Current Monetary Policy and the Federal Reserve

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Introduction: The Fed - Irrational Exuberance, Pennies from Heaven...?

This is an examination of the Federal Reserve and its current monetary policies that affect us now and may have lasting ramifications in the future to come. Research will attempt to show changes in macroeconomics as a direct result of Fed policies.

The 1930’s and the 1970’s were two of America’s roughest economic periods. The 30’s Depression and the 70’s Stagflation, both periods had the ability of the Federal Reserve to make influential and key decisions that should have made the difference. Christina Romer, Barack Obama’s former chair of economic advisors, made a critical observation in a recent paper:

“In the 1930s policymakers saw little benefit for lowering unemployment of further ease and large potential costs in terms of higher inflation. In 1970s they saw little effect on inflation from tighter policy but large potential costs in terms of lost output. We can see in retrospect that these assessments were incorrect and based on misunderstandings of underlying economics...” (Kohn)

Because we are in uncharted waters, and as Romer states of previous incorrect Fed actions, having a misunderstanding of the underlying economics may cause the Feds actions to repeat the previous historical economic difficulties. Should the Fed slowly tighten its monetary policies (as it recently suggested that it may), it does not mean the outcome would be the same as it was during the Depression, which Bernanke had made a life study of. The visual often conjured is “Helicopter Ben” throwing out money,
but its only pennies from heaven to the average American. Yet he continues the same easy money course; low rates and bond buying that “yes” has stimulated some modest growth, but it has also re-introduced speculation and possibly the “irrational exuberance” as Greenspan often stated, by those with easy-access to the vast extensions of the Fed’s credit lines. With the stock market at an all-time high, the macro economy has not followed such an irrational rebound.

I understand Bernanke’s goal was to avoid deflation as with Japan and during the Depression. It is also to simultaneously help put Americans back to work while keeping inflation at bay. The following asserts the goal of current policy from the Fed’s website:

“For example, when short- and long-term interest rates go down, it becomes cheaper to borrow, so households are more willing to buy goods and services and firms are in a better position to purchase items to expand their businesses, such as property and equipment. Firms respond to these increases in total (household and business) spending by hiring more workers and boosting production. As a result of these factors, household wealth increases, which spurs even more spending. These linkages from monetary policy to production and employment don't show up immediately and are influenced by a range of factors, which makes it difficult to gauge precisely the effect of monetary policy on the economy.”

(Federal Reserve)

Although the stated unemployment rate has dropped from near 10% at the time of the height of the Great Recession, the jobs picked up by those back in the labor force are not exactly the “spurs even more spending” type. Most Americans are also simply
paying down debt and live as frugal as possible. This would likely explain why the “Main Street” economy does not parallel the “Wall Street” rebound. Given the disparage between the two, tightening by the Fed will most likely slow “Wall Street” trading as “Main Street” Americans are already cautious to play the investment game again. Even the meager housing market re-bound is being buoyed more by investors than average Americans who have all-time low interest rates. Again, the irrational exuberance of the stock and housing speculation were among the bubbles that burst in 2007, and the Fed was even given new responsibilities to prevent future crisis as stated here:

The Fed’s unprecedented response to the financial crisis has garnered renewed attention on the Fed from Congress. On the one hand, the Fed was given new regulatory responsibilities in The Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) in an attempt to prevent future crises. (Labonte)

If we continue this path, it is this authors belief that we are re-inflating the bubbles that helped exacerbate the strength of the recession that made it so “Great”.

Similar to any citizen in the global economy, the notion that nations can circumvent fiscal responsibility and indefinitely postpone the debt collectors, could be considered a fool’s paradise at best. So long as the assets (both in physical infrastructure, lands, human productivity, resources and Real GDP) equals or out-weights the mountain of debt, then there is still time.
Isolating the true fiscal picture to know where and when your time runs out has to take into account everything, including; underfunded pensions, Social Security, Medicare/Medicaid obligations and unemployment figures that truly consider the under-employed, those that have given up searching and even the under-self-employed barley breaking-even (all would paint a bleaker picture). Then when you consider a fiat currency being diluted (or worse, becoming worthless) and therefore your credibility comes into question, your creditors (just like any mortgager with a defaulting mortgagee) only have one possibility to reclaim their investments; restructuring the debt or assume possession of assets…either would mean a loss of American sovereignty.

**Conclusion: Economics built on a deck of “credit cards” will...?**

This may all seem too unlikely or far-fetched, but the significance of mom and pop investor still sitting on the investment sidelines in cash, the corporate world only spending minimal in capital investments (when they are awash with cash), and major countries still hoarding reserves of raw materials (e.g. gold, oil, metals etc.), illustrates and underlying fear; like the game of chicken where everyone is waiting for someone to flinch so they can duck for cover and let the shoot-out begin.

The flinch could be caused by another 9-11 event, Middle-East disruption, Asian territorial dispute; even an unpredictable catastrophic event like a super-volcano, tsunami or global drought, none of which appear to be factored into the Feds policies or even a global contingency plan by the G7, G20, IMF, Central or World Banks.

So here we stand at the abyss with only a hope (while the Fed continues to play a game of credit card poker), that the safety line, if you can call it that, doesn’t snap.
