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The Fed's Stimulus Is a Chimera

The U.S. central bank should start to normalize rates, but that would cut off the government from its source of cheap financing

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June 27, 2014

The U.S. Federal Reserve Bank's three rounds of quantitative easing and near-zero target for the federal funds rate have not provided the promised stimulus. The idea that dramatically expanding the Fed's balance sheet and rapidly increasing the monetary base would revitalize the real economy is a fantasy. Printing fiat money does not lead to economic growth.

By keeping short-run interest rates near zero and using large-scale asset purchases to suppress longer rates, the Fed has increased risk taking, depressed saving and investment, allowed monetary policy to grease the wheels of big government, and misallocated capital.

Low rates have reduced the velocity of money, and the Fed's policy of paying interest on excess reserves, along with stiffer banking regulations, have substantially lowered the impact of base money on the overall money supply. Consequently, even with the so-called stimulus, nominal income has been growing below trend.

The Fed has been consistently wrong in its economic forecasts, typically being overly optimistic about what its monetary fine-tuning can achieve. The U.S. economy is simply too complex to accurately forecast. Basing the path of monetary policy on pure discretion runs the risk of destabilizing markets, in contrast to a rule-based regime that reduces uncertainty.

With the mushrooming of the monetary base but little inflation, some pundits are arguing that the pressing issue is to avoid deflation and achieve higher inflation. The Fed's target is 2 percent inflation, but economists like Kenneth Rogoff at Harvard have advocated pushing inflation to 4 percent, with the hope that higher inflation will lower the rate of unemployment and increase spending and growth. Have they forgotten the stagflation of the late 1970s?

The vast majority of policymakers advocate keeping interest rates near zero for "a considerable time." Many admit there is a risk of creating asset bubbles, but they downplay that risk and largely ignore the negative impact on savings. One exception is Kansas City Federal Reserve President Esther George who recently stated: "My concern is that keeping rates very low into late 2016 will continue to incentivize financial markets and investors to reach for yield."

David Wessel, director of the newly established Hutchins Center at the Brookings Institution, which focuses on monetary policy, argues that "too much inflation is definitely bad for an economy, but so is too little inflation." He contends that "it's very hard for an economy to prosper" when there is deflation, which he defines as "a generalized decline in wages and prices." He assumes that debtors are harmed when deflation sets in. Let's look at the evidence.

From 1880 to 1900, when the United States was on the gold standard, the price level declined by 10 percent but the economy prospered – real per capita income increased by nearly 50 percent. That outcome occurred because the free market was not burdened by big government and output grew faster than the money supply. There was no central bank, no macroeconomic models, no fine-tuning; but there was monetary stability anchored by the convertibility principle and fiscal rectitude. Deflation was the result of strong growth and a market-based monetary rule.

When Wessel and like-minded proponents of aggregate demand management think about deflation, they are thinking about the U.S. experience during the Great Depression, not the gold standard. Deflation in the 1930s was caused by a failure of monetary policy, not strong growth. While deflation during the gold standard was mild and long-run price stability was the norm, deflation in the 1930s resulted from a sharp decrease in the money supply relative to the demand for money. From 1929 to 1933, the money supply declined by about one-third, consumer prices fell by 24 percent and real GDP decreased by 30 percent.

Nominal interest rates tend to adjust once inflation/deflation is anticipated, rising with expected inflation and declining with expected deflation. Thus, mild and expected deflation – due to strong real growth – does not necessarily harm debtors.

Robust growth is caused by institutions that provide incentives for entrepreneurial activity and rational risk taking, not by monetary ease. The uncertainty caused by the lack of any monetary rule, over-intrusive government, high taxes on capital and numerous other impediments to economic freedom are the main reasons for sluggish U.S. economic growth. It is unrealistic to assume that Fed stimulus can cure those problems.

More likely, the Fed's over-regulation of the banking and financial sector under Dodd-Frank – and its failure to articulate a viable exit strategy – will compound instability. Macro-prudential regulation will not mitigate the problem of "too big to fail." The Fed has extended its reach beyond commercial banks to the entire financial system. Ultimately taxpayers will be put at risk, once again. Moreover, when rates rise, as they must, asset prices will tumble, and the malinvestments generated by distorted interest rates will be revealed.

Regardless of what Wessel and other "doves" say, it is not hard for central banks to generate inflation. If Zimbabwe could do it, so can the Fed. Of course, no one in Washington is calling for hyperinflation, only for "a little more inflation." But unlike deflation, which can be benign, inflation is always harmful: it is a tax on money balances and thus violates one's property right in the value of money. Even low inflation, say 2 percent per year, means the purchasing power of the dollar declines and the cost of living increases. Inflation also disturbs relative prices because new money is never evenly distributed: it hits some prices before others.

The Fed's determination to keep nominal interest rates at historically low levels to stimulate economic activity disregards reality. The Fed should recognize its limits and begin to normalize rates and exit its unconventional monetary policy. Yet, that will be politically difficult as the government does not want to lose its source of cheap financing. That is the real reason Janet Yellen does not want to take away the punch bowl just yet.

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