

# Del Mar Times

## *The Federal Reserve: how it impacts the economy*



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The Federal Reserve, concerned with inflation and skyrocketing energy prices, has had a slowing effect on the economy. People are often confused as to why the Federal Reserve would raise interest rates to slow economic growth.

Over time inflation has a detrimental effect and steepens the business and economic cycles. Keeping inflation at bay helps keep us from going into deep recession; however, in this effort to keep inflation at bay, the Federal Reserve is forced to raise interest rates. This has a negative effect on stock prices.

For example, higher oil prices make it more expensive to produce goods. Producers eventually have to pass higher prices along to consumers. This is inflation without growth. Consumers end up paying more. These factors and many others are the reasons that we have a slowing economy and falling stock prices at this time.

The situation may sound bleak, but it really is not. Although the Fed is trying to slow the economy we still have positive economic growth. This should bring inflation back in check and the Fed should soon be the markets' friend again. We should see the markets on an upturn and we should see improving earnings momentum again.

So what is the Federal Reserve? The Federal Reserve, the central bank of the United States, was founded in 1913 to provide a more stable monetary and fiscal system. It acts in four general areas:

1. Conducting monetary policy.
2. Regulating banking institutions.
3. Maintaining system stability.

4. Providing certain financial services to the government, the public, financial institutions and foreign institutions.

We will focus on the issue of monetary policy. The Fed cannot control inflation or economic output directly. Instead they control them indirectly by controlling how much money is in the system. The Fed does this in several ways:

- Raising or lowering the Federal Reserve funds rate—the rate at which banks loan to each other.
- Raising or lowering the discount rate—the rate at which banks borrow from the Federal Reserve.
- Buying and selling government securities on the open market.
- Controlling bank reserves.
- Purchasing and selling foreign currencies.

The Federal Reserve System is made up of a Board of Governors, which is located in Washington, D.C., and 12 regional Federal Reserve Banks, located in major cities throughout the nation. They have a shared responsibility for supervising the activities of the system.

The Fed raises and lowers the Fed funds rates to keep the economy stable. This may help prevent us from going into a recession, or make it a short one while preventing inflation.

The Reserve currently will need to continue to raise interest rates until they believe they have controlled inflation. There is an old saying that the Fed will raise rates until something breaks. We hope they do not do this and only slow things enough to lengthen the recovery.

It is always hard to know exactly where we are in the economy. This uncertainty has caused a slowdown in consumer and business spending. This affects corporate profits and, of course, lower profits means a lower stock market. At some point, there will be more clarity in the future direction of the economy. The stock market is a leading indicator. This means that the stock market will move ahead of the economy.

If the inflation can cool without slowing the economy too much, the stock market can move higher. Dallas Federal Reserve Bank President Richard Fisher said on an interview with CNBC that we were in the eighth inning of a nine-inning game. If that is so, we are closer to the end than many believe.

Richard Fisher, as the president of the Dallas Fed, is a voting member of the central bank's Federal Open Market Committee. He is somewhat new and as such some are skeptical of how much influence he has and how much he speaks for the Fed as a whole. However it is encouraging to the markets. The stock market will

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perform much better when we are within a couple of rate hikes of the end of the cycle. According to Mr. Fisher we are close to that.

The problem is that the fed has raised short-term interest rates eight times in the past year. The Fed raised rates to make sure the economy did not grow too fast, that inflation did not become a problem, and to help shore up the weak U.S. dollar. But the funny thing is bond market investors have not listened. Instead of acquiescing and pushing up long-term interest rates in tandem, bond market investors happily gobbled up long-term Treasuries and drove long-term interest rates down.

Therefore, the question that faces the fed is, "What should you do next?" Should you keep raising short-term rates and hope you do not stall the economy or, should you stop raising rates and hope inflation will remain in check and the housing sector will not grow out of control?

I think that they will do what Mr. Fisher has stated and we might be in the eighth inning, however as he also stated we might have a couple of extra innings. I think that they will try to talk the housing markets down a little or put restrictions on home financing to help control the housing market.

It could turn out that a year that we conclude that the Fed was right in raising short-term rates to meet its obligations and that long-term bond market investors were right in lowering long-term rates to keep the economy growing. Our economy is so dynamic, diverse, and structured with checks and balances that perhaps the narrowing spread is the right reaction to keep the economy moving in a positive trajectory.

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