The Federal Reserve's Flawed Approach To Monetary Policy

James A. Dorn

James A. Dorn, a monetary policy analyst at the Cato Institute, explains why money printing is not a panacea for the ailing U.S. economy.

After two rounds of quantitative easing, unemployment is still above 9% while annual CPI inflation stands at 3.6%. Technically, the U.S. is now facing the prospect of stagflation. Yet, some economists are calling for up to 4% inflation to get the economy moving again.

Printing money is not a panacea for the ailing U.S. economy. The unemployment/slow growth quandary is due to structural problems and to policy uncertainty, not to the lack of monetary stimulus. High marginal tax rates, especially on capital, uncertainty about pension and health care costs, and the lack of rules in the formation of monetary and fiscal policy have disrupted the normal course of commerce.

In particular, by keeping interest rates too low for too long, the Federal Reserve under Ben Bernanke has underpriced credit and increased risk taking, fueling asset bubbles in the bond and commodity markets.

The Bernanke Fed has kept the interest rate on federal funds near zero since December 2008, and that rate is likely to persist until mid-2013, as announced at the latest meeting

of the Federal Open Market Committee. The low rates signal that the Fed is targeting asset prices –that it is pegging interest rates at low levels to prop up the prices of bonds and other assets.

Investments that normally would not be made occur. But those “malinvestments” cannot be sustained once rates return to normal. F. A. Hayek long ago pointed out the dangers of monetary manipulation to underprice credit and encourage risk taking. Easy money and credit do more than affect the price level; they distort relative prices and production, and thus misallocate resources. Artificially low interest rates adversely affect the structure of production and cause recession when interest rates rise and bubbles burst.

When President Nixon closed the gold window in August 1971, the dollar lost its anchor — even though it was a “wobbly anchor.” Today the world is on a pure fiat money standard, which is no standard at all. The Federal Reserve must comply with its “dual mandate,” which requires adherence to price stability and full employment, but there is no penalty for failure.

The 2008-2009 financial crisis has increased the Fed’s discretionary power, but no one has been fired for failing to prevent the crisis. In buying up massive amounts of government debt, the Fed has sacrificed stable money for funding excessive government spending. Monetizing debt and allocating credit, rather than stabilizing the growth of nominal demand and achieving long-run price stability, have brought the Fed into dangerous waters.

Monetary policy has become more politicized. The Fed pretends to be “independent,” but in reality Bernanke and Co. have become part of the Obama Cabinet, except for a few dissenters.

The lack of any monetary rule to constrain the Fed and the lack of any convertibility principle, as existed under the classical gold standard, means the Fed has a monopoly on base money (currency held by the public plus reserves), the supply of which is determined by a small group of Fed officials who presume to be able to forecast the future.

Under a true gold standard, the optimal quantity of money is determined by market forces—the money supply spontaneously adjusts to the demand for money, and long-run price stability is achieved. The long-run value of money is certain, unlike in a pure fiat money regime without rules or convertibility.

In theory, a discretionary central bank could limit the quantity of money and achieve long-run price stability by controlling the growth of nominal final demand. But in practice, the knowledge problem and public-choice problems make such an ideal bank an illusion.

James Madison, the chief architect of the U.S. Constitution, recognized the problem with discretionary government fiat money and the benefit of a commodity standard and

convertibility long ago. In 1831 he wrote, "The only adequate guarantee for the uniform and stable value of a paper currency is its convertibility into specie. The least fluctuating and the only universal currency."

The Federal Reserve's policy is flawed because the institution itself is flawed. As Madison noted, "I am sensible that a value equal to that of specie may be given to paper or any other medium, by making a limited amount necessary for necessary purposes; but what is to ensure the inflexible adherence of the Legislative Ensurers to their own principles & purposes?"

That is a question that needs to be answered.

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