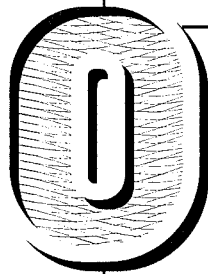


Monetary Policy and the Great Recession



Once, years before the onset of the Great Depression, John Maynard Keynes offered a laundry list of things to which people attribute economic hard times – everything from structural factors to technological change to moral decline. But he then observed that the root of the problem was typically monetary. Keynes was prescient; while conventional wisdom sees it otherwise, the origins of the Great Recession of 2008-09 largely lie in monetary policy, as does the way back to prosperity.

Back in 1998, after publication of my book on the Depression, I was asked what caused that catastrophic collapse of output and employment in the early 1930s. I answered (as others

have) that the decline had its origins in deflationary monetary policy – but reassured the questioner that we weren't likely to see the same mistakes again. Looking at developments since 2008, though, I am dismayed by the similarities between the current policy debate and that of the late 1920s and early 1930s.

Today, hands-on monetary policy is an orphan; no influential group understands and embraces it. Those leaning left have generally treated monetary tools for fighting slow growth as inapplicable or otherwise suspect, and have called instead for public spending and jobs programs to “reboot” the economy. Those to the right are inclined to follow the siren call of hard money and assume that expansion of the money policy is the road to inflation – which, for them, ends the discussion. Also, many on the right have injected some Old Testament fervor into the mix, arguing that the United States must pay for past financial excesses with massive deleveraging of all kinds of private and public debt, which must necessarily exact great pain.

Neither side is persuasive. Monetary policy still matters – a lot. What's more, given the dollar's international role, monetary policy has secondary effects that add to the need to understand how it affects the economy.

Indeed, it's hard to imagine a time in which getting monetary policy right has mattered more. It will largely determine whether the economic recovery stalls or succeeds, who wins the 2012 elections, whether the budget deficit appears more manageable in the next few years and perhaps even whether the unemployment-fueled violence that has swept through Greece and Britain will be visited on America.

I've broken my analysis into the building blocks of the argument against monetary activism (myths) and the counter-arguments (realities).

Myth and Reality

**BY CLARK
JOHNSON**

Myth: The Federal Reserve has followed a highly expansionary monetary policy since August 2008.

REALITY: NEARLY THE OPPOSITE IS THE CASE.

The widely held view that the Federal Reserve has pursued an expansionary policy is based on the rapid growth of some measures of the quantity of money in circulation, and on the Fed's publicly stated goal of keeping short-term borrowing rates very low. But look more closely at each.

The Fed's assets expanded from about \$900 billion in August 2008 to \$1.8 trillion in October 2008 (along with liabilities, since it pays for the assets with cash that ends up as bank deposits); they reached \$2.8 trillion by late July 2011. And it's widely assumed that this trebling of the central bank's balances has led to a trebling of liquidity.

No so. The great bulk of the increase in Fed liabilities has been in the form of bank reserves (commercial bank deposits in Fed accounts) in excess of the minimums required by Fed regulation. These excess reserves have increased *800-fold*, from a mere \$2 billion in August 2008 to about \$1.6 trillion in July 2011. There is no credit-expansion effect from excess reserves as long as they remain on deposit with the Fed rather than loaned to businesses or households.

The reserve accumulation is in large part a response to the Fed's decision in October 2008 to pay interest on reserves for

the first time since the Fed was established in 1913. Rates on reserves have since been set at levels slightly higher than Treasury bill yields, which gives commercial banks every reason to empty their books of T-bills and place the proceeds in their risk-free reserve accounts at the Fed. The impact is almost identical to "open market" sales by the central bank – which are deliberately deflationary.

There has also been an increase in currency in circulation, from \$800 billion to just over \$1 trillion in the same period. Much of the increase occurred during the distress of 2008 and 2009 and reflected demand for immediate liquidity – not an increase in loanable funds. Thus, on balance, any increase in monetary aggregates has been inadequate to offset the crisis-induced boost in appetites for liquidity.

