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The Federal Reserve's Crony Capitalism

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The Federal Reserve's decision to release forecasts for short-term interest rates is supposed to clarify monetary policy and reassure the public. By keeping the federal funds rate close to zero for three more years, and switching from shorter to longer-term securities, the Fed hopes to spur investment and growth. The problem is that manipulating interest rates and allocating credit to favored parties fosters crony capitalism, not market liberalism.

Clarity in capital markets is not improved by distorting interest rates, which are relative prices. Nor is monetary policy improved by engaging in fiscal policy and the allocation of credit. Targeting inflation at 2 percent is 2 percent too much. Nominal interest rates should reflect real interest rates in a world of zero inflation, if they are to perform their function of allocating capital efficiently.

By pegging nominal interest rates at artificially low levels, the Fed is penalizing millions of people who have their assets in saving accounts or money market funds and are getting near zero nominal returns. With CPI inflation of 3 percent in 2011, the real rate on those assets is negative. The Fed's low interest rate policy, designed to help fund big government and stimulate housing, is decapitalizing many households who do not want to take on more risky assets. Private virtue is being penalized by public vice.

Retirees, or those near retirement, typically prefer less risky assets. But with the average rate on a savings account at 0.24 percent, on a money market account at 0.22 percent, and on a 1-year CD at 0.53 percent, nominal returns are close to zero, and real returns are *negative*—even at relatively low rates of inflation.

The longer rates are held artificially low, the more savers will suffer, and the more tempted they will be to take on risks they never would have considered. Risk mismatches will complicate Fed policy when rates must rise to prevent serious inflation. Bond prices will collapse, and those investors who trusted the Fed to support longer-term asset prices will be especially harmed. There will be significant political pressure to keep all rates lower for longer, even if inflation is above the Fed's 2 percent target. So how can that target be credible?

Fed chairman Ben Bernanke has said that he will put equal weight on price stability and full employment, as dictated by the Fed's dual mandate. But "price stability" means zero inflation, not 2 percent. The Fed has no fixed anchor: there is no rule to guide it, only discretion. And that discretion is still influenced by Keynesian thinking and a Phillips Curve mentality.

Bernanke is willing to tolerate a little more inflation to try to engineer less unemployment. Yet, he must know this is a Faustian bargain that cannot work. Indeed, the Fed's press release following the FOMC meeting on January 25 admits, "The maximum level of employment is largely determined by nonmonetary factors."

The Fed has largely lost its independence. Congress has asked too much of the Fed, and Bernanke has vastly expanded the Fed's powers and balance sheet to comply. Some asset prices have been inflated (especially gold and bonds), but overall inflation has remained relatively low because people and businesses have been holding large cash balances, and banks have parked their excess reserves at the Fed for a risk-free return. The Fed has helped create its own "liquidity trap" by paying interest on excess reserves, which has reduced the so-called money multiplier.

However, as the economy regains steam and loan demand increases, those excess reserves will enter the marketplace and increase nominal spending and prices. The Fed will need to reduce the size of its balance sheet and nip inflation in the bud; but policymakers may act too late. The result will be stagflation.

Bernanke has placed the Fed in a precarious position. There is no way the FOMC can accurately forecast interest rates or determine what the efficient allocation of capital should be. Interfering with market interest rates is an exercise in market socialism, not capitalism.

In his press conference following the historic January 25 policy meeting, Bernanke was asked whether the Fed's inflation target of 2 percent was intended to depreciate the purchasing power of the dollar. Bernanke replied that the real purpose is to "avoid deflation." He then tried to downplay the idea that mild inflation would erode the value of money, because most people would protect their money by investing it, and not put it under the mattress. He admitted that interest rates are low now, but in the long run they tend to "compensate" for inflation.

This was an artful dodge. In fact, inflation *always* erodes the domestic purchasing power of the dollar. At the current 3 percent CPI inflation rate, the average level of money prices would increase by 34 percent in a decade, and by 81 percent in 20 years. Even at 2 percent, the price level would double every 35 years—no matter what the interest rate is. By suppressing nominal interest rates, the Fed is denying savers the means to safeguard their property; yet Bernanke barely gives that failure a mention.

Transparency is a noble goal, but it is best achieved under a rule of law and freely determined prices. The Fed's transparency crusade has not imposed any rule on the Fed or moved us closer to sound money. Forecasting short-term rates near zero for the foreseeable future sends the wrong signal—namely, that financial repression and crony capitalism will continue.

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