

The 50-Year History of the Shadow Open Market Committee and the Evolution of Monetary Policy

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A 50-Year Retrospective on the Shadow Open Market Committee and Its Role in Monetary Policy

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Outline of paper

- Section I. Introduction and summary
- Section II. The SOMC's Origins and the 1970s
- Section III. The SOMC during the Great Moderation (1980s-90s)
- Section IV. The Early 2000s
- Section V. The Modern SOMC since the Great Financial Crisis
- Section VI. Concluding Remarks
- Appendices:
 - 1) SOMC members through history
 - 2) Guest speakers at SOMC meetings
 - 3) Archives of SOMC meetings: Policy Statements and Position Papers

Introduction and Summary

- The SOMC was established in 1973 by the leading monetarist economists Karl Brunner, Allan Meltzer and Anna Schwartz
- It promoted Milton Friedman's modern quantity theory model that emphasized that reducing the growth of money supply was necessary to lower inflation
- The SOMC successfully raised the profile of the monetary aggregates during the high inflation 1970s and likely influenced Volcker's disinflationary policies
- Since then, the SOMC has evolved significantly. It continues to promote rules over discretion and argues that stable low inflation is the best foundation for achieving the Fed's dual mandate
- Over the years, its research and recommendations have been wise, and its predictions have been prescient
- The SOMC remains actively involved in providing sound advice on monetary, regulatory and financial policies

Section II. SOMC Origins and the 1970s

- Milton Friedman vs the Keynesians: money matters and inflation is a monetary phenomenon
- Friedman's monetarism was in the distinct minority vs. the economic profession's mainstream that believed inflation is caused by eclectic sources and advocated activist policies based on tradeoffs presented by the Phillips Curve
- Friedman emphasized the critical role of the money supply for the determination of nominal income based on a stable money demand function, stating "inflation is everywhere and always a monetary phenomenon"
- Brunner & Meltzer promoted their principles of monetarism in academic circles, the media and in Congress

The SOMC's in the 1970s

- Perfect timing, right model: SOMC began in 1973 during wage and price controls, when inflationary pressures were rising and Fed Chairman Arthur Burns rejected a major role for monetary aggregates in monetary policy
- The SOMC successfully promoted the critical role of monetary aggregate control amid the disarray of failed Fed and government's policies, rising inflationary expectations and the US dollar crisis
- In mid-1979 President Carter chose Paul Volcker to replace G. William Miller as Fed Chair
- The SOMC continued to propose *gradually* slower monetary base growth
- Volcker: didn't believe in monetarism but understood the role of money
- Volcker's concerns about the loss of credibility supported his belief that aggressive monetary policy tightening was required to break inflation

Volcker and the SOMC's Influence

- In October 1979, Volcker announced the Fed's shift to targeting nonborrowed reserves, which would involve high volatility of interest rates
- Rates zoom to 17% in Spring 1980 and money growth plummeted; Carter's credit controls generated a deep but temporary recession, Volcker reversed the rate increases; the economy recovered and rates rose to 21%; a 2nd deeper and longer recession; inflation fell and expectations followed
- Meltzer, Brunner (as well as Friedman) were initially critical of Volcker's aggressiveness
- But the SOMC and monetarism likely influenced Volcker
- Regardless, the Fed reverted to interest rate targeting as soon as inflation receded in 1982
- The question that still remains is whether Volcker used monetary aggregate targeting as a cover to raise rates or as its true monetary policy instrument

Section III: The SOMC in the 1980s-90s

- The Volcker disinflation ushered in the Great Moderation, a period of moderate inflation and healthy economic performance
- The SOMC worried about a remission back into the unstable 1970s and overplayed its monetarist hand during this period
- It continued to recommend monetary base growth targets, despite acknowledging the short-run volatility of money demand and velocity
- This was perplexing, since Meltzer was close to the theoretical developments, including
 - Transition to interest rates in neo-Classical model and rules that allowed countercyclical policy responses to real output shortfalls, like the Taylor Rule