On Sept. 18, 2008, at a tense juncture three days after Lehman Brothers collapsed, the Fed met and chose not to lower the overnight funds rate from its 2 percent target – an indication that the central bankers had yet to see the need for easier money. When they did see the need, the rate was gradually lowered until mid-December 2008, when the target was set in the very low 0 to 1/4 percent range.

But a near-zero market interest rate – as reflected in the rate that banks charge in overnight loans to other banks – is not al-

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ways expansionary; it may simply reflect aversion to risk in uncertain times. It occurs because commercial banks' supply of unused cash exceeds demand on the part of interbank borrowers. Near-zero interest rates then reinforce this dynamic from the side of lenders. As a consequence, the interbank market is now only one-third the size it was before the 2008 collapse, which makes it more difficult for banks to facilitate commercial lending. It is hard to anticipate any financial sector contribution to an economic recovery until interest rates recover to more normal levels.

Because of the dollar's role as the international currency of choice for storing liquid assets and for financing trade, its exchange value is a useful measure of global liquidity conditions. Until July 2008, with the dollar as weak as \$1.60 to the euro, monetary conditions were quite easy. Then, from early July to mid-October 2008 the dollar rose rapidly to \$1.25/euro, an indication of systemic liquidity squeeze. The Nobel laureate Robert Mundell has argued that if central banks had chosen to stabilize exchange rates somewhere between the dollar's July low and the October high – perhaps in the \$1.40/euro to \$1.45/euro

range – much of the downturn might have been avoided.

This result could almost certainly have been achieved through aggressive, coordinated interventions in the government-debt and foreign-exchange markets. That it was not accomplished was, Mundell concludes, “one of the worst mistakes in the history of the Federal Reserve.”

Beyond these specific missteps, the evidence suggests a broader systemic problem: the Fed has a cramped and unimaginative view of its capacities. Monetary policy works best by guiding expectations of growth and prices, rather than by just reacting to events by adjusting short-term interest rates. The comments of Ben Bernanke during the past three years suggest either lack of conviction about the economy's prospects or acquiescence to expectations of low rates of growth. Instead of assuring the market that growth will be restored, the Fed has set interest-rate targets or promised to undertake specific volumes of open-market operations over defined periods. Much more could be done to create the expectation that the liquidity needed to sustain high rates of growth would be provided.

Myth: Recovery from recessions triggered by financial crises is necessarily slow.

REALITY: EFFECTIVE MONETARY POLICY CAN BRING RAPID RECOVERY FROM FINANCIAL CRISIS.

Compare the aftermaths of the Depression and the nasty recession of 2008-09. The

earlier meltdown involved a stock market crash, followed by upheaval in the banking

sector. In the more recent case, the impetus for downturn was rising doubt about the quality of bank assets, which led to a freeze in lending between financial institutions.

In 1933, recovery occurred as soon as the Roosevelt administration demonstrated that it would take aggressive action to expand liquidity and allow prices to recover. In the 2008-09 case, aggressive monetary ease never really came.

During the first four months of Roosevelt's first term in 1933, industrial production rose by an astonishing 57 percent, the fastest rate ever recorded for a four-month period in the United States. The trigger for recovery was the decision to allow the dollar to float – and, hence, to depreciate – against gold, which was then the world's essential monetary reserve. Doing so led to the expectation that money would be more abundant and prices would rise, which would then facilitate recovery of profits, investment and hiring.

The decision to depreciate the dollar was reinforced at the World Monetary Conference in June, where Roosevelt rejected pressures to fix a new dollar-gold price. Financial markets interpreted Roosevelt's action as again encouraging easier money and price recovery, and stock prices rose again.

Those steps represented the best of Roosevelt's economic initiatives. Unfortunately, he subsequently listened to advisers who discounted the importance of monetary factors. They believed the source of economic hardship was unconstrained free markets that drove down wages and profits – and thus attempted to raise prices by cartelizing industry and restricting output.

This prolonged the Depression considerably – but that's another story.

