The Real Problem Isn't Janet Yellen, It's The Conceit That Is The Fed Itself

James Dorn

10/17/2013

When President Barack Obama nominated Federal Reserve vice chairman Janet Yellen to take over as Fed chairman after Ben Bernanke departs in January, the markets purred a sigh of relief. The Fed's adherence to ultra-low interest rates and quantitative easing to boost risk taking and asset prices is now expected to continue for at least another year and most likely until the end of 2015. That path could prove costly.

The Fed's balance sheet already has soared from $800 billion in 2008 to $3.7 billion today. Continuing to accumulate $45 billion of longer-term Treasuries and $40 billion of mortgage-backed securities per month will further inflate the monetary base and risk igniting inflation.

President Obama, in his nominating speech, noted that "a lot of people aren't necessarily sure what the Federal Reserve does." He then went on to say that because of Bernanke's unconventional monetary policies "more families are able to afford their own homes, [and] more small businesses are able to get loans to expand and hire workers." Apparently the president accepts the idea that printing money, and artificially lowering interest rates, is good for America.

The truth is that many families are still constrained by the loss of equity suffered during the 2008 financial crisis and cannot make the high down payments now required for most home mortgages. Moreover, banks are reluctant to lend to small, higher-risk businesses, and job growth has been painfully slow.

The Fed's dual mandate, imposed in 1977, requires maximum employment and price stability, but the reality is that there are limits to monetary policy. Printing money cannot increase the wealth of a nation. Moreover, there can be no *permanent* tradeoff between inflation and unemployment. Market participants learn to adjust to monetary policy. Once workers anticipate inflation, they will demand higher wages and unemployment will revert to its "natural" level consistent with market demand and supply.

Increasing real economic growth requires improved technology, capital investment, a better educated workforce, and institutions that are conducive to entrepreneurship and prudent risk

taking. Those institutions include a just rule of law that protects persons and property, free trade, sound money, limited government, low marginal tax rates, and market-friendly regulation.

Although printing more money cannot increase society's productive capacity or generate a higher standard of living, it can increase inflation and unemployment, as seen in the stagflation of the 1970s.

The Fed appears glued to the idea that monetary policy is necessary to stimulate growth and reduce unemployment, and can do so by holding interest rates below what free markets would yield, thereby increasing investment, asset prices, and consumption. With nominal interest rates near zero, a little more inflation (above the Fed's 2 percent target) is being seen by some Fed economists as a way to lower real rates and stimulate risk taking and investment.

Janet Yellen accepts that view and has argued the Fed should focus on its employment mandate and not worry too much about inflation at this point in the business cycle. She believes that the Fed "can help ensure that everyone has the opportunity to work hard and build a better life."

There is scant evidence to support this vision—even if President Obama, Ben Bernanke, and Janet Yellen embrace it. After several rounds of QE, unemployment is still abnormally high (7.3 percent), labor participation rates are historically low, and growth sluggish. That is because there are limits to monetary policy: it cannot outfox markets, which ultimately determine real variables like employment and living standards. The Fed can affect relative prices in the short run—e.g., by distorting real interest rates—but in the long run its impact is on the money supply, nominal GDP, and the price level.

By providing cheap credit to the federal government and supporting the housing sector, the Fed is engaging in fiscal policy and credit allocation. Government thus has an incentive to grow beyond its means, investors to overleverage, and households to overconsume. Those are the same incentives that existed prior to the financial crisis. Fed policy is laying the basis for another crisis.

Nobel laureate economist Edmund Phelps and Amar Bhidé of Tuffs University warn that "the Fed's monetary policy has been increasingly hazardous." It may become more so under Yellen who appears committed to keeping rates low—even after unemployment reaches the target rate of 6.5 percent and inflation exceeds 2 percent.

The recent experience with tapering, in which the mere announcement of a slowdown in QE shocked markets, is an indicator of the coming turmoil when the Fed is forced to act. The longer the Fed delays normalizing rates, the higher the future costs of adjustment. The appointment of Janet Yellen as head of the Fed is a signal that debt monetization and credit misallocation will continue, and the risk of asset bubbles will increase as investors search for yield.

The near zero interest rates on saving accounts since 2008 has harmed conservative investors and significantly lowered their lifetime income. Thus, Fed policy has not led to a net increase in national wealth, merely an arbitrary redistribution to favored groups. If the Fed is too slow to increase rates and shrink its balance sheet, inflation will further redistribute income as creditors

are repaid in depreciated dollars. And if the Fed raises rates too fast, the risk of a recession increases.

Consequently, Yellen will be faced with difficult options, none of which is cost free. And there will be strong political pressure to fund an already bloated government, provide relief for homeowners, and create jobs—especially when many voters tend to believe those goals can be accomplished by an all-powerful central bank.

The real problem is not the choice of a new Fed chairman; it is to recognize the limits of monetary policy and the danger of concentrating power in a few individuals who have complete discretion to dictate monetary policy in a world of pure fiat money. Today the Fed is not bound by any monetary rule and the supply of money is not determined by market demand, as it is under a commodity standard.

It is true that an inconvertible currency, whose quantity is strictly limited by Congress in line with economic growth, would have a predictable and stable value. However, as James Madison, the chief architect of the Constitution, stated: "What is to ensure the inflexible adherence of the Legislative Ensurers to their own principles and purposes?" He therefore concluded, "The only adequate guarantee for the uniform and stable value of a paper currency is its convertibility into specie—the least fluctuating and the only universal currency."

Without a rule to bind the Fed and without a convertible currency, the risk of monetary mischief is high and will be even higher if Yellen is appointed chairman. Her belief that a little more monetary stimulus and inflation are the means to full employment and prosperity diverts attention from the real drag on development—namely, monetary, fiscal and regulatory institutions that have failed to limit the size and scope of government and are suffocating the private sector.

A first step toward sound money, and fiscal rectitude, would be to have a national debate on alternatives to discretionary government fiat money, with the goal of creating a monetary regime that would prevent debt monetization, safeguard an individual's property in a stable-valued money, and protect free capital markets. That is why Congress should support HR 1176 introduced by Rep. Kevin Brady (R-TX), chairman of the Joint Economic Committee, to establish a Centennial Monetary Commission, which would lay the framework for institutional change in the pursuit of sound money.