The SOMC and Its Core Beliefs

SOMC | SHADOW OPEN MARKET COMMITTEE

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The Shadow Open Market Committee was organized in 1973 by Karl Brunner and Allan Meltzer to provide a monetarist alternative to the views then prevailing at the Federal Reserve and in the economics profession. At that time the Fed argued that the rising and variable inflation since 1965 was largely attributable to non-monetary forces such as the power of labor unions and oil price shocks, and had little to do with rapid monetary growth.

Based on the principles of monetarism developed earlier by Milton Friedman, the SOMC blamed the Great Inflation squarely on Federal Reserve policies that featured excessive monetary growth. The point was hammered home at subsequent biannual SOMC meetings for the next two decades.

The SOMC helped to prepare the way for Fed Chairman Paul Volcker to end the Great Inflation in the early 1980s and usher in a long period of prosperity without inflation. The priority for price stability perpetuated the Great Moderation under Volcker and Greenspan. The idea that persistent inflation is everywhere a monetary phenomenon was widely adopted by economists and central bankers.

Central banking became more complex with the 2008-09 financial crisis and Great Recession--interest rates hit the zero bound, balance sheets expanded by trillions of dollars, and "too big to fail" became a serious problem. The world of central banking is again undergoing a period of great turmoil and ferment. The lack of consensus is reminiscent of the early years of the SOMC. The SOMC's external perspective on monetary policy and central banking is much needed today.

To help promote its vision and relevance in an era of increasingly complex central banking, the SOMC offers its core beliefs below.

SOMC beliefs are based on theory supported by evidence, and an understanding of central banking practice and monetary history. Their roots lie in the mistakes and successes of past central bank policy. SOMC beliefs embody a timeless understanding of the foundations of effective central banking that the Committee feels best serves as the basis for evaluating specific policy choices and broader strategic goals of the Federal Reserve's Open Market Committee (FOMC). The SOMC's deliberations are intended to foster debate among policymakers, journalists and the public in the hope that wiser policy decisions will result.

The SOMC's core beliefs are as follows:

1. The SOMC takes for granted that U.S. monetary policy will be conducted by the Fed over the foreseeable future.

2. It is essential that the central bank be independent from the fiscal authorities and accountable to the legislature. In particular, the central bank should eschew policies that allocate credit.

3. Price stability is the best contribution that monetary policy can make to overall macroeconomic performance and for this reason should be the primary objective of the central bank. "Price stability" should be defined to insure that the inflation rate, on average, is not above 2 percent per year.

4. Monetary policy should be conducted in a rule-like manner and be somewhat countercyclical with respect to output and employment, as long as price stability over the long run is not compromised. We expect the central bank to announce the policy rule that it follows so that it can be monitored and held accountable.

5. To provide financial stability, the central bank should promote strong capital buffers.

6. The SOMC expects the central bank will serve as a lender of last resort.

In this role:

a. The central bank should state its lender of last resort policy rules clearly in advance.

b. Such activities should be limited to occasional, temporary, well-collateralized lending to solvent, supervised depository institutions at an appropriate interest rate premium.

c. More expansive lending should be agreed and indemnified in advance by the fiscal authorities.

7. The SOMC believes that, by following these basic principles, the Fed would create the monetary and financial framework that best facilitates the efficient functioning of free-market, prosperity-creating, institutions in the U.S. economy.