The proximate cause of the 2008 financial crisis was doubts about the quality of bank assets, reflecting concerns about the banks' holdings of mortgage-backed securities and other difficult-to-price assets. That did not happen overnight: spreads between the interest rate on short-term interbank loans and U.S. Treasury obligations (a reflection of concern about bank solvency) started to rise as early as September 2007, spiking in late September and early October of 2008. Then, on Oct. 13, the Treasury acted through the Troubled Asset Relief Program to extend long-term loans to the large banks. By mid-November, the spreads fell back to where they had been in late September, and they continued downward over the next several months.

If the recession had been driven primarily by credit concerns and a frozen financial sector, it would have eased with the injection of TARP money. But equity and commodity prices around the globe continued to fall for several months following the bank recapitalizations. Only in March 2009 did the Fed begin modest "quantitative easing" (QE), which involved purchases of specified volumes of government securities over a specified period.

QE, along with another round of quantitative easing in 2010 (dubbed QE2), probably had much to do with powering the subsequent two-year recovery in financial markets. But reaction to quantitative easing from the political right has been highly critical, which may have lessened the Fed's enthusiasm for more aggressive measures.

Myth: Monetary policy becomes ineffective when short-term interest rates fall to close to zero.

REALITY: CENTRAL BANKS HAVE WAYS OF STIMULATING DEMAND EVEN WHEN INTEREST RATES HIT BOTTOM.

Keynes pointed to the circumstance – dubbed the “liquidity trap” – in which “the central bank would [lose] effective control of the rate of interest.” Under such conditions, it was (and still is) argued, a central bank’s purchase of short-term Treasury securities on the open market will not be expansionary because the replacement of ultrasafe, highly liquid securities with cash in private portfolios will have little systemic impact.

But there are alternatives to “monetizing” existing debt.

Central banks can use a more aggressive technique (sometimes called a helicopter drop) to monetize new debt. This technique combines Treasury issue of a new security with the Fed’s cash purchase of an already existing Treasury security. The effect is a net increase in cash in the system that, unlike conventional monetary tools, increases net liquid assets.

There’s also a less-radical expansionary measure available to the Fed: it could reverse the unfortunate 2008 decision to pay interest on excess bank reserves held in Fed accounts. Doing so would give banks a profit incentive to increase commercial lending, as large chunks of balance sheets now earning interest would otherwise lie idle.

This discussion, though, still misses the most important influence that central

banks should have over monetary policy, even in conditions of near-zero short-term rates. As Lars Svensson, deputy governor of Swedish Riksbank, observed a few months before the 2008 crisis:

It is now generally acknowledged that monetary policy works mainly through the private-sector expectations of future interest rates and future inflation that central-bank actions and statements give rise to. Those expectations matter much more than the current interest rate. That is, monetary policy is “the management of expectations.”

We have gotten frequent pledges from the Federal Reserve during the past three years of its intention to continue to focus on interest rates and to keep short-term rates close to zero. Yet, far from an augury of an improved liquidity environment, this Fed “assurance” seems more like a forecast that slow growth and high unemployment will continue well into the future.

The critics of quantitative easing are right in one respect. It would be better used as part of an overall effort to shape expectations, and hence to convince markets that interest rates would return to normal levels. Instead, the program has involved Fed purchase of long-term Treasury securities, with the intention of *lowering* their yields. So, while quantitative easing has provided some additional liquidity, it has not addressed the imbalances introduced

by the near-zero rate trap.

Where interest rates are stuck in a liquidity trap, it is usually because markets believe that central bankers are not serious about prying back the trap's hinge – that is, committing to policies that give greater weight to employment and growth. One observes repeatedly that central bankers assert either that they are not capable of undertaking, or not legally permitted to undertake, what, for doctrinal or political reasons, they do not want to do.

Keynes' own view of the way monetary policy works was more nuanced than many of his disciples suggest. He acknowledged later in *The General Theory of Employment, Interest and Money* (1936) that an increase in the quantity of money could affect business expectations and investment independently of any effect on interest rates. This contradicts the frequent claim that Keynes thought monetary policy might become completely ineffective in a low-interest-rate environment.

