Monetary Policy Flexibility: Solution or Problem

By William Poole

Comments by William R White

While the title of this session implies a focus on crisis management, the author has complemented such considerations with a number of comments on crisis prevention. I will indulge myself by doing the same.

A. Crisis Management

1. Identifying some shortcomings in public sector responses

Central banks, particularly those from the largest financial centers, have been rightly proud that their interventions prevented the "cardiac arrest" in the financial markets from becoming terminal. Yet, as Bill Poole notes on page 1 of his paper, the possibility of such a crisis was never acknowledged by the authorities in advance. Thus, they were almost completely unprepared for the crisis when it did hit. This had two unfortunate implications for crisis management.

First, many of the preparations for a possible crisis, that ought to have been made in advance, had not in fact been made. In many countries, deposit insurance schemes were woefully inadequate. In Europe, this first resulted in guarantees being given by the Irish government to essentially all of the liabilities of Irish banks. Within days, amid fears of cross-border flows, this led to similar guarantees being offered in a number of other (and far larger) countries. Insolvency laws, to allow banks to be wound down in a rapid and orderly way, also proved lacking as did Memoranda of Understanding between different government bodies about how who would do what in rapidly changing circumstances. A t the international level, previous efforts to deal with winding down Large Complex Financial Institutions (LCFI) had also come to nothing, as had efforts to work out "burden sharing" arrangements across countries.

The second negative side effect of not having seen the crisis coming, and of not understating its true nature, was that its magnitude, scope and duration took everyone by surprise. For a long time ”denial” was the order of the day, and in some respects it still is. Recall, for example, that when the financial crisis first began, it was said by the US authorities that the bad loans would amount to only $50 billion and that they would be confined to the sub-prime sector of the mortgage market. When it became impossible to deny that the crisis was spreading far beyond that sector, it was said that the underlying problem was a shortage of liquidity. The idea that there might in fact be wide spread insolvencies and systemic threats to the financial system was denied. When this possibility also had to be confronted, what was denied was that there might be significant effects on the real economy. Evidently, this contention also had to be withdrawn when the global economy turned down sharply in the second half of 2008. Not only did demand dry up in big debtor countries (like the US), but it had massive and unexpected effects on creditor countries as well (like Germany and Japan) through trade and other links.

Today, this denial continues since many people continue to underestimate the effects yet to be seen on the supply side of the real economy. Many sectors, where production capacity got too large during the global boom, will now have to shrink. Perhaps even more important, many Asian countries are all geared up to export to countries that can no longer afford to buy. During the long period that such adjustments will take, it is inevitable that structural unemployment will be higher than it would otherwise be.

2. Why was the crisis unanticipated?

Evidently, the next question is why the crisis was unanticipated? As a matter of record, I must note that a number of people at the BIS did see it coming. Moreover, they warned repeatedly both privately and publically of the dangers that were building up. The fact that the author says on page one that he attended every meeting of the FOMC for many years, and that neither the Chairman nor the President of the FRBNY ever passed on the concerns being expressed in Basel, “speaks volumes” about the impact of international influences on policy making in the United States.

Perhaps the most fundamental reason why neither senior central bankers nor their staff anticipated the crisis was that their models (in effect their analytical frameworks) had no room for crises of this (or indeed any) sort. The Keynesian models favored by central bankers are essentially one period models in which stocks, or “imbalances” play essentially no role. The New Classical, New Keynesian and DSGE models favored by academics assume that the economy is self equilibrating and expectations are “rational”. Thus, there can be no such problems by assumption.

In effect, all these analytical frameworks missed the buildup of a number of “imbalances” that are at the core of the current crisis. Asset prices rose to levels that could not be justified by normal criteria. Financial institutions became ever more exposed to a wide variety of risks. Spending patterns changed in bizarre ways such that US spending became was almost entirely dependent on households and Chinese investment (as a proportion of GDP) rose to a level never seen in other large countries. And, finally, trade imbalances rose to unprecedented heights. The analytical models in wide use gave no indication that this would lead to a highly non-linear and convulsive crisis. Many policy makers felt a faint disquiet, but that was it.

The second reason why the crisis was unanticipated has to do with something in human nature. We seem inclined to say “Never look a gift horse in the mouth”. Over the last decade or so, the private sector could not see beyond the extraordinary profits they were making. This did not make it easy for those with a risk control function in financial institutions. Similarly, central bankers could not look beyond the fact that they were achieving their objective of price stability. Indeed, what is truly astonishing is how price stability was ultimately deemed to be “sufficient” to avoid macroeconomic problems, when the original thought was only that it was “necessary”.

3. Implications for managing the downturn

As noted above, the failure to understand the character of the crisis led to a long period of denial. One important implication of this was that insolvency problems in the financial sector were not addressed as quickly or comprehensively as they might have been. Indeed, in light of the continuing

uncertainty about the magnitude of the losses still to be taken on "toxic assets" in many jurisdictions, and potential future losses associated with the economic downturn, it might even be felt that the insolvency problem has still not been dealt with comprehensively.

Another implication of not really understanding the nature of the crisis has been an almost wholesale recourse to Keynesian solutions, not least the sharp easing of monetary and fiscal policy almost everywhere. As necessary as these macroeconomic policies might have been to stabilize the situation, two other considerations are important. First, macroeconomic policies might prove inadequate to reestablish robust real growth. Second, to the extent they do work to stimulate the real economy in the short term, they could do so in ways that will worsen economic prospects over the medium term.

