

Did monetary policy play a role in causing the crisis and what lessons can be drawn for its future conduct?

Remarks prepared by Charles (Chuck) Freedman for the panel discussion at the conference on “Economic and Financial Crisis: Lessons from the Past and Reforms for the Future,” May 14, 2010

Monetary policy and the crisis

- Role of monetary policy as a causal factor in the lead up to the crisis and implications for the future conduct of monetary policy
- At least five approaches have been discussed and debated
- (1) John Taylor -- not the formulation of monetary policy at fault, but implementation

Five approaches

- (2) BIS -- monetary policy made an error in not responding to asset price inflation
- (3) Blanchard -- level of inflation being targeted may be too low
- (4) Stiglitz -- crisis was partly a result of central banks' excessive focus on inflation
- (5) Svensson -- role of monetary policy in causing the crisis minimal and no need for significant changes to the conduct of policy

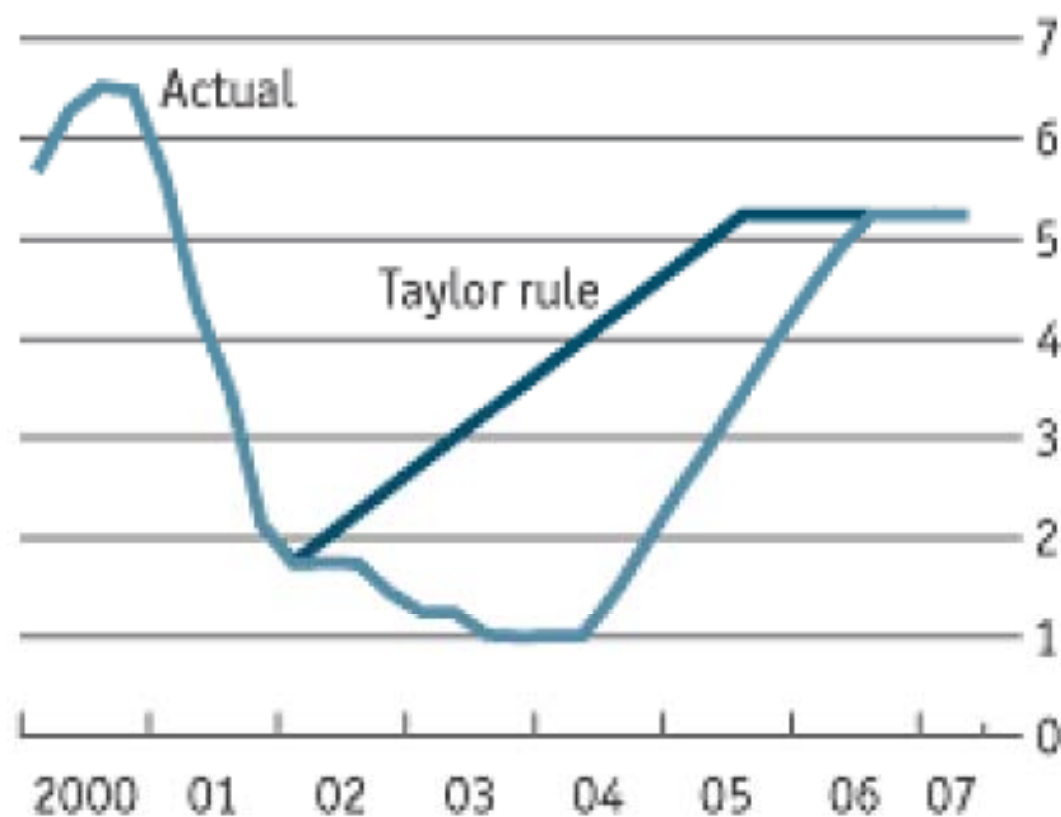
Taylor

- “Monetary excesses were the main cause of that boom [the housing boom] and the resulting bust.” (NBER WP 14631, 1/2009)
- “Monetary policy was too easy during this period [2002-2006]”

Loose fitting

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Federal funds rate, actual and counterfactual, %

