Markets Will Rule in the Long Run

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The Federal Reserve's unconventional monetary policy has pumped up asset prices by suppressing interest rates and has misallocated capital. It's time to end the mispricing of assets and let markets determine rates without interference from the Fed. Waiting to normalize monetary policy will further inflate asset bubbles and make the ultimate normalization of rates more costly.

The Fed has not increased its benchmark short-term interest rate since 2006 and has held the Fed funds target rate near zero since 2008. More important, there has been little interest in reducing the size of the Fed's massive balance sheet by selling off longer-term Treasuries and mortgage-backed securities, because doing so would sharply depress bloated asset prices as interest rates returned to more normal levels.

Quantitative easing (i.e., the large-scale purchases of longer-term government debt and mortgage-backed securities) was designed to lower interest rates and incentivize investors to reach for yield by taking on more risky assets (e.g., stocks, junk bonds and real estate). Meanwhile, near-zero rates on money market funds and savings have severely penalized more conservative investors.

Fed policy has led to large increases in the monetary base (currency held by the public plus bank reserves), but those increases in "high-powered money" have not translated into strong increases in bank lending, deposit creation and nominal income. The so-called money multiplier has been extraordinarily weak.

The two major reasons for weakness in transmitting what appears to be the Fed's easy money policy into robust growth of money, credit and nominal gross domestic product are the Fed's

decision to begin paying interest on reserves in October 2008, and macro-prudential regulations that have led banks to hold much larger excess reserves as a capital cushion.

Fed policy has primarily affected the pricing and allocation of credit, not the growth of monetary aggregates and nominal GDP. By keeping interest rates artificially low to prop up asset prices, and by purchasing government debt and mortgage-backed securities, the Fed has misallocated capital, reduced private saving and investment, and slowed economic growth.

Slow economic growth reflects slow productivity growth due to structural/institutional problems, not slow money growth. The current low inflation diverts attention from the damaging effects of the Fed's unconventional monetary policy. Moreover, policymakers continue to confuse low interest rates with easy money and to think that lower rates produce a permanent wealth effect. The truth is the Fed's "wealth effect" is a pseudo wealth effect: Once interest rates return to normal, asset prices will fall and wealth disappear.

Although the Fed can influence interest rates in the short run, markets will rule in the long run. Real interest rates, which reflect the productivity of capital and people's preferences for future versus current consumption, are naturally positive – not zero or negative. For that reason, the Fed's unconventional monetary policy is highly distortive and cannot persist.

Chair Janet Yellen and her open-market committee should not ignore this basic economic reality. The problem now is that increasing the benchmark rate by even a small amount could lead to a sharp fall in asset prices. That is why financial markets are holding the Fed hostage; but that must end.

It's time to normalize Fed policy and, in so doing, to recognize the limits of monetary policy and why the market rather than the Fed should be setting interest rates. The Fed needs to start exiting its unconventional monetary policy now and recognize that the siren song of its low-rate policy is bound to lead to a shipwreck.

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