

Monetary Policy in Color

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The landscape of monetary policy has changed considerably since the last time the Shadow Open Market Committee (SOMC) met in Spring of 2006. Several financial institutions have failed. Many more have been saved – at least for now. Monetary policy has undertaken a metamorphosis driven by the particular circumstances we face, and the historical consequences of these changes cannot and should not be understated.

Monetary policy has also become more colorful, having veered away from the drab during this season of turmoil and discontent. Several specific hues have emerged on the Federal Reserve's palate. The first color is red – that being the actual and presumed color of a fair share of financial firms' balance sheets and income statements. Systemic issues have bled red in the US economy, as well as in other economies in Europe and in Asia. This red tide is a by product of mis-priced risk, hubris, the systemic deleveraging of the financial system, poor policymaking, lax oversight, and an inappropriate regulatory framework for financial markets.

Against this background, though, the Federal Reserve has pumped green – lots of green. The Federal Reserve's balance sheet is now super-sized. The growth of the monetary basis no long fits on a conventional graph. The federal funds rate is now hovering new zero and will likely be in this range for a *considerable period*, much like it was when the seeds of red were first sown (but I digress). The IMF has gotten in the act too of providing new liquidity. And fiscal policy stimulus is now more conveniently measured in trillions, not millions.

Yet extraordinary challenges require new thinking – blue sky thinking. In the face of simultaneous crises in the areas of systemic cross party risk, liquidity and the de-securitization of financial markets, the Federal Reserve needed to act boldly and creatively. Chairman Bernanke requested such blue sky thinking from an institution not particularly known for such a problem solving approach, and he has received it mnemonically – TARP, TALF, etc...

Red, green and blue are now the colors that define our current monetary policy landscape. Ultimately, however, colors fade and blend. By contrast, monetary policy principles – the black and white – do not. Monetary policy principles have been historical touchstones for the SOMC. Such monetary policy principles identify the following best practices for central banks:

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- Central banks should adopt market based monetary policies.
- Central banks should be independent.
- Central banks should adopt an inflation target to facilitate long run price stability.
- Central banks should contribute to a regulatory and supervisory framework for financial markets that maintains the highest standards of transparency and market efficiency.
- Central banks should take a conservative approach to activist stabilization policies.

Principles, by their nature, matter as much in bad times as in good. Perhaps, one could argue, that they matter even more so in bad times.

Current Federal Reserve Board policies deviate from several of these principles, sometimes in significant ways. That being said, plausible arguments may exist as to why current deviations from these monetary policy principles are necessitated by the financial and economic situation. Whatever arguments are put forward by the Federal Reserve Board to explain their current actions and policies, however, these explanations should be judged on whether they establish a clear connection as to how these best practices of monetary policy will ultimately become institutionalized. While the Federal Reserve Board has engaged in a year of magical and colorful thinking, it now needs to begin to articulate such an exit strategy and provide a time-line, even a conditional one, for its adoption.