Myth: The greater the indebtedness incurred during growth years, the larger the subsequent need for debt reduction and the greater the downturn.

REALITY: THE PACE OF RECOVERY LARGELY DEPENDS ON CURRENT POLICY, NOT ON PAST EXCESSES.

Non-economists sometimes think it is self-evident that piling up debt requires a painful reckoning. Indeed, the "Austrian" school of economics is often cited to support the view that systemwide deleveraging must delay recovery.

Part of what is at issue here is the misleading resemblance between managing the finances of a household or business and the dynamics of national finance. Deleveraging a national economy *can* reduce aggregate spending, but need not. A recent blog post by David Beckworth, an economist at Texas State University, makes the distinction:

Yes, deleveraging is a drag on the economy, but for every debtor deleveraging there is a

creditor getting more payments. ... In principle the creditor should increase spending to offset the debtor's drop in spending. The reason they don't – creditors sit on their newly acquired funds from the debtor instead of spending them – is because they too are uncertain about the economy. There is a massive coordination failure, all the creditors are sitting on the sideline not wanting to be the first to put money back to use. If something could simultaneously change the outlook of the creditors and get them to all start using their money at the same time then a recovery would take hold. Enter monetary policy and its ability to shape nominal spending expectations.

Deleveraging becomes a systemic problem if it leads to uncertainty that increases

demand for liquidity, and thereby slows spending. But uncertainty can be overcome by new injections of liquidity – that is, through monetary policy. Milton Friedman reached this conclusion way back in 1969, using data to cover expansions and downturns over more than 80 years. He wrote that “there appears to be no systematic connection between the size of an expansion and of the succeeding contraction,” and concluded that this phenomenon cast “grave doubts on those theories that see as the source of a deep depression the excesses of the prior expansion.”

A closely related argument in the past was that central banks should discount

(that is, issue money in exchange for) only “commercial” bills (short-term business debt), and not “financial” bills (debts of financial institutions). When the need to de-leverage arises, goes this “real bills” doctrine, fewer commercial bills will be issued, hence there will be less discounting at the central bank, and less systemic liquidity. This practice caused more uncertainty rather than less, and made downturns worse. Lingering adherence to real-bills doctrine among United States and French officials in the late 1920s and early 1930s became an impediment to undertaking monetary measures necessary to overcome the Great Depression.

**Myth: When monetary policy breaks down,
there is a plausible case for a fiscal response.**

**REALITY: NOT USUALLY. FISCAL ACTIVISM
WORKS ONLY WHERE EXPECTATIONS AND THE
MONETARY ENVIRONMENT SUPPORT IT.**

The cycle of uncertainty and rising liquidity preference can be broken by purposeful central bank action, which undermines the case for fiscal activism. But that begs another question: does fiscal stimulus ever work – and, if so, under what circumstances?

Fiscal policy has been caught in the battle between big-government liberals and small-government conservatives. The former, one might infer, will leap on any argument to justify government spending. The latter, by contrast, see economic downturn as an opportunity to “starve” government – and will

reject any government spending, even one-off temporary stimulus spending, as a means of escaping near-depression conditions.

Views regarding effectiveness of fiscal stimulus are, at first glance, irreconcilable. Paul Krugman of Princeton and *The New York Times* often cites studies to support it. John Taylor of Stanford (and formerly of the Bush administration) argues that fiscal stimulus has done little to boost spending or investment.

In fact, there is much common ground in their positions. Krugman would no

doubt agree with Taylor that most fiscal stimulus has had limited success because, when people do not expect the stimulus to last, they save rather than spend what they believe are temporary boosts in income.

Keynesian fiscal activists often cite the impact of the U.S. military buildup beginning in 1940, which finally brought an end to Depression-era stagnation and unemployment. But there's no contradiction here: military spending worked as fiscal stimulus precisely because it was expected to last.

