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Fed Low Interest Rate Policy Distorts The Economy

By JAMES A. DORN Posted 02/10/2012 06:33 PM ET

Investors in stocks and longer-term bonds can thank Federal Reserve Chairman Ben Bernanke for his new policy of providing information on the probable path of the federal funds target rate over the next several years.

In the first-ever forecast for multiyear rates, the Fed indicated that short-term rates likely would stay near zero until the end of 2014. Bernanke and other members of the FOMC did not commit to a permanent low-interest rate policy, but the markets believe the "Bernanke put" will keep asset prices from collapsing.

When interest rates are held too low too long, asset bubbles develop and investment funds are misdirected. Can anyone seriously believe that the runup in bond prices can continue indefinitely, or that the Fed's low interest-rate policy hasn't helped push up other asset prices, including gold and stocks?

Manipulating interest rates via central bank policy distorts the structure of asset prices and penalizes savers. Low nominal interest rates, even at low rates of inflation, can mean negative real rates. Pension plans are also harmed as promised benefits cannot be fulfilled.

In effect, the Fed's financial repression violates long-term contracts, erodes savings and increases risk taking.

The Fed is also trying to suppress longer-term rates by buying longer-term securities while reducing its stock of short-term Treasuries.

The Fed now holds 56% of its assets in long-term government bonds and 32% in mortgage-backed securities. During the press conference following the Jan. 25 FOMC meeting, Bernanke also held open the possibility of another round of quantitative easing.

Monetizing government debt and pegging interest rates are experiments in market socialism, not capitalism. The longer the Fed fails to let market forces determine rates, the more difficult the eventual adjustment will become.

Political forces will dominate as Congress pressures the Fed to keep rates low to hold down the costs of financing the massive government debt. And as long as the Fed is willing to buy that debt, the government can continue its profligacy.

Many economists still cling to Keynesian aggregate demand management as the miracle cure for a stagnant economy. And many appear to think that the Fed can stimulate real economic growth and lower unemployment by jacking up the monetary base. The lessons of the stagflation of the 1970s seem to have been forgotten.

Thus, we hear that letting inflation exceed 2% could have social benefits that outweigh the costs, that consumption (especially housing) needs to be pumped up, that saving is harmful because it cuts aggregate demand, and that artificially low interest rates stimulate investment.

What we don't hear is that inflation, even at 2%, erodes the dollar's purchasing power, that the relative price of housing should be set by the market, that saving is socially beneficial and that the multiplier effect of government spending is zero or negative.

The ascendency of Keynesian doctrine is illustrated by a recent statement by Harvard economist Lawrence Summers, who said, "Government has no higher responsibility than insuring economies have an adequate level of demand. Without growing demand, there is no prospect of sustained growth."

Yet, the problem is typically not one of insufficient demand, except when the central bank in a fiat money regime allows the money supply to shrink sharply, as the Fed did during the early 1930s. Economic growth depends on institutional changes that enhance the role of markets, protects private property rights and enlarges economic freedom.

Instead of focusing on aggregate demand management, the U.S. ought to be restoring economic liberties that have been eroded during the financial crisis with the steep increase in the size and scope of government, including the Fed.

There is nothing in the Constitution about stimulating aggregate demand, but there is an enumeration, and hence, limitation of the powers of the federal government. The Framers accepted the convertibility principle inherent in a commodity standard, and the chief architect of the Constitution, James Madison, held that:

"It is sufficiently obvious that persons and property (not aggregate demand management) are the two great subjects on which governments are to act; and that the rights of persons and the rights of property are the objects for the protection of which Government was instituted."

A return to limited government, the rule of law and sound money would go a long way to increasing economic freedom and prosperity, as opposed to more government stimulus.

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