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Bernanke Administers Another Cruel Dose Of Financial Morphine With QE3

After nearly four years of ultra-low interest rates and a tripling of the Federal Reserve's balance sheet—but with little progress on reducing the unemployment rate— the Bernanke Fed has once again come to the rescue with another dose of financial morphine.

At its recent meeting, the Federal Open Market Committee, by a vote of 11 to 1, announced a third round of quantitative easing (QE3), which unlike the earlier rounds is open-ended and will continue even after the economy picks up steam. The Fed has committed to buy $40 billion worth of agency mortgage-backed securities each month until there is evidence of substantial improvement in the labor market. Operation Twist will continue to the end of this year and the benchmark federal funds rate will be kept near zero until at least mid-2015. The sole dissenting vote was cast by inflation hawk Jeffrey M. Lacker, president of the Federal Reserve Bank of Richmond.

The key passage in the FOMC statement released on September 13, which sharply departs from earlier policy, is that "the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens." That policy change reflects the influence of Michael Woodford, an economist at Columbia University, who has argued that the Fed could gain traction in a low-interest environment by clearly signaling that the federal funds rate would be keep near zero for the indefinite future, even after the recovery is in full swing.

The problem is that Ben Bernanke may be steering monetary policy over a cliff. If the brakes on monetary expansion and inflation are not firmly applied at the right moment, the Fed's go-stop monetary policy could lead to serious stagflation.

Printing money to buy debt from government-sponsored enterprises (Fannie Mae and Freddie Mac), which are now outright state-owned enterprises, is a far cry from making productive loans through a private banking system. It's really no different from China's central bank providing funds to state-owned banks to lend to state-owned enterprises.

More funds will go into housing, but not because of free private markets. Investment decisions will be politicized and risk-taking will increase. Savers and pension funds will continue to suffer under negative real interest rates. And just as in China, financial repression will persist and distort the allocation of capital.

The FOMC rests its decision on the dual mandate of achieving "maximum employment and price stability." But if it's maximum employment that the Fed wants, it could simply tell Congress to pass a law as in the former Soviet Union and make it illegal to be unemployed. Everyone could work for the government and the Fed could print money to pay them. Wage-price controls could then be imposed to suppress inflation, just as happened under President Richard Nixon. When the controls were removed the excess supply of money fueled inflation with a vengeance and Paul Volcker was left to clean up the mess.

Printing money does not create wealth, though it may help create jobs in the short run—at the cost of inflation and a loss of economic freedom. The goal of maximum employment is a chimera. In a free society, the goal should be to expand the range of choices open to people by embracing markets and limiting government. Economic research has shown that the path to prosperity is not money creation but getting the institutions right, and thus getting prices right.

In a market system based on private property rights and the rule of law, people are free to choose, and prices reflect relative values that consumers place on alternatives. The goal of free trade or voluntary exchange is not to create jobs but to create wealth. Labor is allocated to where consumers, not politicians or planners, value the jobs most highly.

If labor and other markets are allowed to function without government intervention, there will be a tendency toward market-clearing prices, including relative wage rates and interest rates that reflect time preferences and the productivity of capital. The structure of the economy will change as consumer preferences, resource availability, and technology change—so jobs will be lost and gained in a process Joseph Schumpeter called "creative destruction."

The Full Employment Act of 1946 made the federal government responsible for job creation and accepted the crude Keynesian idea that aggregate demand management could be used to achieve maximum employment. The assumption was that less than full employment is primarily due to insufficient spending, especially for investment. The Humphrey Hawkins Act of 1978 made the Federal

Reserve responsible for creating the monetary means to achieve full employment while maintaining price stability.

The Fed's dual mandate is providing the impetus for the Bernanke Fed to risk inflation on the fanciful notion that injecting trillions of dollars of high-powered money, most of which is ending up in sterile excess reserves held at the Fed, will somehow create jobs that have a net benefit to society.

No one at the Fed (or for that matter anywhere) knows what the best allocation of society's scarce resources should be or what relative prices will clear the markets for labor, capital, and commodities. What we do know is that an excess supply of money causes inflation and is detrimental to the workings of a market system. Prices are distorted and bubbles created. The Fed's low-interest policy has already produced serious bubbles in bonds, and with QE3 stocks are frothing and the dollar falling.

The "Bernanke put" is driving stock prices to new highs, but the party cannot go on indefinitely. Ultimately, stock prices must reflect expected future profits discounted to their present values by market-determined interest rates. During the second quarter, earnings for the S&P 500 slowed to less than 1 percent, and analysts expect further deterioration in the third quarter. Executives are even more pessimistic than analysts because of expectations of a global slowdown.

Companies have been cutting costs by introducing labor-saving technologies and by moving off-shore. Their goal is to maximize profits not employment. The Fed's policy of increasing aggregate demand will do nothing to increase the skill set of lower-income workers or make workers who are not employable because of high union wage rates or minimum wages employable.

The slow growth in real output and income in the U.S. is not due to lack of nominal spending; it's due to government policies that have increased the cost of hiring workers and priced them out of the labor market. Moreover, the slow growth of business fixed investment, which the FOMC notes in its statement, is due to uncertainty and the high taxes on capital. If tax rates go up next year, the economy will slow even further—even if the Fed continues to pump in $40 billion per month and keeps interest rates near zero.

