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Yellen's Concern for Inequality Ignores Fed's Role in Creating It

Limiting U.S. central bank's power with a rules-based system would ultimately allow economic growth to reduce poverty

By James A. Dorn
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In a widely publicized speech by Janet Yellen at the Federal Reserve Bank of Boston's Conference on Economic Opportunity and Inequality, the Fed chairwoman stated, "The extent of and continuing increase in inequality in the United States greatly concern me." What she didn't say is that the Fed itself has helped fuel disparities in income and wealth by its suppression of interest rates over the last six years.

By keeping the federal funds target rate near zero and engaging in massive quantitative easing (QE) to lower longer-term rates, the Fed has encouraged risk taking, inflated financial markets, stimulated the federal government to borrow at cheap rates and fleeced savers.

The Fed's financial repression has kept real interest rates negative and misallocated capital by favoring government and housing at the expense of the private sector. By paying interest on excess reserves since October 2008, and imposing stricter capital requirements, the Fed has prevented the surge in reserves from having much of an impact on bank lending – and thus on nominal income growth and inflation. Meanwhile, those at the top of the income ladder who have taken on more risk have profited from the Fed's "stimulus."

Former Fed chairman Ben Bernanke engineered QE and ultra-low rates to foster investment and create a "wealth effect" intended to increase consumption spending and real economic growth. He still believes that credit growth – not low interest rates – is the primary source of asset bubbles, which ignores the fact that the Fed supplies the base money for such growth. Yellen is ending QE, for the time being, but thinks interest rates should remain low for "a considerable time."

The Fed has warned against trying to use its policy levers to prevent asset bubbles, yet it has used those levers to prop up financial markets – that is, it is doing the very thing it warns against. Market participants have profited from the Alan Greenspan and Bernanke puts, and are doing so under Yellen's commitment to low rates. Shifting attention to inequality takes her off mission in terms of her responsibilities under the dual mandate.

The Federal Reserve Act of 1913 sought to provide an "elastic currency" and prevent panics. The United States was still on the gold standard at the time and there were no open market operations. The Federal Open Market Committee was not created until the Banking Act of 1933, and the dual mandate was not implemented until 1977-78, when the Federal Reserve Act was amended to require the Fed to maintain price stability and full employment. The Fed is also responsible for achieving "moderate long-term interest rates." There is nothing in the act about promoting equal opportunity or mitigating inequality.

In Yellen's speech, "Perspectives on Inequality and Opportunity," she points to "the high value Americans have traditionally placed on equality of opportunity." She also recognizes that "some variation in outcomes arguably contributes to economic growth because it creates incentives to work hard, get an education, save, invest and undertake risk." However, Yellen warns that "inequality of outcomes can exacerbate inequality of opportunity, thereby perpetuating a trend of increasing inequality."

As the head of the world's most powerful central bank, Yellen is silent about the Fed's own role in increasing inequality by inflating returns for high-income households through ultra-low rates that have encouraged risk-taking and propped up asset prices, while discouraging saving and capital investment.

Today monetary policy has no rudder; there is no monetary rule to guide policymakers. We live in a world of pure fiat money and, in the case of the Fed, pure discretion. That environment breeds uncertainty and ignores the limits of monetary policy.

Bernanke thinks the Fed's 2 percent inflation target is too low; 3 percent would be better. Other economists have recommended even higher inflation targets. But what happened to the price stability mandate? Of course, inflation is a tax on real cash balances, distorts relative prices and benefits debtors at the expense of creditors. If U.S. inflation were to rise to 3-4 percent, or higher, nominal interest rates also would rise. China, with a large portfolio of U.S. debt, would suffer as the real value of U.S. debt fell, the dollar weakened and bond prices declined.

Americans may believe in "equal opportunity," but the U.S. Constitution says nothing about it. The Constitution promises equal rights, not equal opportunity in the sense of endowments. The essence of justice from a constitutional perspective is that the "rules of the game" protect persons and property, and are equally applied. That is what Nobel economist F. A. Hayek meant by "rules of just conduct." Everyone benefits from a rule of law that secures property rights, including the right to a sound currency – that is, one with a stable, predictable value.

U.S. monetary policy should be grounded in constitutional principles and be bound by the rule of law. As public-choice theorist and Nobel economist James Buchanan noted in 1988, the closing of the gold window in 1971 by president Richard Nixon ended any role for gold in the U.S monetary system: "The dollar has absolutely no basis in any commodity base, no convertibility." Nor is the Fed bound by any rule: "What we have now is a monetary authority that essentially has a monopoly on the issue of fiat money, with no guidelines to amount to anything; an authority that never would have been legislatively approved, that never would have been constitutionally approved, on any kind of rational calculus, no matter what the political system.

We have an authority that just happened to get there and happened to be in place when we demonetized gold."

Buchanan argues for a "commission that would look into the whole structure of our monetary authority." However, he is keenly aware of the overwhelming special interests that resist such scrutiny of the Fed, especially its large staff and those who benefit from its existence. Nevertheless, he believes there is a "moral obligation" to think about alternatives to the status quo.

That is why the Cato Institute has established a Center for Monetary and Financial Alternatives to examine the Fed's 100-year performance and to make the intellectual case for a monetary constitution and sound money. Two Nobel laureates, Thomas J. Sargent of New York University and Vernon L. Smith of Chapman University, as well as Stanford University's John B. Taylor, serve on the center's advisory board.

In an article announcing the new center in the Wall Street Journal, the author noted that "the Fed declined to comment," which would not have surprised Buchanan. It is time for Congress to take the Constitution seriously and exercise its authority to "regulate" (i.e., make regular) the value of money. Establishing a bipartisan commission to evaluate the Fed's performance and to consider alternatives to discretionary government fiat money, as proposed by Representative Kevin Brady, a Republican from Texas, would be a step in the right direction.

Limiting the Fed's power by adopting a rules-based monetary regime would reduce uncertainty and safeguard the value of the dollar. With sound money and free markets, U.S. economic growth could once again act as the driving force for reducing poverty.

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