Beyond the Ms: Wise Policy Advice

- The SOMC advocated a low inflation target and rules-based policies, full transparency and accountability; opposed discretion and fine-tuning
- It urged the Fed against intervening into FX markets and criticized role of the IMF and the U.S. Mexican Bailout (Anna Schwartz)
- It favored responsible fiscal policy & spending limitations as a % of GDP
- In the Fall of 1993: recommended monetary tightening that lowered inflationary expectations and led to an economic soft-landing
- In 1999, it urged the Fed to tighten policy despite concerns about Y2K
- Following the 1970s, the SOMC's following dissipated

Transition in SOMC

- 1991: Jerry Jordan left the SOMC to become President of the Federal Reserve Bank of Cleveland
- Lee Hoskins joined SOMC after a stint as President of the Federal Reserve Bank of Cleveland
- Charles Plosser joined the SOMC
- 1998: Bill Poole left the SOMC to become President of the Federal Reserve Bank of St Louis
- 1999: Meltzer retired as Chair of SOMC and Charles Plosser and Anna Schwartz became co-Chairs
- Joiners: Greg Hess (1998), Ben McCallum and Alan Stockman (2000)

SOMC Insights in Early 2000s

- The SOMC's research and recommendations were strident and sound
- 1) Rigorous support of inflation targeting, rules over discretion (SOMC's "rules" are changing); calls for full transparency and accountability
- 2) the SOMC transitioned to interest rate policy recommendations, a process that began in 1990s
- 3) McCallum prepared rigorous analyses of the Taylor Rule and the McCallum Rule to assess current monetary policy in U.S. and Japan

Prescient Recommendations

- The Fed had become fearful of a Japanese-style deflation. The SOMC rejected the possibility of deflation and urged the Fed to maintain a symmetrical risk assessment of inflation
- The Committee's research on the excessive risks of Fannie Mae and Freddie Mac warned about an eventual financial crisis (Greg Hess)
- The SOMC recommended hiking rates beginning in 2002
- The Fed ignored this advice, and adopted an asymmetric interpretation of inflation. It delayed raising rates, fueling debt-financed housing bubble
- This marked end of the Great Moderation

Big Transition at SOMC Prior to Financial Crisis

- Charles Plosser left the SOMC in 2006 to become President of the Federal Reserve Bank of Philadelphia
 - Played key role in the Fed's 2012 Strategic Plan that established 2% inflation target
- Lee Hoskins retired from SOMC, as did Alan Stockman for health reasons
- SOMC temporarily paused meetings

The Modern SOMC Beginning in 2009

- The SOMC added new members who contributed academic rigor and new dimensions of expertise:
 - Marvin Goodfriend
 - Michael Bordo
 - Charles Calomiris
- These new members and future joiners highlight the Committee's high scholarship and intense interest in influencing monetary policy
- SOMC modified its routine: it shifted to ½ day open meetings and invited guest speakers, primarily Fed members and central bankers
- It ceased preparing a Policy Statement

The Great Financial Crisis and Its Aftermath

- The SOMC's focus during and following the GFC:
 - the Fed's expanded scope of policies
 - factors that affected the monetary transmission channels and the economy
 - financial regulations and supervision
- The SOMC was concerned that the Fed's extension of credit and enlarged balance sheet crossed the boundaries into fiscal policy
- Marvin Goodfriend (2009) called for an "Accord" on credit policy that established boundaries of Fed interventions and its lender of last resort policies
- The Committee recommended higher bank capital requirements, reform of Fannie and Freddie, and improved government supervision

The Fed's Balance Sheet and Slow Recovery

- The SOMC worried that the Fed's expanded scope would ultimately threaten its independence
- The Committee urged the Fed to unwind its MSB holdings and move toward an all-treasuries portfolio
- It argued against QEIII: large scale asset purchases, an unconventional monetary policy tool used in crisis management, was being extended under normal conditions to achieve the Fed's employment objective

