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Monetary Policy Essay

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Dan Brocklehurst

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Monetary Policy Essay

"These are the times that try men's souls" is a quote attributed to political writer Thomas Paine. In 1776 Paine used this phrase as the opening line in his pamphlet titled *The American Crisis*, referring the start of the American Revolutionary War. Not to take anything a;0way from Thomas Paine and the tumultuous period when our country was trying to win its independence from Great Britain, but the last two years, beginning when the American economic crisis became apparent in August 2007 till now, can similarly be described as "times that try men's souls."

Today, as the United States struggles to pull out of a economic downturn of historic proportions, this country's monetary policies are under a great deal of strain and scrutiny from politicians, citizens, and the world at large. The economic welfare of the United States is dependent on successful monetary policies issued by an independent government agency, the Federal Reserve System. Simply called "The Fed" by most economists and by the public in general, it is independent of Congressional appropriations and administrative control, so it can make policy without undue influence. In this way, the Federal Reserve System has almost autonomous control over US monetary policy. The Fed uses its control over US monetary policy to foster favorable economic conditions and high employment. It also tries to keep currency values stable along with keeping inflation low. Moreover, it tries to encourage saving while

increasing consumer spending, not an easy thing to do by any means. The Fed also supervises and regulates banks. It also acts as a bank for other banks and for the U.S. government.

Perhaps the Fed's most important responsibility is its duty to manage the nation's supply of money and credit. It does this in three ways:

1.) with *reserve requirements* that banks need to have on hand which limits the amount of credit and currency which is in circulation;

2.) with *open market operations* which are run by the Federal Open Market Committee (FOMC). It buys or sells treasury bills from securities dealers in the private sector. Essentially, buying bills puts money into the market and selling bills takes money out of the market. In this way, the FOMC either increases or decreases the money supply;

3.) by changing *the discount rate* which is the interest rate the Fed charges member banks when they borrow money. By manipulating the discount rate, the Fed can influence the availability of credit.

Although all three tools are useful under certain economic circumstances, the open-market operations is the most important because it is the most flexible. It can greatly affect commercial bank reserves through the purchase and sales of bonds which ultimately can either lower or increase interest rates.

While there are many benefits from the Fed's monetary policies, the Fed cannot easily provide all the answers for the stubborn economic ills that persist in the US today. This is evident by observing the difficulty that Federal Reserve Chairman Ben Bernanke is having trying to

stabilize the US economy. Like trying to ride an untamed mustang, Bernake is taking hold of the reins of a wild economy wrought with problems stemming from poor lending practices by major banks, the sub-prime mortgage debacle, and the lack of regulation on Wall Street.

Economists have always known that an economy regularly goes through business cycles. Federal Reserve Chairman Bernanke, along with his predecessor Alan Greenspan, both have tried to use their position to stabilize and eventually to improve the overall US economy. When the economic "Perfect Storm" became apparent in September, 2008, it not only threatened the US economy, but also the entire global economy. The possibility of an economic Armageddon was real, according to many observant economists. According to them, the US and, indeed, the world were on the precipice and about to fall into a global depression as deep and widespread as the Great Depression of 1929 which had lasted for ten years. Something had to be done quickly to prevent this from happening. It was the perfect time for Bernanke and other decision-makers at the Fed along with then U.S. Treasury Secretary Henry Paulson to step forward to see what they could do to stabilize the tumbling US economy. In September, 2008, Paulson proposed a plan named the Troubled Asset Relief Program, TARP for short, to tackle the subprime mortgage crisis by increasing the liquidity in the global credit markets and to putting an end to the insolvency threats to both domestic and foreign banks with US assets. TARP was incorporated into the Emergency Economic Stability Act of 2008, a law that Congress passed with then President Bush's signature that authorized the U.S. Treasury to spend up to $700 billion worth to buy distressed mortgage-backed securities and make capital injections into banks. The verdict is still out as to whether or not this law has effectively stimulated the US economy to the extent to that was predicted. Nonetheless, even its critics have to admit that, at

the very least, the Emergency Economic Stability Act of 2008 did shore up a very delicate US economy which was teetering on the brink of a treacherous economic fissure.

