The Economist

Making better institutions, in America and Europe

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LAST Thursday, your correspondent attended the Cato Institute's 30th annual Monetary Conference. A previous post covered the first portion of the conference, which was about understanding the causes of the crisis and how to (or whether we should) prevent future crises. This post will cover the remainder of the conference, which concentrated on current events in the United States and the euro zone. The underlying theme was how to create institutions based on transparent rules rather than the whims of individual policymakers—a noble goal difficult to execute in practice when there is so little agreement on what the rules should be.

The first panel in this section was titled "The Limits of Monetary Policy". I was expecting a discussion about the ways in which the transmission mechanism was being affected by the undercapitalisation of intermediaries and household indebtedness. This topic had been partially addressed by Vernon Smith in his keynote speech, so I was looking forward to a more detailed discussion from two former members of the Federal Open Market Committee (FOMC), Kevin Warsh and Bill Poole. Instead, the panel was mostly about the future of the Fed's "independence" and the challenges posed by the "dual mandate", which requires the Fed to aim for maximum employment within the context of stable prices.

The consensus was that the Federal Reserve had been suborned by nefarious elements. Instead of solely focusing on its mandate to restrain the pace of inflation, the allegedly corrupted Fed was concerning itself with trivia like ending the recession. The discussion felt a bit out of place. No matter how one evaluates the Fed's overall performance, the inflation record since 2009 has actually been quite consistent with its stated target. If the Fed had indeed been captured by nefarious elements that had no regard for the price stability mandate, one would have expected faster inflation to have been the result, yet the pace of inflation has actually been slower since the recession began than in the years before.

Mr Warsh and Mr Poole (who was filling in for Allan Meltzer) made a sharp distinction between the "legitimate" efforts to fight the crisis and the subsequent easing actions that were, allegedly, unjustified by the economic fundamentals. According to them, the interventions of 2007-2009 were required to ensure that "the markets could clear", as Mr Warsh put it, while the second round of easing was done to satisfy "political masters" by monetising the debt. In fact, Mr Warsh said that the Fed was being actively unhelpful by "crowding in" Congress's supposedly poor policy choices. He reckoned the Fed would have had more room for maneouvre if the legislature had made a good faith effort to reform entitlements and close the budget deficit. Mr Warsh seems to prefer the approach taken by the European Central Bank (ECB), in which the unelected and unaccountable monetary authority more or less dictates to democratic governments. Supposedly, these conditions are required to prevent "moral hazard". Yet Mr Warsh had no trouble when the Fed was providing unlimited liquidity to troubled financial firms at concessional rates in exchange for dubious collateral during the teeth of the crisis.

David Malpass, the former chief economist of Bear Stearns who unsuccessfully ran for the Senate in 2010, had a very different perspective. Rather than questioning the Fed's motives, he questioned its means. Mr Malpass said that the reduction in interest incomesince the end of 2008 has more than offset the higher asset values and lower borrowing costs that resulted from the Fed's policies. While controversial, this is a defensible position. After all, our understanding of the ways the Fed's actions affect the real economy still leaves much to be desired. One basic unresolved question is whether monetary policy works by affecting the incentives of financial intermediaries to make loans (the credit channel) or by affecting the incentives for households and nonfinancial firms to save and spend (the money channel). Another is whether quantities (the money stock, the volume of the monetary base, the size of intermediary balance sheets, etc) or prices (interest rates, credit spreads, the shape of the yield curve, the exchange rate, stock prices, etc.) are more important. The unwanted side effects of current policy could very well turn out to be more significant than the ostensible benefits. It would not be the first time. Raghuram Rajan, one of the few mainstream academics to have predicted the crisis, has made this point repeatedly. Mr Malpass was less clear when he argued that the surge in government debt since the start of the downturn *caused* the reduction in private debt, and therefore the collapse of the real economy. This seems to be backwards. Almost all of the increase in the deficit can be attributed to declines in taxable income and increased "automatic stabiliser" payments, which suggests that the economy's collapse was the cause rather than the effect.

The après-lunch speech was given by John Taylor. Mr Taylor is known for his concern with governing the Fed's actions according to transparent policy rules. The eponymous "Taylor Rule" is one example, although it was not derived from a first-principles analysis but a regression that compared the actual level of the Fed Funds rate between the mid-1980s and the early 1990s to a simple model. Mr Taylor's rule became very popular in the late 1990s. Over the past decade, he has argued that the Fed held the short-term interest rate too low between 2003 and 2005 on the basis of his rule. Ironically, many who disagree with Mr Taylor's analysis of the bubble nevertheless cite alternative formulations of the policy rule to justify both quantitative easing and fiscal stimulus; according to their interpretation, nominal short-term rates should be negative. Mr Taylor disagrees, preferring the original version of his rule. The dispute is an illustration of the problem afflicting discussions of monetary policy. As Robert Hetzel noted earlier that day, it is hard to have a useful debate about which rule is best when there is no hard consensus about how the central bank affects the economy.

