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The Limits Of Monetary Policy Call For Moral, Sound Money

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The American public does not like the fact that Fed chairman Ben Bernanke has vastly expanded the size and scope of the nation's central bank and bailed out Wall Street while Main Street suffered. Congressman Ron Paul (R-TX), chairman of the Subcommittee on Domestic Monetary Policy, has even argued for a return to the gold standard and ultimately the end of central banking in favor of free-market money.

Although the Federal Reserve is assumed be independent, the reality is that it is subject to strong political pressure, just like any other government agency. In an election year, with high unemployment and a sluggish economy, there will be more voices calling for stimulus than for constraint. Another round of quantitative easing—that is, the purchase of government bonds and mortgage-backed securities (MBS)—is likely, with the

objective of reducing longer-term interest rates to induce spending and growth.

That strategy has not worked thus far. Moreover, expanding the Federal Reserve's already bloated balance sheet could further undermine its credibility in terms of safeguarding the future value of the dollar. The Fed faces a very dangerous tradeoff: risk higher inflation by expanding the monetary base (currency plus bank reserves) in a vain attempt to lower unemployment.

The Federal Reserve's dual mandate is to achieve both price stability and full employment. However, history has shown that when the Fed fails to achieve price stability, the result can be stagflation, as in 1970s—not real economic growth and full employment.

After expanding its balance sheet from less than $1 trillion before 2008 to nearly $3 trillion today, the Fed has had little impact on the rate of unemployment but has greatly altered the allocation of credit and distorted the yield curve. It is ironic that while Congress criticizes China for manipulating its exchange rate, little is said about the Federal Reserve's manipulation of interest rates and asset prices.

It is unnatural to have interest rates close to zero and to distort the yield curve by pegging longer-run bond prices at artificially high levels and suppressing yields. Keeping rates low to finance government debt is not a recipe for long-run growth or for credible U.S. monetary or fiscal policy. Purchasing MBS to fuel the housing market merely delays the readjustment of relative prices that needs to occur before the U.S housing market can return to normal.

Rather than engaging in pure monetary policy to ensure long-run price stability and prevent erratic changes in nominal GDP, the U.S. central bank has engaged in fiscal policy by allocating credit to favored groups and thus politicized monetary policy.

Moving forward, it is likely the Fed under chairman Bernanke will continue to bow to political pressures to stimulate the economy, allocate credit, and distort relative prices. The dismal situation in the eurozone, the long-term deficits in the United States, and the lack of pro-growth tax reform and other structural changes mean the Fed will be held responsible for performing miracles. But there are limits to what monetary policy can accomplish.

Theory and practice both tell us that printing money cannot generate economic growth or lower the natural rate of unemployment, but it can cause inflation. An excess supply of money can also distort relative prices and misdirect investment. The Federal Reserve helped create the bubble in the housing market by keeping interest rates too low for too long and is now creating another bubble in the bond market. Pegging the federal funds rate close to zero for another three years and twisting the yield curve to lower longer-term rates will continue to misprice credit, penalize saving, and encourage risk.

If the Fed engages in a third round of quantitative easing (QE3), designed to lower rates on longer-term securities, and monetizes additional government debt, inflationary expectations are likely to rise. Uncertainty about the future value of the dollar would increase. Moreover, if Congress does not make headway in significantly reducing its addiction to spending and debt, there could be a general downgrade of U.S. public debt. Inflating away the real burden of the debt is not a viable option. Creditors

would demand higher nominal interest rates and the costs of servicing the debt would skyrocket.

Some asset prices need to come down. That readjustment is not deflation. It is the lowering of some prices relative to others in order to let markets clear. The Fed should be more concerned with maintaining a sound currency than with propping up housing prices and the prices of longer-term government securities, including agency debt.

Asking the Federal Reserve to stimulate the economy and lower unemployment is asking too much. Monetary policy can wreak havoc on an economy when it is erratic. But when it limits itself to safeguarding the long-run value of money, it can grease the wheels of commerce and allow markets to perform their magic.