During the months that have elapsed since what some have come to call "the bailout of the U.S. financial system," the US economy has struggled to pull completely out of its downturn. For example, unemployment is still quite high, hovering around 10% nationwide and even higher in states like Rhode Island and Michigan. The question that remains is did the Fed put in place monetary policies which only stimulated the economy *temporarily* and that the hope of generating more jobs (employment) will be a slow and difficult process. Another question to consider is whether or not the massive infusion of credit and debt into the U.S. economy may have actually worsened existing economic problems and may lead to run-away inflation. Meanwhile Fed Chairman Bernanke is keeping an eye on the long-term effects of he Federal Reserve's monetary policy. This delicate balancing act of stimulating the economy, controlling inflation, increasing employment while at the same time keeping the dollar strong is a very daunting challenge for the Fed, indeed.

So how can the Fed use its monetary policies now to pull the US economy out of its languishing recession? Predictably, the Fed is using the key open-market operations mechanism of lowering short-term interest rates. At this time, the Fed is continuing to keep short-term interest rates at their lowest levels on record. Hopefully, this should encourage more borrowing for spending and investment. Consequently, the US economic recovery should gain more strength as time goes on. At least, that's what the Fed is promising (fingers crossed). What must be kept in mind, however, is that the demand for goods and services and the subsequent increase in employment are related to **both** the short-term interest rates *and* the expected rate of inflation.

For instance, a borrower would be pleased if he could get a loan for 9% when the expected inflation rate is 10%, but he would balk at taking on the same 9% loan if the inflation rate is only 2%. It will be important for the Fed continuously to monitor this situation to insure that this strategy won't end up increasing short-term interest rates and inflation in the long run.

Another point to consider is how the Fed's monetary policy affects the value of the dollar. When the Fed lowers interest rates it results in the reduction of the foreign exchange value of the US dollar. This, in turn, not only lowers the prices of US produced goods that are sold overseas, but it also raises the prices that US consumers need to pay for foreign produced goods. But this outcome is not necessarily all bad news. For example, while it's true that unfortunately US consumers may pay more for goods imported from abroad, on the other hand, the goods which are made here and then exported around the world are in higher demand due to the lower exchange value of the US dollar. This makes products made in the USA less expensive to foreign consumers who are more likely to buy them. The decrease of overseas imports combined with the increased demand of U.S. exports does positively affect economic growth by increasing GDP. The ramifications are obviously far-reaching: more foreign demand for US goods leads to a rise in domestic production, higher employment, and more capital expenditure which, in turn, result in more business investment and greater productivity. All of which is very, very good for the US economy, that is, unless inflation pokes its ugly head above the economic fray.

At this time, the Fed's monetary policy is not without its critics. Some economists consider that the Fed's "loose" monetary policy has had some significant side effects which may turn out to be both undesirable and potentially dangerous. On November 4, 2009, the Fed voted unanimously to keep the federal funds rate at a very low range of zero to 0.25% because it felt

that the US recovery was still too fragile, even though recently there have been signs of some recovery. Helping to revive the economy have been the near zero interest rates on overnight loans between banks. However, this “cheap” money appears to be fueling lots of commodity speculation, especially in the gold and oil markets. Record-high gold prices of more than $1,000 an ounce have pushed the value of the US dollar lower against foreign currencies. In addition, crude is now trading at $80 a barrel (a 60% increase this year), even though crude inventories are adequate. The potential danger here is that the general public may begin to think that inflation is catching on since gold is worth more and the US dollar is worth less and that crude prices are rising because of speculation in oil futures. This could result in a self-fulfilling prophecy of higher prices and increased inflation. But the Fed at this time appears to believe that inflation, always a long-term possibility, remains just a distant threat. Subsequently, the Fed seems quite comfortable with its current monetary policy and will most likely continue its monetary practices. Time will tell whether or not the FOMC decisions have been correct and that inflation will not become a problem in the future. It should be kept in mind that if the Fed abides by the Taylor Rule, it will let the FOMC to allow for a 2 per cent “target rate of inflation” which should ultimately lead to a positive and healthy increase in goods and services for the US.

