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Bad Policies Push U.S. In Wrong Direction

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The financial crisis revealed deep flaws in U.S. policy and the dismal record of macroeconomic forecasting.

No one at the Federal Reserve, Treasury or Council of Economic Advisors foresaw the crisis. When the crisis hit, the predictions were that unless the government dramatically increased its role in the economy, the U.S. would fall off a cliff. In reality, after billions in stimulus spending, unemployment is still unusually high, growth is sluggish, and uncertainty prevails.

There is no monetary rule, no fiscal discipline, no clarity of how to deal with more than $100 trillion of unfunded liabilities in Social Security and Medicare, and no widespread understanding that governments fail when they attempt too much.

The federal government has bailed out financial institutions and taken over Fannie Mae and Freddie Mac, the two large mortgage financers, but no effort has been made to let relative prices adjust, or to make those responsible for bad choices bear the costs.

Stimulus funds have been used to bail out states and public employees who make more than private sector workers, but the multiplier effect of such redistributive acts has been close to zero.

Yet, the U.S. government keeps spending and going deeper into debt. Public overconsumption continues, while high marginal tax rates on capital, uncertainty about health care costs, new financial regulations, and the anticipated end of the Bush tax cuts combine to discourage new investment and job creation.

In this environment, the Federal Reserve is prepared to embark on another round of quantitative easing and has postponed letting its balance sheet naturally shrink as its large holdings of mortgage-backed securities and agency debt matures.

Instead, the Fed will reinvest those funds in Treasury bonds with maturities of 2 to 10 years, continuing to peg interest rates at artificially low levels. In effect, the Fed has substituted credit policy for monetary policy.

One of the causes of the crisis was distorted credit markets: with too much credit going to housing and too little into alternative investments. The Fed now holds more than a trillion dollars of MBSs and has expanded its balance sheet from about $800 billion before the financial crisis to more than $2 trillion today.

That jump was made possible by a massive surge in the monetary base, mainly in the form of bank reserves held at the Fed.

By paying interest on reserves and keeping short-term rates near zero, the Fed let banks make large profits through the carry trade — that is, by borrowing at low rates and investing in longer-term government debt that yields about 4%, with little risk.

If the Fed continues to support government bond prices, there will be little incentive to curtail government borrowing and spending. As the U.S. debt grows relative to GDP, the temptation to inflate away the real burden of the debt will become stronger, and markets will price that risk into long-term bonds. Interest rates will rise and crowd out private investment. Bond prices will tank, and China and other large holders of U.S. debt will take capital losses, complicating foreign policy.

We need not wait a decade or more for all this to happen. The expectation of a weaker U.S. economy, a falling dollar, massive debt ratios, and inflation will affect investment decisions today. Policy uncertainty is already creating a steeper yield curve, with 30-year bond yields 3 percentage points or more above shorter-term securities.

Economic growth depends on institutions that reward saving and investment, that expand individuals' choices, and that protect private property rights, allow free trade, and safeguard the value of money.

Policies that lead to higher taxes, more debt, socialized health care, costly regulations, protectionism, and unstable money undermine U.S. economic strength and frustrate the natural equilibrating function that characterizes a dynamic market system based on freely determined prices, the rule of law, and sound money.

The way out of this quagmire is to adopt credible, more transparent policies. The Fed should end credit allocation and focus on maintaining long-run price stability while fiscal policy should aim at limiting the size and scope of government.

Moving to a flat tax and substantially lowering taxes on capital would stimulate growth. The Fed and Congress appear to be going in the wrong direction.

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