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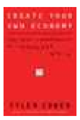

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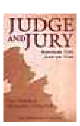

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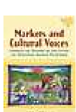

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Faith in the Fed- my last word

In his response to my critique, Tyler calls the Federal Reserve the "saviour institution," a most un-Tyler like phrase although consistent with his earlier plea that all will be well if we just put our faith in the Fed.

Clearly, I am less of a true-believer than Tyler but lets turn from faith based argument towards substantive matters.

I said the case for the Fed is weak, Tyler responds that the case for free banking is weak--this is not a rebuttal. The point is more than rhetorical since there are many alternatives to the Fed as we know it, Scott Sumner has relentlessly made the case for nominal-GDP targeting (with futures markets), Kotlikoff makes the case for limited purpose banking, Tyler and Randy Kroszner once made the case for a similar idea, mutual fund banking (Tyler is less favorable today), Selgin and White make the case for free banking, and of course there are also commodity standards such as a gold standard and the BFH system (e.g. see this piece by Bill Woolsey). Since the case for the Fed is weak, I see work on all these alternative institutions as important and valuable.

In the 1970s and 1980s there was a large literature on rules versus discretion at the Fed, that literature faded out with the great moderation. The great moderation today looks more like a combination of luck and structural change rather than discretionary wisdom. The Selgin, Lastrapes, White paper can be read as an argument to put greater weight on rules.

Tyler argues (but compare here) that "Many of the Fed's most serious mistakes are sins of *omission*, not *commission...*" and then he seems to argue (it's not entirely clear) that alternative institutions are all omission and thus cannot do better. The rules versus discretion debate shows us the falsity of this conjunction. As Sumner has repeatedly reminded us a nominal GDP rule would have required more action not less. Moreover, it's quite possible that other alternative institutions such as free banking would also do better on avoiding sins of omission as well as commission.

Tyler says:

> It takes a good deal of imagination to believe that the Fed's periodic overreaches outweigh the benefits it provides through countercyclicality.

If this were correct the benefits of the Fed in reducing variability would be obvious in the data. The benefits are not obvious in the data, why not? I see several possibilities.

1) As Milton Friedman showed, once we take into account lags and uncertainty it's quite easy to see how counter-cyclical monetary policy can backfire even when the case for monetary policy is strong.

2) As I suggested above, it could also be that alternative institutions

performed about as well on counter-cyclicality as the Fed.

3) It could also be that counter-cyclical monetary policy is not as important as we think. Tyler has argued strongly that the current recession is majority structural (e.g. here, here, here) and thus that neither monetary nor fiscal policy is very effective. If a lot of recessions are structural then monetary institutions of any kind might not matter that much.

Posted by Alex Tabarrok on November 21, 2010 at 05:29 PM in Economics, History | Permalink

Comments

So Tyler now has to defend a specific monetary policy, not just the institutions, against practically all alternatives? We call that "moving the goalposts" over here, after the ball has been kicked no less.

Posted by: Millian at Nov 21, 2010 6:10:04 PM

Last word is for Alex! (unless you count this...)

Posted by: Tyler Cowen at Nov 21, 2010 6:12:35 PM

By the way people, Alex and I more frequently had back-and-forth debates in the early days of MR. You can try the archives, I recall one being about school vouchers. Oddly, the WSJ complained, in print, that we were doing this.

Posted by: Tyler Cowen at Nov 21, 2010 6:20:50 PM

We need better rules, less discretion. Less uncertainty about the gov't. More bankruptcy, especially of the super-rich, super-powerful.

Dems who complain about tax cuts for the rich ... protected them in the Big Bailout (with Bush & McCain cheerleading).

Letting all the Big Banks & AIG type non-banks go bankrupt would have done wonders for reducing income inequality. Also reduced the Moral hazard.

And it's unlikely to have reduced, at all, the loans available to Main Street for new factories or new suppliers of profitable services.

Currently, there are too many bankers. Just like, at the end of 2006, there were too many construction workers. But it was obvious that housing had been overbuilt; it surprisingly doesn't seem as obvious that finance workers are over employed.

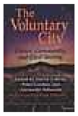
Alex, please make this your last word only for today, or maybe a couple of days. Of the Fed alternatives, which one do you think is most worth arguing in favor of?

(See more remarks on my blog .)

Posted by: Tom Grey at Nov 21, 2010 6:26:42 PM

Tyler puts his comments below the fold and Alex above the fold. A little more assertive for Alex, or perhaps the assertiveness is from Alex having to be more defensive of a bad argument.

We're lucky the Mesopotamian cultures dropped iron for their currency, as that store of wealth would have been a poor choice of an item of



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Alexander Tabarrok: Changing the Guard: Private Prisons and the Control of Crime

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