The Federal Reserve's Rate Hike is just a distraction

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The Federal Reserve raised its target for the federal funds rate by 25 basis points on Wednesday, its first rate hike in more than three years. Fed Chairman Kevin Warsh cited inflation* that has been “too high for too long” as the principal reason for the move. Warsh has maintained a commitment to getting the inflation rate back to the Fed’s stated goal of 2 percent annually since being confirmed.

Opinions vary on the decision. President Trump, always and everywhere a proponent of lower interest rates, managed to criticize the move without castigating Warsh, whom he just appointed chairman. Instead, Trump blamed “the board,” meaning the Fed’s Board of Governors, saying, “The board is very hostile. They're very political. They're doing the wrong thing.”

Meanwhile, longtime Fed critic Peter Schiff argued on his podcast that the rate hike is far too small given the current inflation rate, arguing that the Fed should have started with at least a 50 percent hike and continued higher from there.

To the extent the federal funds rate affects price levels, Schiff is correct. A quarter-point hike is not significant enough to overcome other factors pushing up prices. But everyone, including Schiff, still talks about monetary policy as if it operates the way it did before 2008.

It doesn’t.

Before 2008, the Federal Reserve could only lower the federal funds rate by creating new money. It bought government securities from its member banks through open-market operations with newly created money, increasing the supply of money available for lending and thereby decreasing the price of money, i.e., interest rates. Conversely, it could only raise interest rates by destroying money. It would sell government securities to its member banks, decreasing their supply of money and thereby increasing interest rates.

This had an exponential effect on the supply of money available to the public. It both increased the amount of money available for banks to lend and encouraged them to lend it at lower interest rates than they otherwise would. Given our fractional-reserve system, an increase in lending activity by commercial banks increased the money supply beyond the new money created by the Fed.

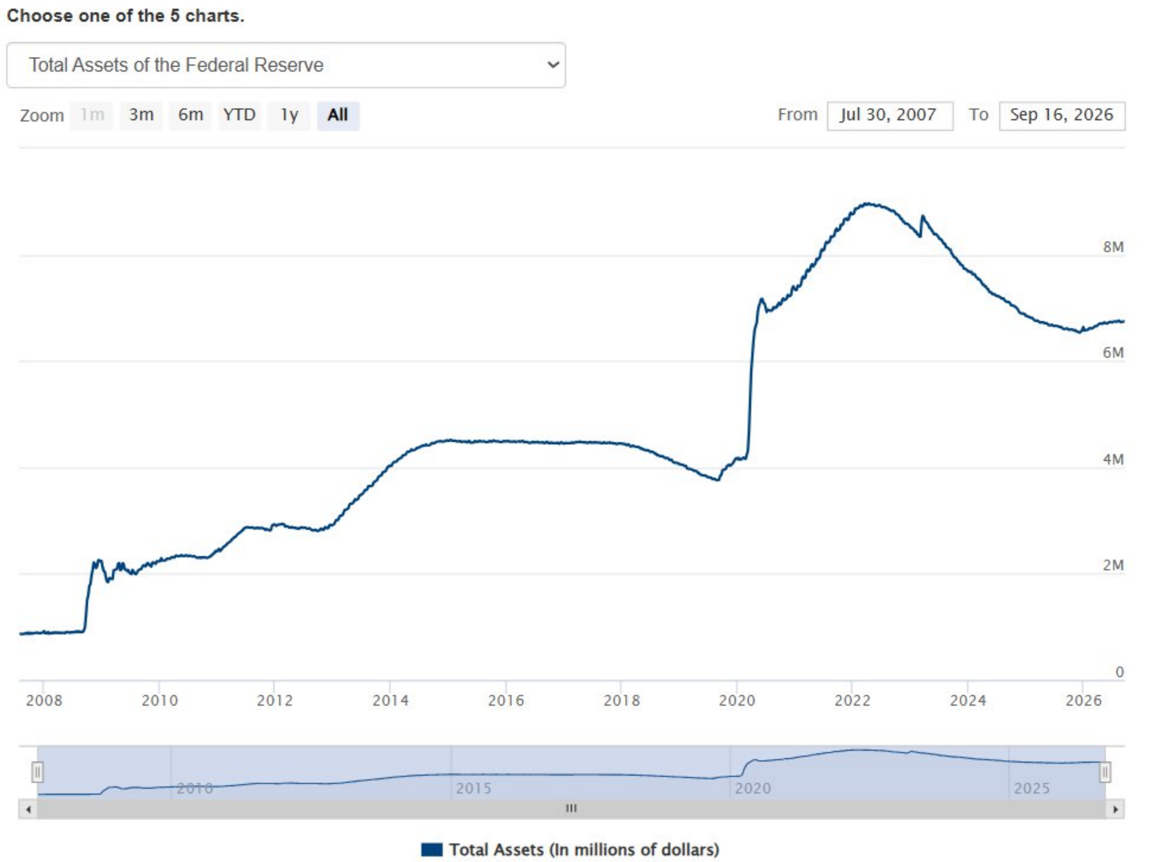
This is not the way monetary policy works anymore. Due to the large reserve balances held at the Federal Reserve by its member banks—a post-2008 phenomenon—the Fed’s interest-rate and money-supply policies are now separate.

