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More Economic Freedom Is Key To U.S. Economic Success

By JAMES A. DORN

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The key question facing policymakers in 2014 will be how to energize the economy and lower the rate of unemployment while avoiding another financial crisis caused by asset price inflation and a misallocation of credit.

The Fed seems concerned with deflation, but the real risk is that the Fed's bloated balance sheet, and the extraordinary run-up in the monetary base during the last five years, will begin to show up in inflationary increases in the monetary aggregates.

In an election year, policymakers will be timid in raising interest rates, so the asset bubbles that are becoming more and more obvious could grow larger.

But no one expects another 26% gain in stock prices. When, not if, longer-term rates rise, the bubbles will deflate.

If the Fed tries to inject funds to forestall the downturn, general inflation could occur, along with a rise in unemployment. Stagflation is more probable than deflation.

From a more fundamental viewpoint, the outlook for the U.S. economy depends on whether policy decisions are supportive of economic freedom. Policies that are consistent with the primacy of the market and limited government will allow individuals to pursue their happiness — and the wealth of the nation will grow along with opportunities for exchange.

The economy is a complex system that cannot be fine-tuned by government. However, sound economic policies can provide a stable institutional framework for markets to create wealth.

Long-term rules that provide for the maximum economic freedom under a rule of law protecting people's rights to own property, trade, and reap the rewards (or bear the costs) of those trades will bring about economic and social harmony.

When government interferes with those rights, undermines the rule of law, and fails to ensure sound money and fiscal rectitude, special interests will trump limited government.

The result will be bigger government, a loss of economic freedom, and disharmony as groups vie for a larger slice of a slowing economy.

The sharp increase in the size and scope of government since the financial crisis has significantly reduced economic freedom.

For two decades (1980—2000), the U.S. was consistently in the top tier of economically free countries, ranking second in 2000 (using the Economic Freedom of the World chain-linked index, published by the Fraser Institute along with the Cato Institute and a number of other think tanks).

By 2011, the U.S. had dropped to 19th place in the world rankings. Hong Kong remains No. 1.

In order for the U.S. to regain its top-tier ranking, there must be a depoliticization of economic life and a move toward policies that enhance market liberalism.

The uncertainty surrounding U.S. fiscal, monetary and regulatory policies, especially since the Great Recession, has made private economic decision-making more difficult and harmed economic growth.

Monetary policy has become a major instrument of fiscal policy and, like fiscal policy, has no long-term rules to guide decisions.

Moreover, the thousands of pages of new regulations spawned by Dodd-Frank, the Affordable Care Act (ObamaCare), and numerous other statutes hamper competition, innovation and employment.

Highly unconventional monetary policy since the Panic of 2008 has greatly expanded the Fed's power, distorted interest rates, misallocated credit, and made the Fed the largest buyer of government debt.

The Fed has kept inflation low by paying interest on banks' excess reserves, thus sterilizing much of the increase in base money created by its asset purchases.

That policy, along with ultra-low interest rates, has made banks reluctant to lend to small businesses already burdened with high taxes and costly regulations — all of which slow investment and job growth.

The manipulation of interest rates — holding real rates near zero or even negative — has depleted savings, increased risk-taking and inflated asset prices. The Fed is engaged in credit and fiscal policy, not pure monetary policy (money growth has been relatively slow).

There is strong political pressure for the Fed to continue holding short-term interest rates near zero. It will be harder to control long-term rates, especially as the Fed reduces its bond-buying program. As rates rise, holders of Treasuries and MBS will suffer capital losses. These include the Fed itself and foreign central banks.

Thus, the Fed under Janet Yellen will have to face some difficult choices. If rates rise too fast, the U.S. economy will slow; if they rise too slowly, inflation expectations will rise.

Also, fiscal deficits will be greatly affected by the Fed's interest-rate policy: Higher rates will significantly increase the cost of funding federal deficit spending as well as servicing the existing debt.

Yet, the longer the Fed adheres to financial repression, the more costly it will become to reverse course and normalize its balance sheet.

If long-term rates do increase in 2014, there will be pressure on Congress to cut the deficit, rein in entitlement spending, and start thinking about tax reform.

Cutting the high U.S. corporate income tax rate would spur investment and make the transition to a more orthodox monetary policy smoother.

The Fed must satisfy the dual mandate of price stability and full employment. The problem is that monetary policy is limited: Printing money cannot spur real economic growth, but it can cause inflation and higher unemployment, as in the stagflation of the 1970s.

There is legislation before Congress to move to a single mandate and require the Fed to focus on long-term price stability. There is also a move by Rep. Kevin Brady, R-Texas, chairman of the Joint Economic Committee, to create a Bicentennial Monetary Commission to evaluate the Federal Reserve's first 100 years and examine alternatives to the current discretionary government fiat money regime.

Rep. Jeb Hensarling, R-Texas, chairman of the House Financial Services Committee, has also announced a major effort to hold the Fed accountable and to conduct hearings in 2014 on the Fed's performance.

Yellen, an experienced policymaker, has said she will continue with Bernanke's low-interest rate policy while winding down QE.

She expects that by keeping short-term rates low for the foreseeable future, long-term rates will be constrained, even after QE tapering begins.

That assumption is questionable. Moreover, according to Stanley Fischer, who is likely to become the Fed's vice chairman: "You can't expect the Fed to spell out what it's going to do, because it doesn't know."

Indeed, the problem with a pure discretionary fiat money regime is that it is short-term-oriented and subject to intense politicization.

Today, there is no monetary rule to anchor expectations and the price level. In a democracy, politicians are myopic; they respond to special interests and have an incentive to get elected.

The U.S. Constitution narrowly defines the powers of the federal government, but that has not prevented the vast expansion of the state.

The biggest challenge in 2014 and beyond will be to recognize the limits of government — especially the limits of monetary policy to stimulate the real economy — and to restore economic freedom so individuals can innovate and prosper.

Many of America's problems stem from intrusive government, not from genuine free markets. Government has an important role to play in a free society, but one limited by the rights of individuals.

The outlook for 2014 and beyond will depend on whether the rule of law and limited government prevail or whether special interests and "democracy" trump what F.A. Hayek called the "constitution of liberty."

The midterm election will provide a referendum on that historic question.

• Dorn is vice president for Monetary Studies and a senior fellow at the Cato Institute in Washington, D.C.