No policymaker or economist knows the optimal amount of money in a dynamic market economy. Forecasting is a crude science, at best. No one at the Federal Reserve foresaw the financial crisis using their fancy stochastic dynamic general equilibrium models. Humility, not hubris, is appropriate when it comes to recognizing the limits of monetary policy.

The sluggish U.S. economy is not due to a deficiency of money, but to structural problems that have not been addressed. Those include chronic fiscal deficits due to overconsumption by the federal government, high marginal tax rates on capital, costly regulations imposed on the private sector, escalating health care costs, uncertainty about future fiscal and monetary policy, and huge unfunded liabilities in Medicare and Social Security.

Rules vs. Discretion

Ben Bernanke has called for greater transparency and better communication in formulating Fed policy. He has also noted that "monetary policy cannot be a panacea." Yet, he has led the charge to greatly expand the Fed's balance sheet and has let the monetary base rise to unprecedented levels. The Fed is highly leveraged and faces the risk of significant losses on its portfolio of MBS and longer-term government securities once interest rates rise, as they must. But the Fed has not told us when it will begin to normalize its balance sheet, and the expectation is that it will further expand its asset acquisition and influence the allocation of credit.

Indeed, some prominent economists are recommending that the Fed expand its balance sheet by another $2 trillion dollars and keep rates low for another 3 to 5 years. If inflation accelerates, then that is the price one has to pay for lower unemployment and higher growth. This Phillips curve (tradeoff) mentality has been proven wrong by decades of research and experience, yet the Fed continues to be under its spell.

Perhaps it is because the Fed must comply with the dual mandate and pay attention to both price stability and full employment. Congress expects the Fed to use expansionary monetary policy to lower unemployment and stimulate growth—even though the truth is that monetary policy cannot overcome structural problems to generate real growth. Many in Congress also want the Fed to monetize government debt to accommodate deficit spending, designed to win votes. Instead of a dual mandate, the Fed now appears to have adopted a triple mandate.

In this environment the Fed wants discretion, not binding rules. But discretion in a regime of pure fiat money can easily go awry. Central bankers simply do not have the knowledge

necessary to fine-tune the economy or to determine the optimal quantity of money. Unlike the classical gold standard, there is no market feedback mechanism to bring the quantity of money in line with the demand for money while maintaining long-run price stability.

In the absence of convertibility into specie, there must be a monetary rule to anchor the nominal value of paper currency. As the world's primary reserve currency, the dollar's domestic purchasing power cannot be allowed to continuously drift downward, as it has since President Nixon closed the gold window in August 1971.

Various rules have been proposed, including a price-level rule (zero inflation), an inflation target rule (2 percent inflation), a nominal GDP target, and a Taylor rule designed to control the growth of nominal income by controlling the monetary base. All those rules would add some certainty to the current discretionary government fiat money regime.

The Future of Money

The existing fiat money regime with discretionary central banking may be coming to an end. The Federal Reserve and other central banks are coming under increasing scrutiny. Congress may require an audit of the Fed and constrain its powers, especially if the Republicans take over the presidency and both houses of Congress next November. Lawrence B. Lindsey, a former member of the Board of Governors of the Federal Reserve System, is open to the idea of free-market currencies, and there is a growing movement to incorporate gold into the global monetary system.

Until a transparent monetary rule that limits the power of the Federal Reserve to its constitutional duty of safeguarding the value of the dollar is enacted, or there is a return to convertibility into specie, which James Madison—the chief architect of the Constitution—called "the only adequate guarantee for the uniform and stable value of a paper currency," the world will face monetary uncertainty.

The challenge will be to engage on fundamental reform and return to sound money under a rule of law that safeguards persons and property, including the property right a person has in the future value of money. A rules-based regime would require less forecasting and generate more discipline than the current regime. As such, markets would be left to allocate credit more efficiently, and price stability would foster financial stability.

What we need is moral money: money that retains its value and can be trusted. The discretionary government fiat money regime has miserably failed on that score. We can do better. A good starting point is to recognize the limits of monetary policy.

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