The Fed can lower the federal funds rate without creating new money simply by lowering the interest rate it pays on those reserves.

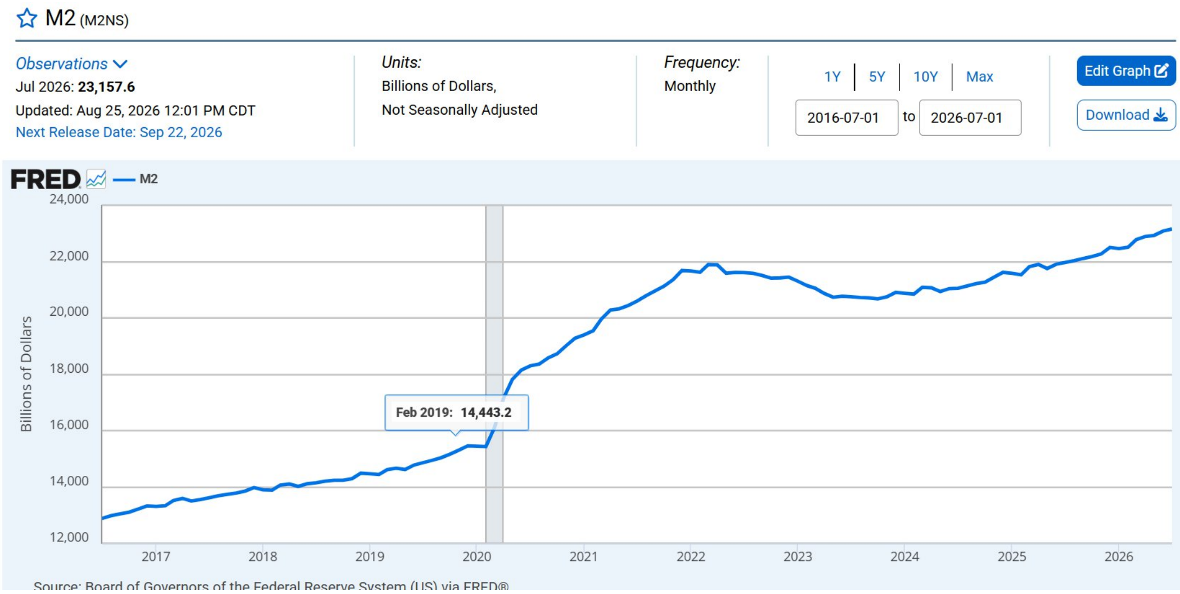
Similarly, it can now raise the federal funds rate without destroying existing money by raising the interest rate it pays on those reserves.

This doesn't mean Fed rate policy has no effect on the economy, but it has much less effect than it did before. It still influences how many loans commercial banks make and at what rates, but it no longer necessarily accompanies that influence with increases in the monetary base. And while interest rates do affect price levels and investment decisions, increases in the money supply by the Fed have a much larger effect. Consider the following charts:

First, the Federal Reserve's balance sheet over time. This shows us how much base money the Fed is creating or destroying at any given moment.



