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The Pitfalls of the Federal Reserve's Zero Interest Rate Policy

Problems such as the Fed's need to reduce its balance sheet and someday normalize interest rates are reasons to revisit unconventional monetary policy

James A. Dorn

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The Federal Reserve has kept its target range for the federal funds rate at 0 to 0.25 percent since December 2008. This is often referred to as the Fed's "zero interest rate policy," or ZIRP. The purpose of near-zero overnight rates – and forward guidance to convince markets that those rates will be maintained – has been to affect the entire rate structure: keeping all rates lower than they would have been in a free capital market.

The idea was to lower rates in order to encourage moving into riskier assets with higher yields, including stocks, junk bonds, real estate and commodities. Lower rates, the Fed argued, would encourage greater leverage, i.e., borrowing to invest, and boost asset prices. This "wealth effect" would then stimulate consumption and economic growth.

Those were the expected benefits of the Fed's unconventional monetary policy, which included both ZIRP and three rounds of quantitative easing (QE), that is, the large-scale purchases of longer-term securities such as government bonds, mortgage-backed securities and agency debt.

The substantial rebounding of the U.S. stock markets since the 2008 financial crisis, along with the return to near full employment while maintaining low inflation, appear to point to the Fed's success with unconventional monetary policy. Ben Bernanke's just published memoir, The Courage to Act, supports the bullish view that the Fed's actions saved the U.S. economy from disaster. Yet, the former Fed chairman recognizes that "monetary policy is no panacea."

The problem is that Fed officials have mostly pointed to the benefits of unconventional policy while downplaying the costs. Some of those costs, oddly, are also the claimed benefits – namely, increased risk taking and surging asset prices. The role of a central bank should not be to promote risk taking or to inflate asset prices.

By holding rates near zero for almost seven years, the Fed has underpriced risky assets, increased leverage and created a pseudo wealth effect, which will be reversed once rates return to normal. Asset prices cannot continuously outpace real economic growth. When the bubbles in the stock and bond markets burst, as interest rates begin to rise toward their natural, long-term equilibrium, the Fed's unconventional wisdom will be called into question.

Central banks throughout history have been used to finance government debt, and the Fed is no exception. The ultra-low interest rates on Treasury debt, with the three-month T-Bill rate now at zero, have allowed the federal government to act as if deficit financing is a free lunch. Those who hold that debt, however, face the risk of rising rates and falling prices, especially on longer-term debt. Consequently, foreign central banks are beginning to unload their holdings of U.S. debt at a record pace, with net sales reaching US$ 123 billion for the 12-month period ending in July.

The Fed's ZIRP has also harmed savers who basically get nothing on their money-market funds and saving-account balances. Indeed, after inflation and taxes, real rates on those instruments are negative. Monetary policy has therefore not only misallocated credit, it has redistributed wealth from Main Street to Wall Street. The lost interest income is a permanent loss of wealth.

It is ironic that Fed Chairwoman Janet Yellen has criticized the increase in inequality of income and wealth since the financial crisis, but ignores the role of the Fed in promoting such inequality.

In a world of scarce resources, including time, individuals prefer current to future consumption, and thus demand a premium to postpone consumption. In addition, scarce capital normally has a positive productivity. Together positive time preferences and capital productivity mean that real interest rates should be positive, roughly equal to the long-run growth of the economy. If the central bank conducts monetary policy to ensure long-run price stability and monetary equilibrium, then nominal interest rates should reflect real rates.

When nominal rates are zero and real rates are negative something is amiss. Monetary policy is the chief culprit. ZIRP and QE have distorted interest rates, inflated asset prices and misallocated resources. Moreover, the Fed's policy of paying interest on bank reserves, introduced in late 2008, and the step-up of macro-prudential regulation have prevented much of the massive amount of new reserves created by the Fed from entering the nominal income stream. Banks have been reluctant to lend out their excess reserves held at the Fed. Consequently, money growth and nominal income growth have not moved in lock-step with the monetary base.

The highest cost of the Fed's unconventional monetary policy is the uncertainty it has generated. The path of monetary policy is based on pure discretion and is data dependent; there is no monetary rule to guide policy. Forward guidance has not worked to calm markets, and Fed watching has become obsessive.

Surely, we can do better. The Fed still faces the challenge of reducing its balance sheet and normalizing interest rates, but no one is sure how to do this. Exit-phobia persists. Financial markets have enjoyed the Fed "put" and fear losing it. Emerging markets fear capital outflows as U.S. rates rise. Yet, the longer the Fed waits to act, the higher the costs of final adjustment will be.

It's time to rethink unconventional monetary policy and move from a pure discretionary government fiat money regime to a more market-directed monetary system that is guided by rules and resiliency rather than by unaccountable central bankers.

James A. Dorn is vice president for monetary studies and a senior fellow at the Cato Institute in Washington, D.C.