Kudlow's Guest Commentary

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Is Loan Demand Interest Inelastic?

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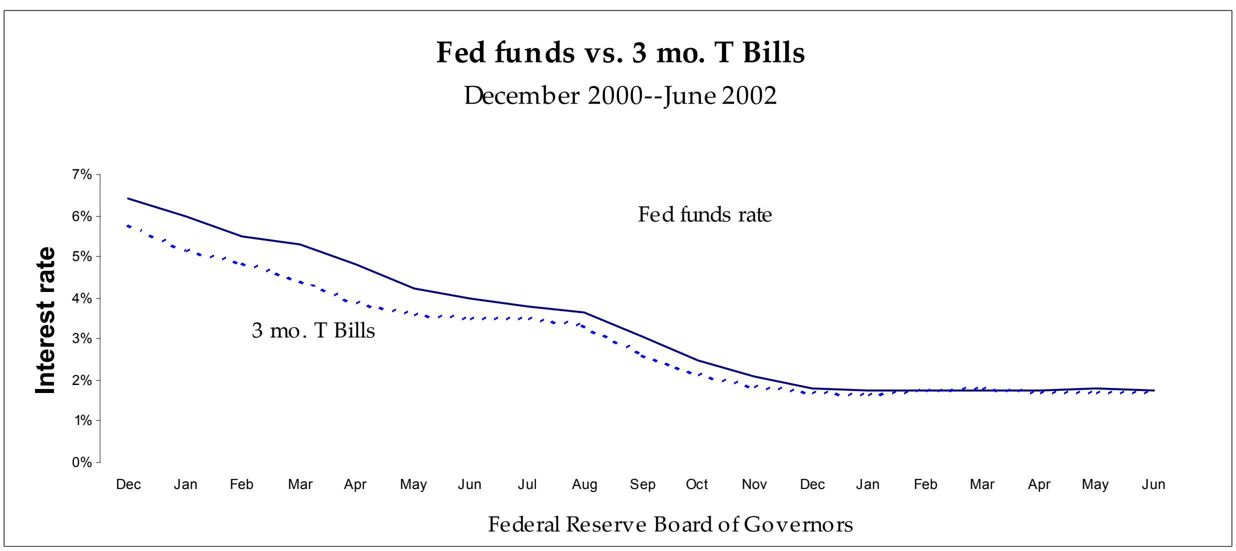
Since the beginning of 2001 the Federal Reserve has embarked upon a program of "easy money." The manifestation of this easy money policy is the Fed's decision to lower interest rates. The mechanism through which the Fed lowers interest rates is the Fed funds rate, the rate that banks lend reserves to one another to meet stipulated reserve requirements. The Fed does not set the fed funds rate; that can only be set in the marketplace where banks actively trade Fed funds. However, the Fed can influence the Fed funds rate by either buying or selling government securities thereby impacting the reserves of individual member banks. The Fed's purpose in lowering interest rates, i.e., easy money, is to stimulate economic activity by increasing loan demand. The theory is that, as interest rates fall, consumers and businesses will borrow more and spend more thus increasing economic activity.

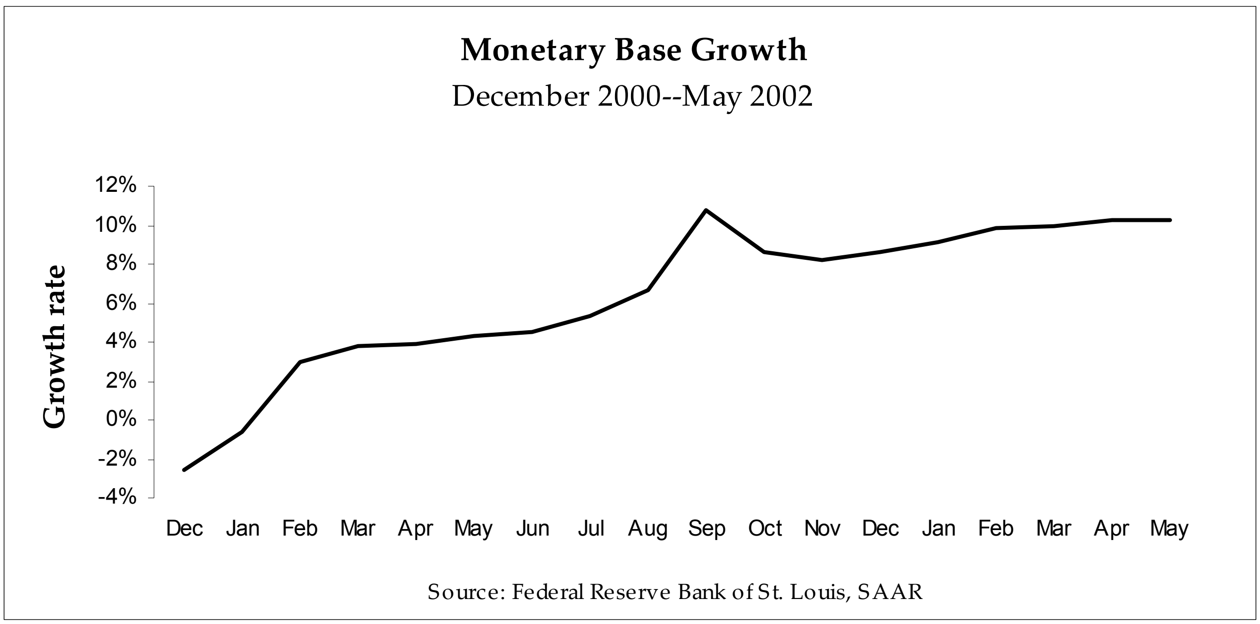
During the last eighteen months, the Fed has lowered the Fed funds target rate eleven times, from 6½% to 1¾%. Other short-term interest rates have fallen in tandem with the Fed's easy money policy (Exhibit #1). The rapid decline in interest rates encouraged market observers to breathe a sigh of relief and forecast a strong stock market within twelve to fifteen months and a renewed economic expansion.