I have recently written a paper[1] which evaluates the arguments for "cleaning up" after a crisis as opposed to "leaning against" the wind of the credit excesses in the first place. It is concluded that cleaning up might become increasingly difficult and could, in the end, prove impossible as the transmission mechanism became increasingly ineffective. The "headwinds" of debt increasingly constrain both the willingness to borrow and to spend. Further, for financial institutions, the "headwinds" of capital inadequacy increasingly constrain the willingness to lend. Recall that Chairman Greenspan first used the word "headwinds" in the early 1990's to describe this process. We have now had twenty more years to allow those headwinds to gain further force.

Even if easy money polices did succeed in stimulating real growth in the near term, they might also have unwanted medium term implications. One possibility is that such easing would work through creating yet another asset price bubble. What has gone on in financial markets since March of 2009, especially in a number of emerging market economies, supports the view that this might indeed be happening. A second possibility is that very easy monetary conditions, sustained for a long time, might have negative supply side effects.

[1] White William (2009) "Should the Monetary Authorities "Lean or Clean"?" Federal Reserve bank of Dallas, Globalisation and Monetary Policy Institute, Working Paper 34

In such an environment, “zombie” companies are encouraged to drag down the healthy ones, and the same situation prevails in the banks that finance them. In addition, saving is further discouraged by such policies with potentially serious implications for countries that suffer from a chronic lack of saving and investment.

Finally, there is a low but still significant probability that very easy monetary conditions will eventually cause inflationary expectations to come unstuck in spite of stagnant output. . We know this is possible since we have seen such processes at work in Latin America for decades. Evidently, countries with large external deficits and a vulnerable exchange rate would be most exposed to such a stagflationary outcome.

Recognizing all of these potential shortcomings of easy money implies that we should be thinking beyond demand side remedies for the crisis. Supply side responses also have a role to play, not least better procedures for writing off debt, structural reforms to increase economic potential, and . policies to support (rather than interfere with) needed adjustments out of declining industries. If this is what Bill Poole means, on the last page of his paper when he talks of “structural reforms… to increase economic and financial stability”, then I am with him all the way.

Regardless of what many academics assume, it is evident that our economic and financial system is not inherently stable and self equilibrating. Thus, we need reforms to make it more stable. Moreover, we need measures to prevent the economy from being pushed beyond the “corridor of stability” where instability becomes much more likely[2]. This brings me to the second issue of crisis prevention.

[2] For more on this concept see Axel Leijonhufvud (2009) “Out of the corridor:Keynes and the crisis” Cambridge journal of Economics 33, pp741- 757

B. Crisis Prevention

The author makes suggestions concerning regulation, monetary policy and measures to limit leverage. Let me briefly address each in turn.

1. Tougher regulation

Bill Poole's proposal on subordinated debt seems to me to be fundamentally sound. Nevertheless, I still wonder how it relates to other proposals that would turn such debt into equity using some form of a "capital trigger".

On rules versus discretion, I am also sympathetic to his preference for the use of rules though perhaps for somewhat different reasons. In particular, using discretion to lean against the upswing of the credit cycle, with either regulatory or monetary policy, might prove too difficult. Both popular opinion and the political establishment would be against it. In contrast, it is not too hard to think of rules that would gross up capital requirements (set under Pillar 1 of Basel 2) to resist procyclicality in the system as a whole. In effect, we would have "automatic" financial stabilizers to complement the generally accepted use of "automatic" fiscal stabilizers.

Finally, the author is opposed to the "Volker rule" to prevent banks from doing proprietary trading. He is certainly right that this will be technically difficult. I would add as well that this solution also fails to address the still more fundamental issue of "ignorance" on the part of both bankers and rating agencies, which lead to the huge losses associated with structured products. Super- senior tranches of structured products were rated AAA and kept on the books of the banks because they were thought riskless. What only became clear after the event was the extent to which some of the highly technical assumptions behind these judgments really mattered.

2. Monetary policy

I am certainly in agreement with the author that "targetting" asset prices as an objective of policy is not a good idea. Rather, we need to think of using such variables as "indicators" in Taylor type reaction functions to condition

monetary policy to lean against imbalances of various sorts. However, what I do not agree with is his notion that, without an adequate formal modeling of the implications of such a policy for the real economy, nothing should be ventured. In a nutshell, my response would be that " The best is often the enemy of the good". History in fact provides us with plenty of guidance as to what policymakers should be worried about and how they might react in consequence.

Finally, the author raises the issue of novel policies and the law of unintended consequences. I agree in principle that this is always a problem. However, I also feel that a credible commitment on the part of policymakers to resist credit bubbles (and such symptoms as generalized asset price increases) might well change people's behavior in a more stabilizing way. Indeed, do central bankers not believe that their commitment to keep inflation under control led to a similar and stabilizing change in wage setting behavior?

3. Limiting leverage

I agree with the author that leverage has been an important contributor to the current crisis. Yet, leverage is also the essence of a fractional reserve banking system and there are not too many people supportive of the 100 percent reserve alternative. In my judgment, we have to balance off the advantages of leverage, speculation and risk taking (the process of "creative destruction") against the disadvantage of occasional crises. How much repression is enough? Do the author's conclusions go too far? These are questions for which there are no right answers, only difficult tradeoffs.