Like Mr Warsh and Mr Poole, Mr Taylor agreed that the expansion of the Fed's balance sheet in the aftermath of Lehman's collapse was appropriate, comparing the episode to what occurred after the terrorist attacks of September 11, 2001. He believes that the panic was a liquidity crisis rather than a solvency crisis, which is why he argued that the balance sheet should have shrunk back to its pre-crisis level by the beginning of 2009. Again, it is difficult to square this support of the Fed's concessional lending programmes with his campaign against the evils of moral hazard. Unlike Warsh and Poole, however, Mr Taylor argued that he cared deeply about the fate of the unemployed. He seems to sincerely believe that reversing the Fed's current policies would eliminate "uncertainty" and lead to a robust recovery. Regrettably, I was not able to ask Mr Taylor to provide more detail on how this would work.

Despite the fact that your correspondent was not called on, Mr Taylor was nevertheless asked two interesting questions. One young man asked whether the adoption of a nominal GDP target would satisfy Mr Taylor's desire for the Fed to be governed by rules rather than the whims of policymakers. Mr Taylor had no problem with steady nominal GDP growth as a *goal* of monetary policy but he did not see how a rule along the lines of "keep NGDP on its trend path" would be useful because it does not address *how* to achieve this objective. Expectations matter, he noted, but they are nothing without actions that justify those expectations. A policy rule is useless if it does not to relate to the instruments at the disposal of policymakers. Mr Taylor's critique applies equally to consumer price inflation targets. In fact, he argued that the Fed was too concerned with the threat of deflation in the early 2000s. Unconstrained by a simple rule, policymakers acted too aggressively and, according to Mr Taylor, inflated an asset bubble.

Interestingly, Mr Taylor seems to have had a different answer to this question back when he wrote about the subject twenty years ago (from the paper linked above):

> *A policy rule need not be a mechanical formula, but here there is more disagreement among economists. A policy can be implemented and operated more informally by policymakers who recognize the general instrument responses that underlie the policy rule, but who also recognize that operating the rule requires judgment and cannot be done by computer. This broadens the definition of a policy rule significantly and permits the consideration of issues*

> *that would be excluded under the narrower definition. By this definition, a policy rule would include a nominal income rule in which the central bank takes actions to keep nominal income on target, but it would not include pure discretionary policy.*

Another young man asked whether a policy rule or an inflation index should include asset prices. This is an old idea historically rejected by the academic establishment. Mr Taylor, reflecting the consensus, said that asset prices are too volatile for a central bank to react to them. He also argued that it is not necessary for central bankers to focus on asset prices in order to prevent bubbles. According to Mr Taylor, America's housing bubble would have been prevented had the FOMC simply followed his advice at the time. Most of the people involved in running the Federal Reserve during the period, including Alan Greenspan and Ben Bernanke, now claim that higher short-term interest rates would have made little difference because long-term interest rates were being suppressed by the "global savings glut".

However, transcripts of the meetings of the FOMC from this period (like this one) suggest that the Fed felt perfectly capable of raising long-term rates at the time. After all, the yield curve was quite steep. The debate among policymakers was whether the output gap was wide enough to justify inflating a bubble. As Donald Kohn, then the Vice Chairman of the Federal Reserve Board, said:

> *Some observers have been arguing that our patience should be wearing thin sooner rather than later. One argument is that policy is very accommodative by historical standards and that many of the reasons for adopting such an accommodative policy no longer pertain. Demand has strengthened substantially, and the threat of pernicious deflation has receded. A second concern is that policy accommodation—and the expectation that it will persist—is distorting asset prices.* ***Most of this distortion is deliberate and a desirable effect of the stance of policy. We have attempted to lower interest rates below long-term equilibrium rates and to boost asset prices in order to stimulate demand.***

Advocates of low rates within the FOMC evidently agreed with Mr Taylor's claim that the Federal Reserve was inflating asset prices. Unlike Mr Taylor and other critics, however, Mr Kohn and his colleagues thought the positive consequences of this decision outweighed the negative ones. The more interesting question is whether Mr Taylor's preferred policy would have been sufficient to prevent the housing bubble. It is doubtful that it will be answered anytime soon.

The final panel your correspondent attended was on the euro crisis and featured an excellent group of participants: George Tavlas, the Director of the Bank of Greece, Jürgen Stark, the former chief economist of the ECB, Wolfgang Münchau, a columnist with the *Financial Times*, and Pedro Schwartz Giron, a professor at San Pablo University in Madrid. Most of the discussion was not actually about the euro crisis, however, but the high level of sovereign debt in Greece. While interesting, the origins of that nation's troubles are largely unrelated to what happened to Spain, Ireland, Italy, or Portugal, much less Iceland and the Baltic nations. Nevertheless, the discussion was illuminating.