Presently, the Federal Open Market Committee (FOMC) seems to believe that the US economy is still relatively weak, although the economy has made some progress recovering from the economic tsunami of the last year or so. Therefore, the Fed is going to continue to keep short-term rates low, hoping to encourage more borrowing for both consumer spending and business investment so that the economic recovery will continue to gain strength and pull the US economy out of the worst economic downturn since The Great Depression (1929-1939). This expansionary monetary policy will continue to lower interest rates (both the federal funds rate

and the prime interest rate) in order to bolster borrowing and spending. This should result in increased aggregate demand and also an expansion in real output.

But there are some dark clouds on the horizon. US economists and citizens alike have begun to worry about the deficit spending that Congress has been guilty of over the last eight to ten years. Proponents of the recent Fed's monetary policies argue that it has been necessary to deficit spend in order to help the economy recover and to increase jobs. However, critics argue that the Fed has mortgaged the nation's future. NBC's nightly news broadcast on Feb. 7, 2010, reported that the US National Debt will reach 12 trillion this year. Comparing today's figures with those 20 years from now, state and federal taxes of 31% of personal income for 2010 will escalate to 45% of personal income by 2030 unless something is done to lower this huge national debt. Perhaps this might affect the future of the country in two ways. First, since China is holding most of this debt, it certainly will weaken the United States strength overall. Second, it will take away any leverage the US might have to negotiate with China. In the future China, once thought of as "the sleeping giant," may awaken to become the world leader, and the United States might end up being a distant second (or worse). Some economic analysts have made some dire predictions. They believe the damage from the current monetary policies of the Fed and the Bush and Obama administrations (maybe Clinton's, too) has damaged the US economy beyond repair. Time will tell if their predictions will be realized. Understandably, most US citizens and politicians hope that the critics are wrong and that the country will pull out of this lingering recession. As one recent TV commercial selling insurance that I saw touted, "Will this be the Great Recession, or will it be the recession that made us *great*?"

Meanwhile, on a personal level, the Fed's monetary policies to pull the US economy out of recession did not come soon enough to save my job as a business-to-business representative at Crellin Handling Equipment in East Providence, RI. Crellin is a family owned, med-sized company that has been around for over 50 years. As a new employee at Crellin, I was hired in July, 2008, to fill a brand new position that the owners had recently created in order to better meet the needs of their customers. My job was to expedite the transactions between the company's warehouse and its business clients by making sure that parts and supplies for Crellin's forklifts and trucks were readily available and properly installed. After four months on the job, I was let go for two reasons: a decline in Crellin's revenue due to the economic downturn that had been building nationally for over a year but which exploded in the local economy and on Wall Street in the fall of 2008 and the fact that RI Blue Cross/Blue Shield raised the rates it charged Crellin to cover its employees. Unable to find a way to overcome the loss of revenue and the increase in health insurance costs, Crellin let the "new guy" go, another victim of the economic downturn. Promising "change," President Barack Obama got elected in November, 2009 continued Bush's economic stimulus package, and the Fed developed its expansionary monetary program combining fiscal and monetary policies initiatives to save the country which, according to some economists, was teetering on the precipice of economic disaster. But as all economists know, it's impossible to turn an economy around in a matter of weeks, months, and even years. It takes time for monetary policies to take hold and to show outcomes. In fact, the verdict is still out on the monetary policies that the Fed has put in place and which have been supported by the Obama administration and by many Congressmen (especially the Democrats). For me, my lack of employment and the worsening RI economy, prompted me to go back to college to finish my business degree in order to make myself more

marketable when the economy does turn around and the country pulls out of its recession. Ideally by the time I graduate in 2012 with an accounting degree, I hope that the US economy is healthy and robust with lots of productivity, business investment, low interest rates, low inflation, and a strong housing market. I am also looking forward to having a well-paying job with benefits. I am not alone. But if this sounds too optimistic, then I may settle for less, as long as the economic trend is going in the right direction and President Obama's promise of "Hope and Change" is part of the Federal Reserve's monetary policies and the country's long-term economic plan.

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