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Snapping ropes and breaking bricks

James Hamilton of Econbrowser is concerned about the current state of monetary policy. On the blog, Jim writes:

> "I would suggest first that the new Fed balance sheet represents a fundamental transformation of the role of the central bank. The whole idea behind open market operations is to make the process of creating new money completely separate from the decision of who receives any fiscal transfers. In a traditional open market operation, the Fed buys or sells an existing Treasury obligation for the same price anyone else would pay for the security. As a result, the operation itself does not involve any net transfer of wealth between the Fed and the private sector. The philosophy is that the Fed should base its decisions on economy-wide conditions, and leave it entirely up to the market or fiscal authorities to determine where those funds get allocated.
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> "The philosophy behind the pullulating new Fed facilities is precisely the opposite of that traditional concept. The whole purpose of these facilities is to redirect capital to specific perceived priorities. I am uncomfortable on a general level with the suggestion that unelected Fed officials are better able to make such decisions than private investors who put their own capital where they think it will earn the highest reward."

After I looked up "pullulating," I found much to agree with in Professor Hamilton's description—or at least I did up to that last sentence. I certainly share his discomfort with a presumption that "Fed officials are better able to make… decisions than private investors," but that doesn't quite capture my view—and I emphasize *my* view—of how nontraditional policy is supposed to work. My own description of what the "fundamental transformation" of central bank policy is all about appears, hot off of the virtual press, in the first quarter issue of *EconSouth*, the Atlanta Fed's regional economics publication:

> "I have a simple way of thinking about how monetary policy works. Imagine a long rope. At one of end of the rope are short-term, relatively riskless interest rates. Farther along the rope are yields on longer-term but still relatively safe assets. Off at the other end of the rope are multiple tethers representing mortgage rates, corporate bond rates, and auto loan rates—the sorts of interest rates that drive decisions by businesses and consumers. In the textbook version of central banking, the monetary authority grabs the short end of this allegorical rope, where the federal funds rate resides, and gives it a snap. The motion ripples down and hopefully reaches longer-term U.S. Treasury rates, which then relay the action to other market interest rates, where the changes reverberate throughout the economy at large.
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> "That's the story in normal times, and over the past year and a half the Federal Open Market Committee (FOMC) has done a fair bit of rope-snapping. In August 2007 the FOMC set the federal funds rate target—the overnight rate on loans made between banks—at 5.25 percent. As of December 2008, the rate target was lowered to a very low range of 0–0.25 percent. As the committee noted then (and reiterated in January), 'weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.'
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> "These FOMC statements held another extremely important message: 'The focus of policy going forward will be to support the functioning of financial markets and stimulate the economy.' In a speech to the National Press Club on Feb. 18, Federal Reserve Chairman Ben Bernanke elaborated:"
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> > 'Extraordinary times call for extraordinary measures. Responding to the very difficult economic and financial challenges we face, the Federal Reserve has gone beyond traditional monetary policy making to develop new policy tools to address the dysfunctions in the nation's credit markets.'
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> "One way to view the effects of those credit market dysfunctions is to imagine that someone had placed a series of bricks at strategic points along the segment of rope connecting short-term interest rates to broader market rates. With these bricks in place, it is simply not enough for a central bank to keep snapping short-term interest rates: The bricks—dysfunctions in the markets—will keep the impulse from being transmitted to the interest rates that are directly connected to market outcomes. Thus, a new set of policy instruments is needed, instruments that allow the monetary authority to circumvent blockages in the monetary transmission mechanism."

The "policy instruments" I have in mind, of course, are the pullulating new facilities that have Jim Hamilton worried. But it is worth emphasizing that many of these facilities are motivated by "unusual and exigent circumstances," a point emphasized in the recent Treasury-Federal Reserve statement (which is discussed in some detail by Tim Duy):

> "As long as unusual and exigent circumstances persist, the Federal Reserve will continue to use all its tools working closely and cooperatively with the Treasury and other agencies as needed to improve the functioning of credit markets, help prevent the failure of institutions that could cause systemic damage, and to foster the stabilization and repair of the financial system."

How long will those conditions persist? Returning to my *EconSouth* commentary:

> "No set timetable exists, but one would presume that as long as the bricks of market dysfunction are lying around, the tools will be necessary. Eventually, of course, markets will heal, the bricks will crumble, and the stage will be set to a return to business as usual in monetary policy and the economy. The sooner the better, but in the meantime it's helpful to have the tools in hand to start cracking the bricks."

That's my story, and I'm sticking to it.

By David Altig, senior vice president and research director of the Atlanta Fed

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