

American economy

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In a broad sense, the macroeconomic policies developed and implemented by the Federal Reserve (the Fed) are those which regulate the national supply of money. Either through foreign exchange operations, or management of public funds, the Fed seeks to maintain the level of money supply in ways that would sustain stable inflation rates. It should be noted that while Fed's macroeconomic policies tend to impact aggregate demand and GDP these are primarily short-term effects, with the rate of inflation being the main long-term target of any monetary policy.

Now, in conditions of the growing financial crisis, it is more than important to reconsider and reevaluate the effects of the major Fed's macroeconomic policies on the major sectors of the U. S. economy. Given the instability of the current financial and housing markets, this analysis is expected to become the source of useful policy recommendations in short and long run.

American Economy Introduction In a broad sense, macroeconomic policies developed and implemented by the Federal Reserve (the Fed) are those which regulate the national supply of money.

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S. economy. Given the instability of the current financial and housing markets, this analysis is expected to become the source of useful policy recommendations in short and long run. Monetary policies have long been the issue of the Fed's major concern. Through the prism of numerous monetary factors, the Fed used to evaluate the causes and consequences of particular monetary decisions and their effects on economic behaviors. The truth is, however, that in order to evaluate the effectiveness of the macroeconomic policies in the U. S.

, a detailed review of the structural factors that stand behind the current economic crisis is required. The combination of the housing and credit crunch drivers needs to be reconsidered, to realize the real-life implications of all monetary initiatives the Fed has been able to implement over the course of the last three years. To start with, the current economic crisis originates from the strategic change in equilibrium within housing markets, as well as the decline in house prices “ as the market gives back the excessive part of the rise in real house prices - the part not justified by realized rentals” (Wu, 2008).

These structural shifts have obviously impacted the situation with employment, banking, and construction. Another set of structural factors is readily visible in the financial sector, where subprime mortgages and the following illiquidity and reduced supply of loans have led the banks to the need for increasing their assets and making their share prices vulnerable to even the slightest changes in business sector (Kutter & Mosser, 2007).

The slowdown of productivity, the decreasing value of business and economic expectations, and oil prices have also contributed in the expansion

of the current financial crisis, which is more the result of structural shifts in global and national economy, rather than the direct consequence of ineffective monetary approaches. In this context, the natural question is what the Fed has done to decrease the negative impact of financial crisis on the major sectors of business and economy, and whether Fed's macroeconomic policies in their traditional form remain relevant in the changing financial and economic conditions.

Since the end of 2006 and up to the beginning of 2009, the gradual increase of the Fed's reserve balances has been the distinctive feature of the Fed's response to the expanding economic crisis. The increase in reserve balances have become particularly visible and sharp by the end of 2008, when the Fed faced a serious need to provide banks and business entities with additional liquidity instruments and loans (Lacker, 2009). In a very short-time period, the Fed has increased the reserve balances supply by over 100-fold, with the latter reaching the amount of \$848 billion (Boivin & Giannoni, 2008).

Purchasing securities and providing financial institutions with guaranteed loans was one of the reasons for such sharp reserve balances increase, but beyond that, the Fed sought to finance its loan activities by creating additional money. It should be noted here, that with the need to obtain additional financial instruments, the Fed can follow the three different pathways: creating money, borrowing funds from the U. S. treasury, and issuing debt (Gilpin, 2008).

Selling government securities is just another option the Fed can utilize to obtain additional funds. Importantly, with the emergence of the economic threats and during the first months of crisis the Fed chose to follow the <https://assignbuster.com/american-economy/>

fourth path, adjusting its portfolio to its economic and financial needs by selling off government securities, but with the amount of government securities being insufficient to maintain financial and monetary stability in the U. S. , the Fed has come to realize the need for creating new money.

In the light of the essential structural shifts, and given the long-term impacts which the process of creating new money produces on all areas of economic activity, these macroeconomic policy decisions have already turned into the source of increasing professional concerns, and there are several reasons for that. First, the effectiveness of federal reserves increase seems doubtful due to the inflationary trends with which it is usually associated. Under the impact of falling commodity prices, when inflation risks seem at least improbable, the Fed nevertheless should not lose the sense of caution.

The fact is that when the need withdraw the funds and to reduce the amount of federal reserves arises, the Fed is likely to face another inflationary challenge, and whether it is able to avoid long-term increase in prices will depend on the moment the Fed chooses for reducing the amount of funds (Boivin & Giannoni, 2008). Second, Gilpin (2008) suggests that as long as the Fed is increasingly involved into selective financing as a part of its macroeconomic initiatives, the Fed's independence from other governmental institutions becomes irrelevant and at least doubtful.

Rudebusch (2008) writes that “ the recent request by the Treasury for the Fed to assist in creating a Consumer and Business Loan Initiative is certainly reminiscent of the request by Treasury for the Fed to help out in its own borrowing operations before the Accord of 1950”. Thus, whether the Fed acts in accordance with macroeconomic principles or follows the <https://assignbuster.com/american-economy/>

recommendations and requirements of Congress will also determine its consistence as the central financial body and as the source of the major macroeconomic initiatives.

Finally, as Congress is trying to tie the Fed to its authoritative decisions, and the Fed does not look beyond the need for creating additional money and applying selective funding principles, the only effect the Fed has been able to produce is proving its inability to act as an independent financial body. The problem is that against the continuous success of its expansionary initiatives and the absence of deep recessions, the Fed found itself in the midst of predictable policies and workable macroeconomic guidelines.

Since the end of 2006, however, those guidelines and policies have gradually lost their effectiveness (Rudebusch, 2008). Scholars and professionals in economics recognize the declining effectiveness of the major Fed's initiatives: the Fed is no longer able to produce immediate positive effects on the interest rates; the benefits of the major macroeconomic initiatives have been muted by the mortgage securities market issues; investors are disappointed with the recent Fed's decisions - all these factors significantly contribute into the expansion of the current financial crisis, making the financial image of the Fed even more negative.

