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The Fed's Monetary Policy of Zero Interest Rates

"A More Than Questionable Bernanke Fed Monetary Policy."

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"If the American people ever allow private banks to control the issuance of their currency, first by inflation and then by deflation, the banks and corporations that will grow up around them will deprive the people of all their property until their children will wake up homeless on the continent their fathers conquered." **Thomas Jefferson (1743-1826),** 3rd US President

"It is well enough that people … do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning." **Henry Ford (1863-1947),** American automobile industrialist

"When plunder becomes a way of life for a group of men living together in society, they create for themselves, in the course of time, a legal system that authorizes it and a moral code that glorifies it." **Frederic Bastiat (1801-1850),** French economist

It is becoming increasingly obvious that the Bernanke Fed's monetary policy of fixing short-term interest rates at close to zero percent, and (with inflation at two percent or so) of forcing negative real interest rates, was primarily designed not to help the U.S. economy but to shore up the super large American banks that were on the verge of bankruptcy when the investment bank Lehman Brothers failed on September 15, 2008. Indeed, with this policy, the Bernanke Fed has transferred hundreds of billions to these super banks at a huge cost to the rest of the economy and to international holders of U.S. dollars.

Just as the Greenspan Fed created the housing bubble and let the derivatives market explode, thus sowing the seeds of the 2007-2008 financial crisis, the Bernanke Fed, using faulty economic analysis, has embarked upon a policy of zero short-term interest rates for many years, —an open-ended QE3 policy of buying mortgages and other financial instruments with newly printed money, thus creating the largest bond bubble in U.S. history.

When the distortions it has created in the U.S. economy unfolds in the coming years, the true costs of this policy will become clearer. Indeed, when the Fed tries to unload the financial assets it has acquired from the near-insolvent super large American banks, in a not too distant future, bond prices will be in danger of collapsing and nominal interest rates could spike, with a very negative impact on financial markets and on the real economy.

Economists know that price controls and price fixing do not work, at least, not for very long.

Credit markets are not immune to this economic reality. In any market, for any good or service, when prices are fixed by a government or a government agency below the market clearing price, sooner or later a gap develops between the excess quantity demanded and the insufficient quantity offered.

The classical example of resource misallocation is rent control implemented in some cities and in some countries. The inevitable result of such a policy is eventually the appearance of a shortage of rental units and a deterioration in the quality of those still offered. In fact, if any given government wishes to create housing slums and a housing shortage, it can just impose stringent rent controls on a permanent basis. This does not mean that housing cannot be subsidized. But freezing prices is generally not an efficient way to subsidize housing or any other commodity or service.

Now. What happens when the Fed artificially sets the short-term interest rate at close to zero for a long period? A long series of negative economic repercussions follow.

> -First, large banks which have access to Fed loans at this artificially low rate will borrow as much of that newly created money as they can and they will lend risk-free to the deficit-laden government at two or three percent. Nice trade if you can get it!
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> -Second, the demand for bank loans will go up with the banks' prime borrowing rate artificially low. However, banks will increase their borrowing requirements for private borrowers since they can invest their excess reserves risk-free, either at the Fed itself, albeit a low rate, or by lending to the government at a higher rate. Private borrowers will be frustrated and valuable projects may remain under-financed, while the government has little incentive to curb its deficit.
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> -Third, banks and their preferential clients will use part of their excess reserves obtained at close to zero percent to buy financial assets. Stock prices and bond prices will go up.
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> -Fourth, other investors such as insurance companies and pension funds, with the knowledge that the Fed will keep short-term rates low for an extended period of time, will buy staggered long-term bonds and keep their prices artificially high, when one considers the inflation risk and the time risk involved.
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> -Fifth, with borrowing rates so low for so long, some financial operators will begin buying up companies with leveraged money, thus placing finance ahead of industry.

—All of this translates into negative economic and financial distorsions in the long run.

Maybe that's the reason the Bernanke Fed seems so popular on Wall Street. It has been a powerful tool for asset reflation. I even personally heard a financial commentator on the CNBC financial TV network declare that Ben Bernanke was the "best Fed chairman, ever" because he was being credited for a stock market rally!

Such is not the consensus among economists and on Main Street, where savers and retirees on fixed income have seen their revenues collapse over the last five years. That reminds me how Fed chairman Alan Greenspan was venerated on Wall Street, that is, until it became clear that his policy of low interest rates, easy money, junk mortgages and inadequate banking regulation brought down the financial house of cards. In economics, there is no magic, and the piper has to be paid sooner or later!

I don't know if it is because of the fact that the American central bank and its federal banking system is partly owned by large private banks, or because there are so many bankers who sit on the Federal Open Market Committee (FOMC), (the committe that sets interest rates) and who are in conflict of interest, but the Fed has a recurring and nagging tendency to create financial bubbles and economic booms and busts that end up—more often than not—benefiting large banks and their CEOs, at a huge cost to the real economy. The Fed is really an institution primarily designed to subsidize large banks with public money.

The American government itself subsidized the large banks with its $700 billion TARP program. We agree that the Fed had to intervene during the financial panic that followed the failure of Lehman Brothers, whatever its role in creating that crisis. However, did it have an obligation to keep subsidizing the super large banks for five years or more and dump the cost on the rest of the economy while imposing very little restraint on their lax behavior? I don't think so.

The Fed cannot argue that without such a prolonged subsidy policy, the economic recovery after the 2008-2009 recession would have been thwarted. In fact, this has been the **slowest recovery** from a recession since WWII. And the Bernanke Fed should share some responsibility for that.

But now that the Bernanke Fed has dug itself into a monetary hole, it should be extra prudent and careful in reversing course, less it precipitate the U.S. economy into another recession.

People have suffered enough in losing their jobs and, for many, their homes, and for many retirees, the income from their savings, without again being the Fed's victims.

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