There is no clear idea of what the Fed's mandate of full or maximum employment means. Even Bernanke admitted that "there's not a specific number we have in mind" when asked when the Fed would end its asset purchases. More important, the very idea of full employment engineered by the central bank is socialistic and incompatible with limited government and a free society. Prosperity depends on sound money, free markets, private property, and a rule of law that protects individual rights.

What Wilhelm Röpke, the great German liberal economist, wrote in 1952 for the American Enterprise Institute on "The Economics of Full Employment" is still relevant today: "Stiff taxation of investment profits, ruthless exploitation of labor monopolies, cynical disregard of firm principles in economic and financial policy, threats of socialization, currency manipulation, reckless budget deficits and ever higher public debts, contempt for private property nationally and internationally, arbitrariness and insecurity everywhere—all these may be regarded as highly progressive. But one must not be surprised if, when such conditions prevail, the amount of investment [and employment] is less than it might and should be."

QE3, by artificially lowering long-term interest rates and injecting high-powered money, is an exercise in social engineering. Paying interest on excess reserves will initially sterilize the new high-powered money, without much impact on bank lending and nominal incomes, let alone real GDP growth. The housing sector could benefit from lower rates and more funds. However, if prices in that sector are already too high, the Fed's policy will create more distortions and postpone necessary relative price adjustments. The real economy is just too complex for central bankers to fine-tune.

Meanwhile, if Fed policy does lead to growth in nominal income, it will be because inflation will start to rear its ugly head, not because printing money will spur production. The Fed will have to trim its massive balance sheet, now approaching $3 trillion, but political obstacles will prevent a rapid response to accelerating inflation. The dual mandate will be tilted toward low interest rates for a prolonged period and favor monetary stimulus to promote "maximum employment." The result is likely to be stagflation.

As inflation expectations rise, nominal interest rates will rise and bond prices tank. Inflation expectations are driven by excessive money growth. But, to date, money growth has been constrained by large excess reserves, which the Fed pays interest on. When sustainable real growth is in sight, banks will want higher returns and start lending at a quicker pace. Monetary velocity will pick up and nominal income and prices will rise.

In August, the CPI increased 0.6 percent on a seasonally adjusted basis. Year-over-year CPI inflation is slightly less than 2 percent. The implied inflation rate for 10-year TIPS is 2.4 percent. Any inflation rate greater than zero means there is too much money chasing too few goods, which means the Fed should not be injecting new high-powered money if it wants to have price stability (zero inflation). In fact, the Fed defines price stability as 2 percent "core inflation," which excludes energy and food price rises. Some economists now argue for an inflation target of more than 2 percent to stimulate nominal income growth.

With inflation expectations that exceed the nominal interest paid on saving accounts, money market funds, and Treasuries, real returns are negative. Bernanke argues that keeping interest rates low will spur economic growth and that the benefits of QE3 will outweigh the losses. But he ignores the fact that savers are incurring *permanent* losses by being deprived of normal rates of return on risk-free assets. The average return on money market funds is now 0.19 percent. If that rate persists for three more years, someone with $100,000 invested would earn interest of $571.08, as opposed to $9,272.70 if the return were 3 percent.

That difference compounded over 30 or more years amounts to a considerable loss of permanent wealth, which is unlikely to be made up by QE3. Indeed, once rates start to increase, the cost of financing the large federal debt will mushroom and taxes must increase—imposing additional costs on society. If the Fed chooses to reduce the real burden of the debt via inflation, the purchasing power of money will fall along with the foreign exchange value of the dollar, and those who trusted in U.S. public debt will suffer. Moody's has already threatened to follow Standard & Poor's downgrading of U.S. debt if Washington cannot get its fiscal house in order. Asking the Fed to engage in stealth fiscal policy will not increase the confidence of creditors.

It's time to end the fantasy that the Fed can print money to grow the real economy. It's also time to dispel the myth that central banks can ignore market prices and dictate interest rates to spur investment and bring about "full employment." What the Fed can do is to limit the supply of high-powered money to prevent inflation.

Say's Law tells us that the supply creates its own demand—that is, consumption depends on prior production, which depends on a host of real factors and institutions that safeguard property rights. Freely determined market prices and a monetary system that allows the supply of money to meet demand through market processes and a convertible currency ensure long-run prosperity. Discretionary government fiat money, prolonged monetary disequilibrium, and price distortions do not.

A congressional commission to explore the best way to achieve monetary equilibrium and safeguard sound money would be welcome. As the Federal Reserve approaches its centennial, it should be held accountable for its failures and its reach for additional powers to fight the financial crisis, which the Fed itself helped create.

The United States needs to restore the monetary constitution and adhere to rules that limit the fiscal and monetary powers of government. There is nothing in the Constitution that makes the federal government responsible for achieving maximum or full employment, nor is pure fiat money sanctioned. A small unelected group of experts at the FOMC now have more power than the president, Congress, or the Supreme Court.

The Fed needs to stop pretending that creating more fiat money will solve problems of slow growth and unemployment, and begin thinking about making the economy healthy by free private markets and the rule of law—not administering another dose of financial morphine.

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