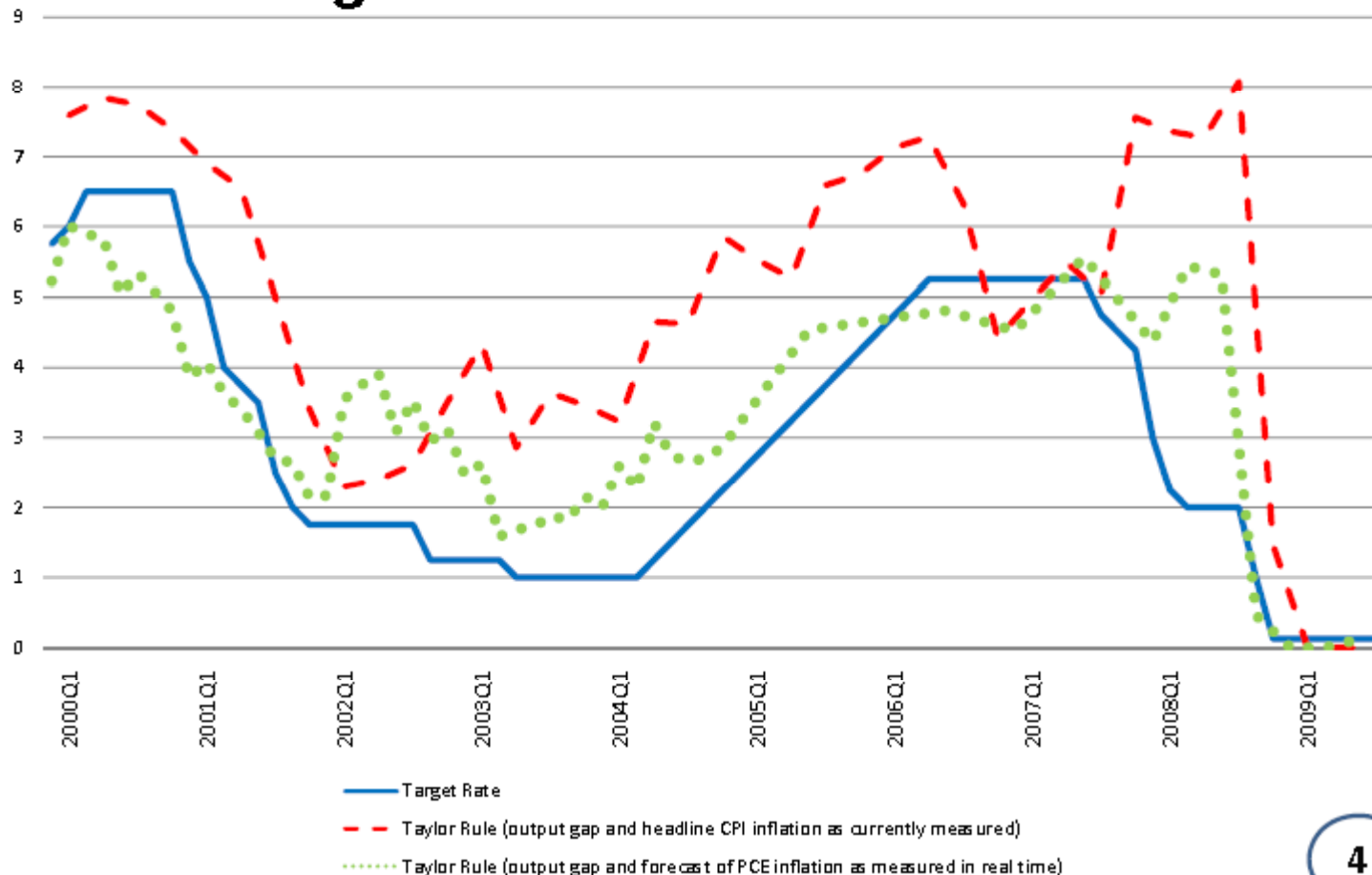


Source: John Taylor, "Housing and Monetary Policy", Sept 2007

Bernanke on Taylor

- Bernanke (AEA 1/2010) emphasizes difference between the Taylor rule prescription based on currently observed values of the data and that based on real-time estimates of the output gap and forecasts of inflation
- Inflation forecasts put more weight on increases in inflation expected to be longer-lasting than on those expected to be temporary
- “the alternative Taylor rule [green] prescribes a path for policy much closer to that followed throughout the decade [blue]”
- Also, possibility of deflation in the early part of the period

