Commerce in Rhode Island on May 21, 2015, Janet Yellen recalled her economics classes at Brown University saying, "Gee, I didn't realize how much influence the Federal Reserve has on the health of the economy." She added that to work at the Federal Reserve "would be a worthwhile thing to do."[3] Ending Federal Reserve power and authority to manipulate the money supply and interest rates remains the only way to bring an end to these cycles of booms and busts. This seems unlikely though with "activist" policy addicts like Yellen running the central bank.

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Notes

1. An earlier version of this article appeared at EpicTimes.com, May 25, 2015.

2. Semiannual Monetary Policy Report to the Congress, July 15, 2015. Available at http://www.federalreserve.gov/newsevents/testimony/yellen20150715a.htm.

3. Greater Providence Chamber of Commerce in Rhode Island, May 21, 2015. Available at http://www.federalreserve.gov/newsevents/speech/yellen20150522a.htm.