Mr Tavlas argued that the euro, contrary to popular arguments, is not actually like the gold standard. A real gold standard, for all of its other flaws, would never have allowed Greece's current account deficit to get so large. Instead, Greek borrowers would have had to pay increasingly higher interest rates to obtain credit, which would have prevented the accumulation of such large external debts. But the euro ensured that, for awhile at least, the spread on Greek borrowing costs against those in Germany and the Netherlands was always very low. Mr Tavlas did not blame the ECB for this, even though it was at least somewhat responsible for the borrowing costs prevailing in Greece. In fact, the ECB applied an equal haircut to all euro-denominated sovereign debt when making loans to member banks, which discouraged financial markets from distinguishing between the creditworthiness of the various countries in the eurozone.

Mr Stark devoted his presentation to a narrative in which profligate southern Europeans supposedly pay too little tax and are insufficiently hard-working. However, it is not clear these problems have much to do with the current crisis. After all, Spain and Ireland had budget surpluses until 2008. Government debt in both countries declined relative to GDP throughout the period. Italy was running budget surpluses after interest payments and also saw its government debt/GDP ratio decline, until it was hit by the crisis. Greeks work much longer hours than every other nation in the currency bloc. Mr Stark avoided mentioning any of these relevant facts, suggesting that his narrative of the crisis is incomplete. He did admit that the Maastricht treaty, which places strict limits on government borrowing, was first broken by the Germans in the early 2000s. His talk might have been more helpful if he had explained how Germany had avoided a crisis for all the years it ran large budget deficits and endured slow domestic growth. Mr Stark concluded by saying that the euro will survive because the leaders of Europe are committed to creating the institutions that will impose the requisite discipline. It is not clear whether this should be cause for optimism.

Mr Münchau began by recalling a conference on the creation of an Asian currency union that he had attended earlier in the year. He was asked what Asians should learn from the euro zone when making their own single currency. His advice: "don't". The root of the euro zone's problems, according to him, is that it was based on three incompatible propositions: no defaults, no exit, and no bail-outs. While member states all agreed to this arrangement, everyone placed greater and lesser emphasis on different elements. The Germans cared more about the "no bail-out" clause, while the financial markets clearly thought the "no default" and "no exit" clauses were paramount. This might not have been so bad were it not for the fact that, unlike the old gold standard or other currency peg regimes, countries in the euro zone have no easy means of escape. They cannot simply devalue. Instead, they would have to replace an existing currency with another one—a process that would immediately lead to capital flight and the collapse of the local banking system. Moreover, many private debts would remain denominated in euros. Devaluation could actually increase the indebtedness of households and firms.

It is entirely possible that the pain associated with leaving the euro will become relatively attractive compared to the pain of staying within it but, according to Mr Münchau, there is a better way: the creation of a genuine "banking union". The key feature would be a pan-euro-zone deposit insurer and resolution authority modeled after the American Federal Deposit Insurance Corporation. This solution has the virtue of forcing the lenders from northern Europe to take their lumps for having been so imprudent in shoveling money to the south, while also breaking the link between troubled banks and government indebtedness that has been so ruinous in Spain and Ireland. So far, most politicians in the north are opposed. What they fail to understand, according to Mr Münchau, is that, "the euro zone is not an optimal currency area. Our task is to make it one."

The final presenter, Mr Schwartz Giron, is perhaps best known in the anglosphere for debating Paul Krugman over the summer about the merits of austerity. On Thursday's panel, he focused on the experience of the Baltic nations, which endured tremendous pain in order to keep their currency pegs to the euro. This was achievable for several reasons, particularly the relatively low levels of indebtedness prior to the crisis. Moreover, keeping the pegs was desirable because most private borrowing had been denominated in euros. Also, the small nations were desperate to remain part of Europe. As a result, they were willing to endure Depression-level declines in GDP if that was the price of independence from Russia's orbit.

While interesting, it is unclear how applicable this experience is to Greece or Mr Schwartz Giron's native Spain. The levels of GDP in Latvia, Lithuania, and Estonia are still below the pre-crisis peaks, while unemployment remains excruciatingly elevated. In that sense, the Baltic nations have not meaningfully escaped the crisis. To be fair, they have been improving steadily since the trough in 2009, unlike the peripheral nations of the euro zone, which continue to do worse and worse. But does this really mean, as Mr Schwartz Giron argued, that the euro zone's problem has been the shallowness of its recession thus far? More controversially, Mr Schwartz Giron argued that the euro has to be held together without any bail-outs or transfers in order for it to fulfill its purpose as the new gold standard. It is not clear whether the founders of the euro thought of it that way. The other panelists did not seem to share Mr Schwartz Giron's view.

Each member of the panel had a distinct view on what had gone wrong in the euro zone, although all implicitly agreed that the blame could be assigned to dysfunctional institutions and insufficient attention to rules. In that sense, they were like their

American counterparts discussing the virtues and vices of the Fed's actions. The unresolved question for both currency areas is how to make them work better.