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Enough With the Interest Rate Cuts

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It's time for the Federal Reserve to stop reducing the federal funds rate, because the likely benefit is small compared to the potential damage.

Lower interest rates could raise the already high prices of energy and food, which are already triggering riots in developing countries. In order to offset the inflationary impact of higher imported commodity prices, central banks in those countries may raise interest rates. Such contractionary policies would reduce real incomes and exacerbate political instability.

The impact of low interest rates on commodity-price inflation is different from the traditional inflationary effect of easy money. The usual concern is that lowering interest rates stimulates economic activity to a point at which labor and product markets cause wages and prices to rise. That is unlikely to happen in the U.S. in the coming year. The general weakness of the economy will keep most wages and prices from rising more rapidly.

But high unemployment and low capacity utilization would not prevent lower interest rates from driving up commodity prices. Many factors have contributed to the recent rise in the prices of oil and food, especially the increased demand from China, India and other rapidly growing countries. Lower interest rates also add to the upward pressure on these commodity prices - by making it less costly for commodity investors and commodity speculators to hold larger inventories of oil and food grains.

Lower interest rates induce investors to add commodities to their portfolios. When rates are low, portfolio investors will bid up the prices of oil and other commodities to levels at which the expected future returns are in line with the lower rates.

An interest rate-induced rise in the price of oil also contributes indirectly to higher prices of food grains. It does so by making it profitable for farmers to devote more farm land to growing corn for ethanol. The resulting reduction in acreage devoted to producing food crops causes the supply of those commodities to decline and their prices to rise.

Rising food and energy prices can contribute significantly to the inflation rate and the cost of living in the U.S. The 25% weight of food and energy in the U.S. consumer price index means that a 10% rise in the prices of food and energy adds 2.5% to the overall price level. Commodity price inflation is of particular concern now that the CPI has increased 4% in the past 12 months. Surveys indicate that households are expecting a 4.8% rise in the coming year.

In lower-income, emerging-market countries, food and energy are generally a larger part of consumer spending. A rise in these commodity prices can therefore add proportionally more to the cost of living in those countries, and therefore depress real incomes to a greater extent than in the U.S.

Government actions to dilute these effects by increased subsidies on the prices of energy and food add to the government deficits, reducing the national saving available for investment in plant and equipment that would otherwise contribute to faster economic growth.

The rise in the U.S. inflation rate, and the adverse effects in emerging market countries, might be defensible if lower interest rates could significantly stimulate demand and reduce the risk of a deep recession. But under current conditions, reducing the federal funds interest rate from the current 2.25% by 50 or 75 basis points is not likely to do much to stimulate demand.

The current conditions in the housing industry and in credit markets mean that a further lowering of interest rates will have a smaller impact on demand than in previous recessions. In previous recessions, lower rates stimulated aggregate demand by inducing increased home building. But with the massive inventory of unsold homes - up 50% from a few years ago - a further cut in the fed funds rate would have little effect on housing construction.

Moreover, lowering the fed funds rate has not brought down mortgage interest rates. While the fed funds rate is down three percentage points from this time last year, mortgage interest rates are down by less than 0.5 percentage points.

The dysfunctional state of the credit market means that many individuals and businesses are unable to get credit. Lowering interest rates will not stimulate demand for those who cannot get credit.

Economic recovery will require resolving the difficult problems of the credit markets, dealing with the millions of homeowners who may now be tempted to default on mortgages that exceed the value of their homes, and reducing the risk that the ongoing decline in house prices will push millions of additional homeowners into a vulnerable, negative equity condition. A lower fed funds rate will not solve any of those problems.

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