



## The Mythology of Fed Control of the Economy

by Richard E. Wagner

Why do so many people pay so much attention to our Federal Reserve and its Chairman? Our nation has many Fed watchers who report on or speculate about what the Fed has done or might do. These Fed watchers, moreover, play to a large audience of interested bystanders. It is reasonable to wonder what is going on here. We know that bystanders will gather to watch a shell game, and perhaps it is the same for Fed watching.

To be sure, the Fed and its officials do not claim to be playing a shell game. To the contrary, they assert that they are providing essential economic navigation in perilous seas. Navigation is the primary image by which the Fed portrays itself. Chairman Greenspan is at the helm, and it is his charge to keep the economy moving forward despite the choppy seas and erratic winds that plague us.

The trouble with this navigational image is that it is false in several respects. For one thing, the Fed has little by way of significant tools to move the economy. The only thing it controls directly is what is called the Federal Funds rate. This is the interest rate that is charged on overnight loans among banks. The Fed has no direct control over the interest rates people pay for mortgages or the choices people make about business investment and consumer spending. The Fed is more like one of the passengers in the ship than the captain of the ship.

For this, we should perhaps be grateful. Suppose it were accurate to think of the Fed as sailing the ship, with the Fed using the interest rate as its navigational tool. We would then be confronted by the stale nature of all economic data. Some preliminary figures for November might become available in mid-December, with corrected figures to come in later months. Those November figures, moreover, refer to commercial decisions that people had made in earlier months. What is relevant to economic steerage in mid-December is what it is that people are preparing to do then, not what they did months earlier.

Imagine trying to sail a ship where your information always arrives late, and where your instructions are always put into effect with a lag. The wind might change direction at 1:30, but notice of this change will not reach you until 2:15, at which time you send instructions to change your sails. Those instructions, however, do not take effect until 3:00. It would surely be safer to stay at home than to set sail under such circumstances.

Fortunately, the economy is not a ship, and the Chairman of the Federal Reserve does not occupy the helm of the economy. An economy is what is called a self-organizing system. What this

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means is that an economy will manage itself pretty well. Errors are self-correcting. Economists study how these processes of self-correction work. Many of these processes and their operations are summarized by the principles of supply and demand. If people desire more toothpaste and less garlic, producers in their search for profits will find themselves producing more toothpaste and less garlic. It does not take some Chairman of the Federal Reserve to tell people to do this. Energetic producers figure this out on their own, and far faster than the Fed Chairman ever could. The most the Federal Reserve can do is to avoid creating trouble, a task at which it often fails.

It is easy enough to understand why political leaders of all types and parties want to make it seem that they are indispensable. All the world's a stage, as Shakespeare put it in *As You Like It*. This is pretty clear. Who occupies center stage, and for how long, is up for grabs in any society. Politicians are among those who seek to occupy center stage. Not just elected politicians do this. Appointed officials do so as well. The Chairman of the Federal Reserve cultivates an image of being responsible for economic well-being. The image that is created is one of navigation. The economy is a ship adrift on a rough sea. To sail this ship safely requires a masterful captain.

Not everyone claims that Greenspan's performance has been masterful. Some critics claim that he encouraged a bubble in stock prices, allowing them to reach too high a peak. Bubbles can happen, but the Fed does more to promote them than to prevent them. We don't need a Federal Reserve to prevent bubbles, which is something it couldn't do anyway. Yet we have our Fed, and its policies will surely continue to do more to promote bubbles on occasion.

It is understandable why mythology of Fed control over the economy persists. It's good theater, and the play appeals to the egos of the participants. It is a heady experience to be thought indispensable, even if it is also a myth.

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