Next, the Fed's M2 money supply chart. This shows us roughly how much money is available to the public for lending, borrowing, spending, etc.



During the COVID-19 pandemic in 2020–21, the Fed both lowered interest rates and more than doubled the size of its balance sheet, from just over $4 trillion to a peak of $8.9 trillion. This is the primary reason general price levels rose so dramatically in the ensuing years. Coupled with a huge drop in the quantity of goods and services available due to lockdowns, this was a recipe for disaster in terms of price levels.

The Fed actually made some technical moves that somewhat muted the effect of this tsunami of money. I broke them down here. In simple terms, that $5 trillion increase in the money supply really amounted to a $3 trillion increase. That's still a lot—almost identical to the post-2008 increase from $800 billion to $4 trillion.

Note that the increase in M2, the money available to the public, was about double the increase in the Fed's balance sheet. This is because commercial banks also create new money when they make loans, since they are lending money that depositors can still withdraw at any time (fractional-reserve banking).

The roughly $6 trillion increase in M2 is the reason prices in general rose so dramatically in the years since 2020. It is also the reason prices continue to rise.

The headlines blame the Iran war for higher prices, and certainly it is responsible for higher prices for oil, fertilizer, and other products. But without an increase in the supply of money and credit, increases in the prices of some products must be accompanied by reduced demand and, therefore, decreases in the prices of other products. Only an increase in the supply of money and credit can cause an increase in all prices.

That brings us back to the Fed's recent rate hike. Yes, it will discourage lending and raise lending rates on the margins, but it will not have the kind of effect in the opposite direction that increasing the money supply by almost 50 percent did in 2020–21. For the moment, the Fed has returned to increasing its balance sheet at a slow pace, which has returned M2 to the slow increases we are accustomed to during "normal" times.

We shouldn't forget that this normal policy is the reason prices rise over time instead of falling, as they naturally would—and did—with a stable currency as production efficiency increases.

M2 is also increasing "normally" at present. This is why prices aren't rising nearly as quickly as they did during the first years after the pandemic. That they are rising over 3 percent rather than 2 percent is harmful, but not nearly as harmful as the 7-10 percent increases we experienced after the initial Covid interventions.

Consumers are hurting far more due to prices not decreasing than the 1 percent difference between current price increases and the Fed's 2 percent target.

However, as far as markets are concerned, we shouldn't forget that modest rate hikes are cumulative. Due to the malinvestment that artificially low interest rates encourage, bubbles form that eventually pop when a series of modest hikes pushes interest rates beyond the point at which these malinvestments are sustainable. We may be close to that point now, or it may take several more hikes to get there. We can only separate the malinvestments from the sound investments retrospectively.

Bubbles can form around new innovations like AI, even if the underlying assumptions about increased productivity are correct. This is what happened with the internet in 2000. There was indeed a reason for large amounts of capital to be directed toward technology. But artificially low interest rates set by the Fed encouraged investment far beyond what could be supported by increases in earnings. When the bubble burst, bad investments like Pets.com were liquidated and the good ones survived. But the process was painful.

There is good reason to suspect there is a similar bubble around AI, even though it is a great innovation that will ultimately make society wealthier. If so, we will have another painful liquidation period, otherwise known as a recession, after which the good investments in AI will continue to pay dividends.

Then we will find out if Warsh is truly committed to fighting inflation and ending the "Fed put." That will depend upon whether he is willing to forgo creating trillions more in new money to bail out the markets.

In the meantime, this quarter-point hike is just a distraction.

*Inflation is used colloquially to describe the phenomenon of rising prices, when in fact the word really means the expansion of money and credit by the central bank, as any paper 20th-century dictionary will confirm.

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Tom Mullen is the author of *It's the Fed, Stupid* and *Where Do Conservatives and Liberals Come From? And What Ever Happened to Life, Liberty, and the Pursuit of Happiness? Part One* and host of the *Tom Mullen Talks Freedom* podcast.