The Target Rate and the Taylor Rule Prescriptions Using Real-Time Inflation Forecasts



Source: Federal Reserve Board, Bureau of Labor Statistics, Bureau of Economic Analysis, and Federal Reserve staff calculations.

Taylor's response to Bernanke

- Taylor's response (WSJ 1/2010)
- (1) Fed's forecasts of inflation too low
- (2) With average private sector inflation forecasts, interest rate still too low for too long
- (3) Bernanke cites no empirical evidence that his alternative to the Taylor rule improves central bank performance

Assessment of Taylor

- Central banks judge whether inflation movements likely to lead to longer-lasting pressures or not, and respond mainly to former
- Taylor understates concerns about deflation
- Even if interest rates too low for some period, which might explain at least part of the asset price bubble, could not explain implosion of financial sector
- Taylor also places considerable weight on other errors of policy in explaining the effects of asset price bubble and bust on the financial sector
- In any case, implication that Fed should do better job, but no fundamental changes needed to policy framework

BIS

- BIS has long argued that central banks should pay more attention in conduct of policy to asset price movements
- BIS -- can identify circumstances in which asset prices and credit increasing at excessive rate, and interest rates should be adjusted in such situations to avoid damage from inevitable reversal of bubbles
- Borio and Lowe WP 114, 2002 – “sustained rapid credit growth combined with large increases in asset prices appears to increase the probability of an episode of financial instability”

BIS

- View in central banks that very difficult to determine whether sharp asset price increases result of boom that will inevitably reverse, or of change in equilibrium asset prices in response to favorable economic or technological developments
- Conventional wisdom that monetary policy should not react to asset price movements but should stand ready to respond to effects of asset price bust
- Bill White -- Should monetary policy “lean or clean”? BIS view monetary policy should lean against the upswing of credit cycle ; conventional view in central banks lower interest rates effective in cleaning up the effects of the bust afterwards

Assessment of BIS

- Clearly, in most recent episode, “cleaning” not sufficient
- One problem with BIS prescription is that difficult to make it operational
- Could interest rate movements have much effect on asset price increases expected to be in double digits without having massive effect on the economy?
- Given lag in effects of interest rate adjustments on economic variables, what should central bank do as the bubble appears to be nearing peak – raise interest rates to prick bubble or lower interest rates to help offset the negative effects on economy from bust part of asset price cycle?

Stiglitz

- “Interpreting the Causes of the Great Recession of 2008”
- Argues that many elements contributed to the crisis; low interest rates may have played some role in contributing to crisis, but should not be blamed for crisis
- “Some critics put the Fed’s loose monetary policy at the center of the crisis. I want to argue here though that the question is far more complex. The list of those who and what contributed to the crisis (and the policies that contributed to the crisis) is long: global imbalances, rating agencies, investment banks, mortgage originators, mortgage brokers, CRA, Fannie Mae, foreign purchasers of securities, economists, moral hazard created by previous bank bailouts, deregulation, bankruptcy reform, tax law changes that encouraged leveraging, the reckless rescues.”

Stiglitz

- “This paper places the onus for the crisis on failures in the financial system, including its flawed incentives and models...The paper identifies other factors that may have contributed to the magnitude of the crisis, such as low interest rates (both as a result of Fed policy and global imbalances) and inadequate risk assessments by investors... It argues, moreover, that low interest rates are neither necessary nor sufficient for the existence of bubbles and that low interest rates could have been a boon to the economy if the funds had been well allocated and risks well managed by the financial system.”
- “From this perspective, low interest rates cannot and should not be blamed for the crisis.”

