**Financial Services Committee Hearing**

**"Monetary Policy and the State of the Economy"**

**February 26, 2008**

Mr. Chairman,

Price controls are almost universally reviled by economists. The negative economic consequences of price floors or price ceilings are numerous and well-documented. Our current series of hearings have been called to discuss the most important, but least understood, price manipulation in the world today: the manipulation of the interest rate.

By setting the federal funds rate, the rate at which banks in the Federal Reserve System loan funds to each other, the Federal Reserve inhibits the actions of market participants coming together to determine a market interest rate. The Federal Reserve and the federal government do not deign to interfere in setting the price of houses, the interest rate on mortgages, or the prices of wood and steel. The Fed's actions in setting the federal funds rate however, because it reflects the price of money to a borrower and thus affects demand for money, affects prices throughout the economy in a manner less pervasive but just as damaging as direct price controls.

The example of the Soviet Union should have taught us that no one person, no group of people, no matter how scientifically trained, can arbitrarily set prices and not expect economic havoc. Only the spontaneous interaction of market participants can lead to the development of a functioning price system that allows the needs and wants of all participants to be met. The sense I get from reading much of the punditry is that the federal funds rate is set often by the whims of the Federal Reserve governors. Even mechanistic explanations such as the Taylor Rule rely on inputs that are often left up to the discretion of the Fed policymakers: what is the potential GDP, do we use CPI or PCE, overall CPI versus CPI less energy and food, etc.

The setting of the interest rate strikes me as quite similar to the way FDR used to set gold prices in the 1930's, at his whim, resulting in economic havoc and uncertainty. When market actors have to devote much of their time to discerning the mindset of government price-setters, to parsing FOMC statements and minutes, they are necessarily diverted from productive economic activity. They cease to become purely economic actors and are forced to become political forecasters. This is not a problem isolated to this particular case, as businesses are forced to reckon with tax increases, expiring tax credits, import tariffs, subsidies to competitors, etc. However, because the interest rate determines the cost of borrowing and therefore determines whether or not marginal long-term business investments are undertaken, this politicized interest rate manipulation has far more impact than other government policies.

This setting of the interest rate introduces the business cycle into the economy. Until we understand the results these Federal Reserve actions have, we will be doomed to repeat these periods of boom and bust. I urge my colleagues to study this matter, and to resist the urge for greater Federal Reserve intervention in the market.