This brings us full circle. Expansionary

monetary policy can break the lock of the zero-interest trap only when it succeeds in driving market expectations. Similarly, fiscal stimulus will succeed if it reduces uncertainty to the point that market participants are ready to resume spending.

Fiscal activism thus works when it succeeds in altering monetary dynamics – that is, by increasing the public's demand for liquidity and its willingness to spend. In the unusual event that the market can be convinced that fiscal stimulus is likely to endure, it can succeed. Otherwise, probably not.

Myth: The rising prices of food and other commodities are evidence of expansionary monetary policy and inflationary pressure.

REALITY: RISING COMMODITY PRICES REFLECT (IN PART) INTEREST-RATE-DRIVEN SPECULATION. THUS, IF THE LEADING CENTRAL BANKS COULD REGAIN CONTROL OF INTEREST RATES, SPECULATION WOULD DECLINE.

Commodity prices have increased at a rate of 20 percent or more annually since 2007, except for a sharp plunge from about the middle of 2008 to the middle of 2009. And it is widely asserted in popular discussion that the rise in commodity prices was a consequence of the expansionary policies of Bernanke and his “wrecking crew” at the Fed.

Economic growth in emerging markets (in contrast to growth in the United States and Western Europe) tends to be linked proportionately to consumption of commodities. Indeed, the evidence is clear that commodity price changes correlate closely

with growth, or lack of it, in emerging markets (including China, India, Indonesia and Brazil, whose dynamic economies are not tightly linked to their own resource endowments). And, given the prospect of high growth in these countries, it is likely that the cost of commodities will continue to rise in the United States and the other industrialized countries.

There is more to it, though. Added liquidity in the United States has spilled into emerging markets. Central banks in these rapidly growing countries have responded by trying to mop up this liquidity by selling bonds and otherwise containing domestic

monetary growth. But their efforts have been thwarted in part by “hot money” flows attracted by much higher interest rates than are available in stagnating near-zero interest rate environments – notably in the United States.

At the very least, then, it is in the interest of the United States to not oppose the imposition of capital controls by countries threatened by “hot money” flows. The most desirable policy (from our perspective as well as that of emerging markets) would be a U.S. monetary policy that in-

creased investment opportunities at home. U.S. financial markets seem to anticipate that commodity price increases do not presage a general increase in prices. Yields on medium- and long-term bonds generally reflect the market’s expectations of inflation. And the yield on five-year U.S. Treasuries fell in early August 2011 to the lowest level in more than half a century, even as commodity prices continued to rise. Inflation, present or future, appears to be the least of concerns in the U.S. Treasury market these days



The Road Forward

The Japanese experience of near-zero interest rates over the past two decades should serve as a warning of the consequences of setting the goals of monetary policy in terms of interest rates rather than in terms of expectations. The zero-interest trap has meant stagnation, weak financial markets and soaring national debt. Yet the Federal Reserve has indicated that its near-zero rate policy, in place since late 2008, will now continue at least into 2013.

To be effective, U.S. monetary policy must include a program for raising interest rates to levels at which the interbank credit market can function. Financial markets are global rather than national, so it might be difficult for a single central bank to take such action. Ronald McKinnon, the Stanford economist, has thus proposed that the four leading central banks (the Fed, the European Central Bank, the Bank of England and the Bank of Japan) “move jointly and

smoothly to phase in a common minimum target – say, 2 percent – for their basic short-term interbank rates.”

Such an agreement would help break the central banks’ habit of using interest rates as their primary tool in fighting recession. Once somewhat higher interest rates were again in place, further additions to monetary stocks would be more likely to find their way into commercial lending – and less likely to turn up as “hot money” in emerging markets.

There is little recognition today that tight monetary policy is even an issue, or of the role it had in converting a banking crisis into the 2008-09 Great Recession. It took three decades after the 1929-32 crash – until the publication of Friedman and Schwartz’s *Monetary History* – for understanding of its monetary causes to reach anything like critical mass. One wonders how long it will take this time. M