

Interest Rates & the Economy

Towards the end of the 2nd quarter 2003, the Federal Reserve cut interest rates by $\frac{1}{4}$ %. The action followed 12 similar rates cuts over the past three years and has helped imbed in the public psyche their importance to the economy. However, do we really understand what the Federal Reserve is doing and why? How do lower interest rates help encourage growth? Are there limits to the Fed's effectiveness? These questions may be easily answered by some, however, with Alan Greenspan gaining almost rock star status, it bears reviewing what role Mr. Greenspan and the Federal Reserve play in our lives.

First of all, when the Fed announces it has cut interest rates, they are changing the Federal Funds Rate. This is the rate at which banks lend to each other. Regulators impose certain requirements on banks, one of them being a minimum level of capital, measured on a daily basis. At the end of a day, if banks are short of capital, they can borrow from another institution overnight. A lower federal funds rate, thus, makes it cheaper for banks to meet their capital requirements.

Savings realized from a lower fed funds rate is passed on in the form of lower interest rates for businesses and consumers. Lower debt payments on credit cards and home mortgages mean more money in a consumer's pocket. Consumer spending accounts for roughly $\frac{2}{3}$'s of GDP and has been a pillar for the economy the past three years.

For businesses, lower rates mean a cheaper source of funds. Cheaper money makes previously unprofitable projects viable, and investment in new plants and equipment more attractive. However, when a business already has factories lying idle, there is no incentive to build more, no matter how low rates become. Existing debt can be refinanced, but that does not create jobs.

Taking a global perspective, lower rates in the U.S. relative to foreign interest rates should cause the value of the dollar to fall. For example, if the U.S. and Japan both start the year with their rates at 10%, and half-way through the year U.S. rates are cut to 5%, where do you want to invest money? Japan. Thus, demand for U.S. dollars declines and the value of the dollar falls relative to the Yen. A less expensive dollar makes our goods more affordable overseas, helping our domestic industries.

Despite the powerful and far reaching nature of monetary policy, it has limitations. As mentioned, businesses cannot build more plants if they have no end markets. Tax policy, industry regulation, public sentiment, manipulation of currency markets, foreign trade barriers – these issues also affect the economy and dent the influence of Mr. Greenspan and company. Recently, Wim Duisenberg, president of the European Central Bank (ECB), stated that “monetary policy in Europe has done all it can. It is time to examine the question of structural change within the economy(ies).” Whether he is right or not, his statement highlights the fact that monetary policy cannot cure all ills.

While this article may be short on astounding revelations and investment advice, I hope you enjoyed the content and I look forward to discussing many other topics in the future. Thank you for reading.

Sincerely,

Brian Lawrence, CFA