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The Hidden Costs Of Monetary Mischief

By James A. Dorn
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The Federal Reserve, the world's most powerful central bank, has used unconventional monetary policy since 2008 to suppress interest rates, encourage risk taking, support asset prices, fund government debt, and allocate credit.

In doing so, the Fed has created one asset bubble after another, harmed savers, incentivized big government, and misallocated credit.

The costs of financial repression (keeping real interest rates negative and politicizing the allocation of credit) are often hidden in the short run. But they will come back with a vengeance in the longer run when interest rates rise and the full effects of monetary mischief appear.

The time is now ripe for the normalization of interest rates. Yet even with the unemployment rate at 5.6%, the Federal Open Market Committee remains "patient."

The federal funds target rate is unlikely to be increased until midyear, and perhaps not until 2016. The last increase occurred in 2006.

The specters of deflation, slower global growth, and stagnant U.S. wage growth are providing ammunition for the Fed to continue to delay raising rates. Painting mild deflation — and the failure to achieve 2% inflation — as a threat, however, diverts attention from the danger of continuing the Fed's zero interest rate policy.

The longer the FOMC waits to begin exiting its low-rate policy, the greater the risk to financial stability and long-run growth.

The Fed's dual mandate requires it to focus on full employment and price stability, without recognizing that monetary stimulus cannot permanently increase real output.

The stagflation of the late 1970s and early 1980s should have taught us that there is no trade-off between inflation and unemployment: a little more inflation does not guarantee lower unemployment.

Yet the Fed persists in thinking in terms of the Phillips Curve and assumes that moving closer to full employment will mean more inflation.

But the Fed is not concerned with inflation at the moment. Indeed, there has been discussion about increasing the target rate of inflation from 2% to as high as 4%—5% in order to further stimulate employment and output, and reduce real interest rates.

Proponents of that approach, however, underestimate the risks. Once the inflation genie is out of the bottle, it is difficult to put back in.

The Fed has expanded its balance sheet from less than $800 billion before the Great Recession to $4.5 trillion — and exploded the monetary base (currency held by the public plus reserves at the Fed) — in the hope of returning the U.S. to full employment. Normally the rapid increase in high-powered or base money would lead to increases in the monetary aggregates and nominal income.

However, that process has been short-circuited by the Fed's policy of paying interest on excess reserves since October 2008 and by the use of macro-prudential regulation.

With ultralow interest rates and the need to rebuild balance sheets, banks have been reluctant to extend credit.

It is easier to park reserves at the Fed and earn a safe return, enter the carry trade, or buy government debt then to engage in private lending. Until recently, commercial and industrial loan growth has been weak.

The revival of economic growth has increased the demand for credit. When banks start lending out more of their excess reserves, the Fed will need to take steps to prevent inflationary growth in the broader monetary aggregates.

Traditionally this would have meant selling short-term Treasuries in the open market and draining reserves; the fed funds rate would then rise along with other rates.

But with no short-run securities in its massive portfolio, the Fed is exploring other means to stem excess money growth and avoid selling longer-term assets, which would result in capital losses as rates increased.

The Fed is at a crucial juncture in its 100-year history. When it first opened its doors in 1914, the world was still on the international gold standard and the dollar was fully convertible.

Today we live in a pure fiat money world, the Fed has gained enormous power, and there is no monetary rule of any sort.

Interest rates are too important to be left to the Fed; they should be set by free markets under the rule of law.

The Fed's dual mandate should be ended, and a simple monetary rule should take the place of pure discretion. The choice of the rule should be up to Congress, which has ultimate responsibility for sound money.

The 114th Congress cannot wait for the Fed to reform itself. Leaders such as Rep. Jeb Hensarling, R-Texas, chairman of the House Financial Services Committee, need to retake responsibility "to coin Money" and "regulate the Value thereof."

Establishing a Centennial Monetary Commission to carefully examine the Federal Reserve's performance and explore alternatives to government fiat money, as proposed by Rep. Kevin Brady, R-Texas, would be a step in the right direction.

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