Until present, the ineffective macroeconomic activity of the Fed has only led to re-appreciation and reconsideration of the benefits of fiscal stimuli and responses to the changing economic conditions. Against the inconsistency of the Fed's decisions, the scope of the Fed's operations was limited to adjusting federal funds rate and issuing additional financial instruments.

Federal Reserve lending in the broader macroeconomic contexts has also become the topic of increasing professional interest.

In response to recent slowdown, the Fed has developed a whole set of lending initiatives, which either targeted specific groups of assets, or specific business entities or institutions, or implied the need for standard discount window lending (Lacker, 2009). From the viewpoint of macroeconomics and the long-term impact which these interventions tend to produce, before the middle of 2008 the Fed had been working to provide lending in ways that would not increase the monetary base but would instead redirect additional bank reserves to cover its lending commitments.

Since the end of October 2008, however, the Fed has no longer been able to maintain its monetary base unchanged, and had to combine its lending ideas with additional monetary stimuli (Lacker, 2009). These lending programs have been effective to the extent that changed the balance of credit in specific markets, and “ while some market segments benefit from reduced funding costs, others may actually see their costs rise as credit is diverted to those markets that have been targeted by support” (Lacker, 2009).

In relation to lending, it is essential to note that over the last three years the Federal Reserve intentionally chose to conduct its monetary interventions with the help of the federal funds rate, which provides the Fed with an increasingly active position regarding macroeconomic policies in the U. S. By changing the discount rate, the Fed gives financial institutions a chance and the right to borrow directly from the Fed, and the Fed’s board can either approve or deny the loan (Gilpin, 2008).

The situation is similar with other lending initiatives, but when it comes to supporting specific business entities or markets, the Fed risks losing its independence and faces a decision-making challenge of cooperation with Congress. More than that, with lending being one of the major macroeconomic operations initiated by the Fed in the last 3 years, professionals have come to realize the inconsistency and the distorted vision of the Fed with regard to discount rate as the central policy instrument.

In other words, where financial institutions seek to replenish the lack of liquidity, they prefer borrowing overnight, thus leaving the Fed no time to review the real financial needs of financial institutions (Krugman, 2007). As a result, it was not before the middle of 2007 that the Fed has become concerned about the decreasing liquidity of its assets and the need to reduce the discount rate for primary credit.

Since that time, the Fed continuously supported its “federal funds rate reduce” line, which suggests that reducing discount and federal funds rates was one of the least ineffective macroeconomic approaches and did not extend beyond producing short-term positive impacts on financial and commodity markets (Yuan & Zimmerma, 2008). The structural forces that currently govern the economic and financial balance in the U. S. and the world inevitably impact the so-called natural interest rates, of which the Fed seems unaware.

That means that while the current rate of return on equities is above 5.5%, it is also much higher than the policy rates which the Fed adjusts to make them fit to the current rates of inflation (Gilpin, 2008). Furthermore, given that the origins of the current economic crisis lay within the limits of the

housing markets, it is very probable that “ what will be driving real rates of interest once the economy settles into its new growth path is the rate that households require on loans” (Krugman, 2007).

Thus, in its credit initiatives, the Fed has obviously neglected a whole set of important factors, which make its macroeconomic policies at least irrelevant. While the Fed seeks to expand the liquidity of available funds by maintaining interest rates at the levels close to zero, it distorts the macroeconomic balance. The fact is that against the reduced wealth levels and the growing negative expectations, the expected rates of interest in future will be much higher than the Fed currently promotes (Krugman, 2007).

With the growing need for funds on the side of financial and business entities, the Fed is likely to face the crisis of expectations, where it is either unable to maintain sustainable interest rates or fails to provide businesses with sufficient amount of financial assets. Thus, whether the Fed is able to promote the success of its major macroeconomic initiatives depends on its ability to timely review its macroeconomic attempts and to adjust them to real-life market contexts.

In the light of the increasing inefficiency of the major Fed’s interventions, special attention needs to be paid to the so-called moral hazard problem. “ Safety net support for financial institutions encourages private market participants to view some institutions as ‘ too big to fail’ and weakens those institutions’ incentive to monitor and manage the risks they face in their business strategies and financial market transactions” (Gilpin, 2008); as a result, this inattentiveness to the major market risks weakens financial and business institutions and increases the cost of this financial protection.

In other words, while the Fed pursues the need to reduce the cost of credit for ultimate borrowers by providing financial and credit institutions with additional financial assets, it unintentionally leads these institutions undertake higher additional risks than they otherwise would be willing to recognize (Lacker, 2009). As a result, the cost of borrowing substantially increases, leaving these institutions in the need to absorb the effects of moral hazard without external support.

Does that mean that the Fed has initially chosen a wrong macroeconomic path? This question lacks a single and obvious answer, and while many financial institutions and business entities will require expanding the range of available liquid resources by using federal funds, a stronger regulatory basis and strict system of monitoring could significantly increase the efficiency of all macroeconomic policies aimed at reducing the negative impact of the current financial crisis. Conclusion

The Federal Reserve has appeared completely unprepared to facing the challenges of the expanding economic crisis. Despite the relevance of the new liquidity mechanisms and the Fed's striving to expand the range of available financial instruments, these measures will hardly be effective in the long run. Moreover, given the undue risks financial institutions and business entities undertake and the limitedness of the Fed's financial resources, its current macroeconomic initiatives are likely to become counter effective in the U.

S. striving to preserve its leading position among the major economic powers. In this context, strict regulation and a well-developed system of federal monitoring will increase the effectiveness of all Fed's initiatives at the

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