

Recommendations for Further Reading

Timothy Taylor

This section will list readings that may be especially useful to teachers of undergraduate economics, as well as other articles that are of broader cultural interest. In general, with occasional exceptions, the articles chosen will be expository or integrative and not focus on original research. If you write or read an appropriate article, please send a copy of the article (and possibly a few sentences describing it) to Timothy Taylor, preferably by e-mail at taylort@macalester.edu, or c/o Journal of Economic Perspectives, Macalester College, 1600 Grand Ave., Saint Paul, Minnesota, 55105.

Smorgasbord

The Bank of International Settlements, in its 80th annual report includes a chapter on “Low Interest Rates: Do the Risks Outweigh the Rewards?” Previous episodes of low interest rates suggest that loose monetary policy can be associated with credit booms, asset price increases, a decline in risk spreads and a search for yield. Together, these caused severe misallocations of resources in the years before the crisis . . . In the current setting, low policy rates raise additional concerns since they are accompanied by considerably higher long-term rates. This may lead to a growing exposure to interest rate risk and delays in the restructuring of the balance sheets of both the private and public sector. The situation is further complicated because low interest rates may have caused a lasting decline in money market activity, which would make the task of exiting from loose monetary policy

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same assets. When leverage is loose, asset prices go up because buyers can get easy credit and spend more. Similarly, when leverage is highly constrained, that is, when credit is very difficult to obtain, prices plummet. This is what happened in real estate and what happened in the financial markets. Governments have long monitored and adjusted interest rates in an attempt to ensure that credit did not freeze up and thereby threaten the economic stability of a nation. However, leverage (equivalently, collateral rates) must also be monitored and adjusted if we are to avoid the destruction that the tail end of an outsized leverage cycle can bring. . . . Put bluntly, the market alone will not take care of outsized leverage. It is thus imperative that the Fed put outside limits on leverage. . . . The most direct way to regulate leverage might be by empowering a 'leverage supervisor' who could simply forbid loans at too high leverage in ebullient times, setting different leverage limits for different security classes. Banks would simply not be allowed to lend 97 percent of the value of the house, and repo lenders would not be allowed to reduce haircuts too far." Federal Reserve Bank of New York *Economic Policy Review*, August 2010, vol. 16, no. 1, pp. 101–131. At (<http://www.newyorkfed.org/research/epr/10v16n1/1008gean.pdf>).

James M. Buchanan reflects on "The Constitutionalization of Money." "[T]here is no economic reason why any money system, in an idealized setting, would allow for leverage at any level. No holder of a unit of money, as an entry in a balance sheet, should be authorized to lend more than the face value of this unit, quite independent of probabilistically determined expectations concerning potential redemptions. Why not? Because to allow separate banks to create short-term liabilities to a multiple of the base money on the asset side of the account removes from the issuing authority some of the control of the aggregate amount of that value treated as money in the economy without offsetting benefits, thereby making the financial structure vulnerable to unpredictable shifts among instruments, which, in turn, generate changes in real values. The modern dilemma is that we are left with a massive resource-using, financial-banking structure that has a functional purpose quite different from that which is widely accepted. The system in existence emerged from a historical process, the characteristics of which were partially appropriate for a monetary standard defined in terms of some commodity base, but which, ultimately, make no sense under a fiat system." *Cato Journal*, Spring/Summer 2010, vol. 30, no. 2, pp. 251–58. This issue and the Fall 2010 issue of the *Cato Journal* include nearly two dozen papers on the subject of "Restoring Global Financial Stability." As James Dorn writes in an "Editor's Note": "Even if it is unlikely that the Federal Reserve and other central banks would be abolished any time soon, it is useful to consider the properties of private, rule-based, market-friendly monetary regimes." Available at (<http://www.cato.org/pubs/journal/index.html>).

Government Deficits and Debt

Gene Steuerle describes "America's Related Fiscal Problems" and Henry Aaron responds with "How to Think about the U.S. Budget Challenge" in a point/counterpoint