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Who needs money?

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Financial markets, primed to expect a rise in American interest rates, await the Federal Reserve's next announcement. In the not-too-distant future, however, its actions may cease to count

ACCORDING to many Wall Street analysts, when the Fed shortly raises interest rates by the expected quarter or half of a percentage point, nothing much will change: the economy will carry on growing, profits will carry on increasing and the stockmarket will carry on surging regardless. As one such analyst put it this week, when investors expect annual stockmarket returns well into double figures, why should a barely perceptible rise in the price of money alter their behaviour?

It is a good question. So long as the stockmarket and the economy at large are driven by boundless confidence, small changes in the price of money may have little direct effect. Of course, if the Fed set out to terrify the markets—raising interest rates, say, by two full points—it might burst the Wall Street bubble and bring the economy to a sickening halt. But even then the downturn would not be caused by dearer money itself so much as by the shock of bad unforeseen news.

On the face of it, this is odd. Apart from knowing in advance about its own decisions, the Fed knows little or nothing about the economy that is not public information. The Fed's influence on the economy ought therefore to be confined to the direct effects of interest-rate changes, effects that are already small and seem likely to get smaller. Yet the Fed's influence goes beyond this. Its indirect power to move the markets, and hence the economy, is great—despite being, as it were, a confidence-trick.

Maybe the direct effects, albeit small, are enough to give the Fed a fulcrum against which to apply its indirect leverage. This raises an intriguing question. What happens if the direct effects of changes in the Fed's interest rates are zero?

This is an imaginable state of affairs, as a recent paper* by Benjamin Friedman of Harvard University points out. Traditional models put bank deposits and/or bank lending at the centre of the financial system. The Fed exerts influence because it is the monopoly supplier of the reserves that back the supply of bank money. By reducing the supply of reserves, it can cause the supply of bank money to fall—and market interest rates to rise. So goes the theory.

But bank money already matters much less than it used to. For instance, consumers nowadays routinely pay for goods and services not with cash or cheques drawn on their bank accounts but with credit cards, including cards not issued by banks. Meanwhile, other innovations have attacked the demand for bank credit. Non-bank intermediaries—pension funds, insurers and mutual funds—have greatly increased their share of the American credit market. These institutions do not hold balances with the Fed; for them, its monopoly over reserves is already irrelevant.

Furthermore, the advantage that banks traditionally enjoyed over non-banks in judging borrowers' creditworthiness has been eroded by information technology: products such as home mortgages have become automated and commoditised. Even when banks initiate loans, the resulting assets can be turned into a security and sold. More than half of all American home mortgages are now held by securities-market investors; smaller but fast-growing proportions of consumer credit, trade credit and ordinary commercial loans are also being securitised. Again, these loans create no demand for reserves at the central bank.

In judging the significance of all this, it is best not to get carried away. For instance, the development of non-bank money in the form of non-bank credit cards does not entirely displace the Fed. Not yet, anyway. Final settlement of credit-card balances is still carried out through banks: the demand for bank money (and hence reserves) has been reduced rather than eliminated. However, Mr Friedman argues that the trend can go further. The crucial question is whether sellers will one day be willing to accept balances with non-banks, rather than only with banks, in final settlement. This is at least conceivable, as advances in information processing and encryption further erode the banks' special position.

If it happens, incidentally, this is what "e-money" will mean. There will be no need for new units of account with silly names: for reasons of convenience, e-money will be denominated in dollars (or yen or euros). What matters about e-money is that in principle it need not be bank money in any sense. To use an old-fashioned term, it could take the form of purely private monies, entirely unsupported by reserves at the Fed. If the process went all the way, and the lines between banks, non-bank financial institutions and other sorts of enterprise blurred into invisibility, the Fed would indeed be left with no direct way to move the economy. And perhaps its indirect influence would then disappear as well: the chairman's view on the cost of credit would have as much sway as his view on the Dow Jones Industrial Average.

Would this matter? Maybe less than you might suppose. The Fed would lose its power to use interest rates to soften the business cycle. But during the current expansion it has chosen by and large not to use this power: emphasising uncertainties about the "new economy", the Fed has tended to follow market rates rather than lead them. (Mr Greenspan has no truck with the old maxim that a central banker's job is to take away the punch-bowl just as the party gets going.)

The Fed's ability to act as a lender of last resort would be missed, but the government could take on that job. And if banks fade away, that might be to the good. Banks are inherently fragile and systemically hazardous. Finance based less on deposits and more on securities might be less accident-prone. What about the risk of ever-expanding credit and persistently high inflation? Don't worry too much. These were unknown before the 20th century—that is, before powerful central banks were invented.

*"The Future of Monetary Policy". International Finance, November 1999.