Rates on Hold as Fed Bows to Wall Street and Washington

Capital is being destroyed because when the Federal Reserve has been asked to support asset prices and keep rates low, it has complied

By James A. Dorn

March 30, 2015

The biggest story coming out of the latest meeting of the Federal Open Market Committee is that Federal Reserve Chairwoman Janet Yellen does not want to take away the punch bowl, yet. The Fed continues to play to the tune of Wall Street and Washington by stoking asset bubbles, allocating credit, using monetary means to achieve fiscal ends, financing federal debt on the cheap, undermining the incentive to save and ultimately destroying capital.

Yellen is opposed to a congressionally mandated audit of the Fed and to any type of monetary rule. She favors pure discretion and worries that making monetary policy subject to greater congressional oversight would weaken the Fed's independence and politicize monetary policy.

The truth is the Fed has gained substantial power since the 2008 financial crisis and used that power to politicize the allocation of credit. It has suppressed interest rates for more than six years and used quantitative easing to expand its balance sheet to more than US$ 4.5 trillion. Wall Street expects the Fed to support asset prices, and the Fed has complied; Washington expects low rates to persist, and the Fed has complied.

In its March 18 statement, the Federal Open Market Committee noted that "even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."

Moreover, in her press conference, Yellen calmed investors by noting that "Just because we removed the word patient from the statement doesn't mean we are going to be impatient." The

U.S. stock markets cheered, as did government officials who recognize that any rise in interest rates could be catastrophic for public finances, from the federal to the municipal level.

Meanwhile, savers continue to suffer from negative real interest rates. The longer-term consequence is to reduce saving and investment, and thus slow economic growth. Negative rates also have a devastating impact on pension funds. Meanwhile, the federal government continues to secure cheap credit at the expense of more productive private investment.

The politicization of monetary policy has eroded the Fed's independence. More important, Yellen's opposition to a rules-based monetary regime, or even to an audit, ignores the fact that Congress has the constitutional authority to engage in fundamental monetary reform.

The Federal Reserve Accountability and Transparency Act of 2014, introduced during the 113th Congress to rein in the Fed, and to consider alternative rules to guide monetary policy such as the Taylor rule, is expected to be reintroduced in the 114th Congress.

Under the Taylor rule, the Fed would keep its longer-run target rate at about 4 percent, which is considered "normal." In contrast, under current policy the Fed's target of 0 to 0.25 percent is likely to persist until September or even early 2016. The pace of any rate increases thereafter will also be slow; the benchmark rate is now expected to be only 2 percent by the end of 2016.

U.S. economic growth is still sluggish, registering only 2.3 percent last year and expected to reach a mere 2.5 percent this year. That's after three rounds of quantitative easing and more than six years of ultra-low interest rates. On this basis, the Fed's unconventional monetary policy has failed.

Indeed, unsound monetary policy has crowded out market-liberal reforms that could have treated the causes of slow growth rather than the symptoms. Low U.S. productivity growth cannot be cured with financial morphine. Supply-side remedies like lower marginal tax rates on labor and capital, removing onerous regulations, and institutional reforms that limit the size and scope of government would do more to revitalize private markets than the Fed's failed monetary experiments.

A rules-based monetary policy, whether aimed at stabilizing nominal income growth or the price level or some other policy target, would lend certainty to economic life. It would reduce the power of the central bank, add transparency to policy, and make those subject to the rule accountable. It would mean that Yellen could not tell the Senate Banking Committee, as she did on February 24: "I don't want to set down any single criterion that's necessary for (rate increases) to occur."

While the Fed has held rates near zero and pumped up its balance sheet and the monetary base, it has also initiated paying interest on reserves and engaged in macro-prudential regulation. Those actions have sterilized the new base money and limited the effect of low rates on nominal income growth. They also have increased the reach for yield and increased the inequality of income distribution. The Fed's monetary policy has turned into misdirected credit policy and allowed Washington to spend far beyond its means.

The lack of any monetary rule to anchor expectations about the future path of monetary policy and the purchasing power of the dollar unnnecessarily increase uncertainty and volatility in financial markets. "Forword guidance" without a rule is a misnomer. No one knows for sure when the Fed will increase rates, and the opportunity costs of Fed watching continue to mount.

Although the Fed touts the "wealth effect" of its unconventional policies, the reality is that any wealth effect of monetary manipulation is transitory, not permanent. In the long term, capital is destroyed, not created, by negative real interest rates. When rates rise, as they must, the pseudo wealth effect of Fed policy will become apparent as asset bubbles are deflated.

Real wealth is created by capital accumulation from saving and by choices informed by competitive market prices, not by suppressing interest rates. The sooner central banks learn that lesson, the better off we will be.

James A. Dorn is vice president for monetary studies and a senior fellow at the Cato Institute's newly established Center for Monetary and Financial Alternatives