The Fed Has Forgotten Sound Money, And Now Just Manipulates Interest Rates

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While some members of Congress and Republican presidential hopeful Mitt Romney want to label China a “currency manipulator,” little is said about the Federal Reserve’s role as an interest-rate manipulator. Interest rates are relative prices that should be freely determined in private capital markets, not manipulated by the central bank. The Fed is now an allocator of credit, not a trustee of sound money.

In 2008, the Federal Reserve started on a path that has resulted in a near-zero Fed funds target, which is expected to last through 2014. The Fed has also engaged in two rounds of quantitative easing that have more than doubled the size of its balance sheet, acquiring more than $2.5 trillion of Treasury debt and mortgage-backed securities. Most recently, the Fed extended its “Operation Twist,” in which it sells short-term Treasuries and buys longer-term securities with the goal of reducing long-term rates.

Although the stated intention of the Fed’s low-interest policy is to stimulate economic growth, the U.S. economy is still sluggish and unemployment stubbornly high. A more politically motivated goal is to assist the Treasury in funding the massive U.S. public debt, which is expected to increase by nearly $10 trillion over the next decade. Last year the Fed bought more than 60 percent of newly issued Treasury securities.

The Fed’s dual mandate requires gearing monetary policy toward maintaining full employment and price stability, but the Fed is ill-equipped to have much influence on real GDP growth, which is best left to entrepreneurs and markets. Indeed, common sense tells us that printing money does not create new wealth—just look at what happened in Zimbabwe. Moreover, a host of economic research has shown there is no long-run (and perhaps no short-run) tradeoff between inflation and unemployment. Instead, the stagflation of the 1970s revealed that high and variable inflation causes unemployment to rise and growth to slow.

In its statement from the June19–20 meeting of the Federal Open Market Committee, the Fed reported that “to support a stronger economic recovery and to help ensure that inflation, over time, is at the rate most consistent with its dual mandate, the Committee expects to maintain a highly accommodative stance for monetary policy.” By which the FOMC meant keeping the Fed funds rate at “exceptionally low levels . . . at least through late 2014.” The Fed also stated that

it was “prepared to take further action as appropriate to promote a stronger economic recovery.” The only dissenting member was Jeffrey M. Lacker, president of the Federal Reserve Bank of Richmond.

The presumption is that the Fed can promote economic growth through easy money and “exceptionally low” interest rates. More likely, the Fed is creating another asset bubble, this time in the bond markets. Treasury yields are at historic lows. The quest for higher yields is inflating a bubble in junk bonds, and investors are taking on more risk as they try to improve their performance.

John B. Taylor, an economist at Stanford University, has been an outspoken critic of Fed policy, arguing that the central bank held interest rates too low for too long from 2003–05, which helped fuel the subprime crisis, and that today’s ultra-low rates threaten to repeat earlier mistakes.

By suppressing long-run interest rates, the Fed is distorting asset prices, including housing prices that need to fall to restore long-run equilibrium. Shifting investors into riskier assets should not be the role of the Fed; yet it has become so since the 2008–09 financial crisis. As former Fed vice chairman Donald L. Kohn stated in a speech at Northwestern University in November 2009, one of the goals of the low interest rate policy “is to induce investors to shift into riskier and longer-term assets.”

Investors have relied on the Fed to prop up prices when economic news is dismal. The “Bernanke put” has replaced Greenspan’s. The longer the Fed waits to normalize rates, the more costly the final adjustments to market realties will be.

While Bernanke and company try to stimulate the economy by allocating credit and holding rates low, U.S. savers are being fleeced and induced to take on more risk. A “high-yield savings account” now pays 0.85 percent; certificates of deposit from a year to 30 months all pay 1 percent; the average annual total return on T. Rowe Price’s Prime Reserve Fund is 0.01 percent. Conservative investors have an incentive to become less so.

The Fed has also upset the monetary transmission mechanism by paying interest on excess reserves. Banks now park their funds at the Fed rather than lend them to private investors, while the Fed buys government debt to fund public over-consumption.

The underlying problem, of course, is that in a world of pure government fiat monies and no monetary rule, the Fed and other central banks are subject to political pressure to “stimulate” the economy—a goal that is unattainable via money creation or interest-rate manipulation.

Getting rid of the Fed’s dual mandate, eliminating interest on excess reserves, moving away from interest-rate targeting and toward directly controlling the monetary base, and focusing on long-run price stability would be a start. Getting

rid of monopolistic central banks and moving toward a rules-based system of competitive "free banking" would offer an alternative that is consistent with a liberal economic order.

Liberalism—in the sense of limited government, individual freedom, and responsibility—requires sound money. Central banks always pose a threat to liberty. Today, in Zambia, the central bank has outlawed all transactions using foreign currencies (mostly U.S. dollars). Those who disobey face a prison term of up to 10 years. Monetary freedom cannot be ensured while central banks have a monopoly on money.

The dollar's long-run status will depend on adhering to long-run principles, not manipulating interest rates to achieve short-run results. This spring while U.S. interest rates were at historic lows, U.S. Treasury Secretary Timothy F. Geithner was busy criticizing China for holding deposit rates too low, depriving savers of higher returns. Since that time, the People's Bank of China has relaxed interest-rate controls and now allows the deposit rate to exceed the benchmark rate by up to 10 percent. Meanwhile, the Fed continues to fleece U.S. savers by keeping rates abnormally low.

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