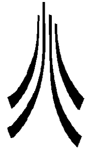

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Interest rates must be able to function freely
***Financial World,* February 2006, p. 6**

Last autumn, economic commentators called for an interest rate cut in the face of soaring oil prices. Such a recommendation is based on upon a pseudo-scientific analysis of statistical aggregates and averages.

Enoch Powell famously remarked that ‘political careers always end in failure’. Political failure often results from the state of the economy. At the very least, government is expected to ‘do something’ to head off recession. For that, it must anticipate current trends but forecasts are notoriously unreliable. Bad forecasts sent Denis Healy cap-in-hand for an IMF loan, after which he concluded ‘that most of the theories on which economics is based are bunkum.’

Sound economic management is elusive. Almost 30 years have passed since James Callaghan lectured to a Labour Party Conference: ‘We used to think that you could spend your way out of recession .., it only worked .. by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment ... that is the history of the last 20 years.’

The full paraphernalia of monetary and fiscal instrumentation are no longer routinely deployed, but interest rates remain central. The belief persists that interest rates can be tailored to benefit the economy. That belief is central to debate relating to the euro, which goes something like this. Economy A is overheating and deflation is needed. Economy B is in decline and needs a boost. Interest rates should be raised in economy A and lowered in economy B. So, with the euro, one size cannot fit all.

Although the recent call has been for an interest rate cut, before too long, the recommendation will be to tweak rates in the opposite direction. Bunkum, to be sure!

The price system is a proven means to secure economic efficiency across complex trading patterns; and oil prices are included. Interest rates are inter-temporal prices that have a rightful place within the market system of spontaneous prices adjustments. The notion that one set of (oil) prices and another set of (inter-temporal) prices are uniquely linked - such that when one set moves it becomes necessary to readjust the other - is bizarre.

When interest rates are manipulated, consumption and production patterns become misaligned. For example, an interest rate cut encourages consumers to bring their expenditures forward (so that saving falls), while it encourages producers to invest more for future consumption, even though that is not what consumers are asking for.

Market-based interest rates allow the economy to grow at a sustainable rate. Artificially low interest rates set saving (too little) out of line with investment (too much) and direct the economy onto an unsustainable growth path. Investments are deployed in the wrong places, the wrong goods are produced and sustainable growth is compromised.

Free market interest rate mechanisms are an integral part of the price system. Their free functioning is indispensable to a liberal ethos and a market economy. None of this appeals to the economic tinker-men. Certainly not to the central bankers as they contemplate their next moves on interest rates.