The Fed's 2012 Strategic Plan and the Fed's Evolving Interpretation of its Dual Mandate

- The SOMC applauded the Fed's establishment of an inflation target in 2012, but worried about the Fed's asymmetric tilt toward its employment mandate
- Under Yellen, the Fed more explicitly prioritized employment
- As labor markets improved, the Fed's worries turned to low inflation
- The SOMC urged the Fed to end its zero interest rate policy

New Members Join SOMC

- Post-GFC: Peter Ireland (2011); Athanasios Orphanides (2014); Charles Plosser (returned to SOMC in 2015 from the Fed)
- Deborah Lucas (2017); Andrew Levin (2019)
- Recent additions: Jeff Lacker, formerly president, FRB of Richmond (2022) and Jim Bullard, formerly, FRB of St Louis (2024)

The SOMC Establishes “Core Beliefs” in 2015

- The SOMC conducted a self-assessment and established its Core Beliefs. These had many similarities with the original SOMC:
- A central bank that is independent from fiscal authorities and avoids credit allocation;
- Pursues price stability (2% inflation) through rules-like manner with a policy rule that provides countercyclical support as long as price stability remains intact; and
- Promotes financial stability with strong capital buffers and establishes lender of last resort rules and boundaries that are agreed upon in advance

SOMC Criticized the Fed's Growing Worries about Too Low Inflation and its New Strategic Framework

- The SOMC argued that inflation was not too low, that inflation expectations were well anchored and that the Fed's fears of collapsing expectations and the effective lower bound (ELB) were overstated
- The SOMC emphasized the importance of maintaining a symmetric assessment of dual mandate
- The Fed ignored the SOMC's suggestions
- The SOMC (led by Mickey Levy and Charles Plosser) criticized the Fed's NSF: its new flexible average inflation targeting (FAIT), prioritization of employment and discard of preemptive tightening

The SOMC Accurately Predicted Higher Inflation; Criticized Fed's Extended Excessive Ease

- Based on unprecedented surges in money growth and deficit spending, SOMC members including Mickey Levy, Michael Bordo and Peter Ireland were among the earliest to predict the recent high inflation
- The Committee correctly identified excess demand as the source of inflation, while the Fed's focus was on transitory supply shocks
- It urged the Fed to raise rates above inflation

Key Research by SOMC Members: Recommendations on Rules-Based Policies

- SOMC members Athanasios Orphanides and Peter Ireland have proposed different rules, showing how each would have outperformed the Fed's discretionary approach and poor judgment
- Deborah Lucas and Charles Calomiris have emphasized that regulations and supervision should also be established and conducted in a rules-like manner

Issues in Fed Governance

- SOMC members Andy Levin and Jeff Lacker have identified flaws in the Fed's governance that constrain the diversity of opinions, reduce dissents and adversely affect policy deliberations
- They recommend changes in the Fed's process of selecting FOMC members and FOMC member voting rights, and improved communications and accountability, and more

The Fed's Balance Sheet and Credit Policies

- The SOMC led by Charlie Plosser has analyzed how the Fed's enlarged balance sheet ultimately threatens its independence, and he favored a narrower scope of monetary policy
- Andy Levin has measured the costs to taxpayers of the Fed's enlarged balance sheet while Debbie Lucas has measured the costs of the Fed's bailouts of the GSEs during the GFC and the costs of the government's credit extensions and forbearance

Summary and Conclusions

- The SOMC has been an active and insightful external constructive critic of the Fed
- It has evolved from its monetarist origins and continues to promote sound monetary policy based on systematic rules that focus on price stability as the best foundation to achieve the Fed's dual mandate
- It identifies the flaws in consensus themes that influence monetary policy and recommends alternative ideas for improving policies

Summary and Conclusions

- The SOMC has accurately predicted each of the Fed's largest policy missteps and undesired outcomes in modern history
- SOMC members appreciate the Committee's rich history and enjoy the role they play in the policy debate