Stiglitz

- In a lecture delivered in South Africa in July 2009, Stiglitz argued that rigid inflation targeting by central banks partly to blame for global financial crisis and that decisions by central banks to focus on low inflation led to many taking their eye off the ball, which was financial stability.
- "The crisis is partly a result of central banks' focus on inflation -- they lost the thread of financial stability and growth."

Assessment of Stiglitz

- Argument that central banks did not pay sufficient attention to financial stability because of excessive focus on price stability
- Central banks have important role to play in financial stability, but not sole responsibility as in monetary policy in most countries
- Instruments of monetary policy cannot play important role in achieving financial stability
- Will have to use variety of regulatory and structural instruments to achieve financial stability

Blanchard

- Blanchard and co-authors -- Rethinking Macroeconomic Policy (IMF Staff Position Note 10/03),
- Zero lower bound – should policymakers aim for higher target inflation rate in normal times to increase room for monetary policy to react to very large contractionary shocks?
- When inflation rate becomes very low, should policymakers err on side of more lax monetary policy, so as to minimize likelihood of deflation?

Blanchard

- *IMF survey online*: “Central banks have chosen low inflation targets, around 2 percent. In your paper, you argue that maybe we should revisit this target. Why?”
- Blanchard: “The crisis has shown that interest rates can actually hit the zero level, and when this happens it is a severe constraint on monetary policy that ties your hands during times of trouble.
- As a matter of logic, higher average inflation and thus higher average nominal interest rates before the crisis would have given more room for monetary policy to be eased during the crisis and would have resulted in less deterioration of fiscal positions. What we need to think about now is whether this could justify setting a higher inflation target in the future.” (Feb 12, 2010)

Assessment of Blanchard

- Earlier literature -- target rate of inflation of 2% in industrialized economies would allow economy to avoid ZLB with very high probability
- Was size of downward demand shock during crisis very low probability outcome or indication that earlier research significantly underestimated probability of such an outcome at 2% target?
- Also have to consider costs of higher rate of inflation
- Need to evaluate in context of system in which regulatory and other instruments available to help avoid similar crisis in future

Svensson

- Number of conclusions in speech last September on lessons from the financial crisis
- “The crisis was mainly caused by conditions that had very little to do with monetary policy and were mostly due to regulatory failures and, to some extent, to specific circumstances, including the US housing policy to support home ownership for low-income households.”
- Expansionary policy [in 2001-2005] was very appropriate
- Somewhat higher interest rates would have made little or no difference in stopping credit growth and housing boom

Svensson

- Possible that Fed's emphasis on readiness to relax monetary policy aggressively in wake of sharp fall in asset prices may have induced expectations of floor under future asset prices and contributed to asset price boom. (This is a communication issue rather than a policy issue.)
- More generally, price stability is not enough to achieve financial stability.
- Interest rate policy not enough to achieve financial stability.
- Best instruments to achieve financial stability are supervision and regulation, including appropriate bank resolution regimes.

Svensson

- With respect to flexible inflation targeting, central banks may have to focus on longer forecast horizons. Financial factors may have a strong and deteriorating effect on transmission mechanisms, making standard interest rate policy much less effective.
- More research is needed on how to incorporate financial factors into the standard models of transmission mechanism
- “In the end, my main conclusion so far from the crisis is that flexible inflation targeting, applied in the right way in using all the information about financial factors that is relevant for the forecast of inflation and resource utilization in any horizon, remains the best-practice monetary policy before, during, and after the financial crisis

Assessment of Svensson

- I am very much in agreement with views set out by Svensson (and others who have expressed similar views) that monetary policy not central cause of crisis and that fundamental changes not needed in conduct of monetary policy
- Other instruments – regulatory, supervisory and structural – needed for financial stability

Concluding Remarks

- Multifaceted explanation for crisis
- Largely structural and regulatory, although low interest rates may have played some role
- Flexible inflation targeting with low target rate of inflation remains best framework for monetary policy
- Regulatory and structural instruments best suited to dealing with financial stability issues
- More research needed on financial-macro linkages