Exhibit #1



One indicator that confirmed the Fed's commitment to easy money was the growth in the monetary base, the measure of money that the Fed controls. When the Fed buys government securities it increases member bank reserves. As these reserves increase, observers say that the Fed is increasing the money supply. Exhibit #2 reflects the increase in the monetary base over the past eighteen months.

Exhibit #2



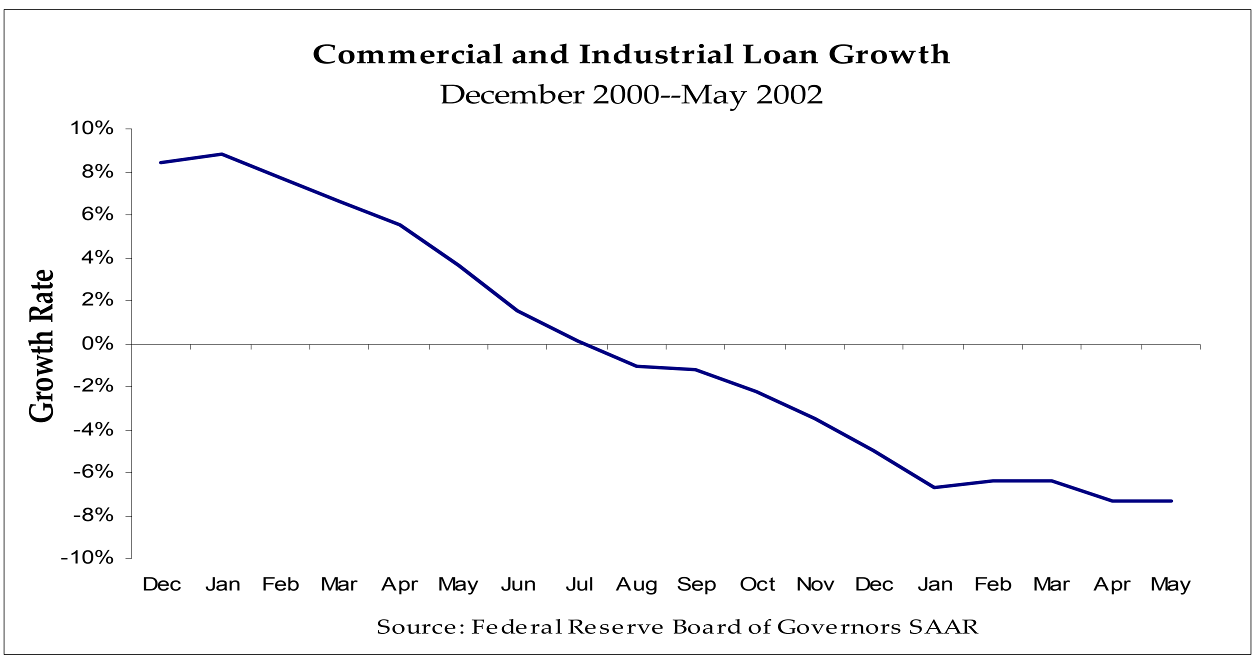
The Fed's easy money policy initiated in January of 2001 coincided with a trailing twelve-month growth rate of 8.8% in commercial and industrial loans. As the Fed continued to lower interest rates to encourage borrowing, loan growth slowed and turned negative in August of 2001 (Exhibit #3). Loan growth continued to decline throughout the balance of 2001 and was declining at a 7.3% annual rate by May of 2002. This divergence would lead one to conclude that low interest rates failed to stimulate business loans.

One explanation for declining loans was that banks tightened their lending standards. As economic activity weakened, corporate liquidity fell and credit ratings were revised downward. As the Fed lowered interest rates to encourage bank lending, the banks responded by reduced lending to borrowers who experienced a diminution in their credit quality. Lower interest rates had virtually no impact on increasing loan "supply" for industrial and commercial borrowers even though loan demand was increasing. In the face of a weakening economy, the independent variable driving loan demand was credit quality and banks' willingness to lend, not the level of interest rates.

The inference that the Fed will ease further in coming months to accelerate borrowing suggests a lack of understanding of these relationships. If banks won't lend at a prime rate of 5¾%, they won't lend at 4% or 3% either.

There has been sufficient growth in the monetary base to fund increased loan demand. If the Fed is truly committed to expanding economic activity through increased bank lending, then the Fed should act to foster policies that encourage lending to lower quality credits or companies that have obviously fallen on hard times temporarily. If the Fed refuses to encourage banks to lend to companies with declining credit ratings, then business loans will languish and economic growth will slow.

Exhibit #3



Conclusion:

Monetary policy that was designed to stimulate economic activity by lowering interest rates has failed—in the short-term. A few economists have correctly identified the problem: the deterioration in business credit quality and a conservative banking system that has been trained to avoid making risky loans and therefore limiting loan "supply." Yet, businesses usually need loans when they are having problems with cash flows. If the Fed is truly interested in stimulating business activity, its policies should no longer revolve around managing interest rates, they should encourage bank loans without the regulatory big stick that has reduced banks willingness to lend.

If banks increase loan supply, then the economic expansion will accelerate and equity markets will respond by emerging from the current bear market.

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