BOOM AND BUST BANKING

The Causes and Cures of the Great Recession

Edited by David Beckworth

Boom and Bust Banking
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Introduction

David Beckworth

IN 2009, the entire world economy stopped growing, the first time this had happened in well over fifty years. In the United States, the epicenter of the great recession, GDP shrank, unemployment rates skyrocketed, and budget deficits exploded. The twenty-first century had opened with optimism, as first technology and then housing boomed, but by the end of the decade confidence had been drained. Why did the boom-and-bust cycle return in such force after several decades of economic stability? Most studies answer this question by pointing to financial innovation, a global saving glut, poor governance, industry structure, housing policy, and misaligned creditor incentives.[1] Though these areas are an important part of the story, the amount of attention given to them makes it easy to ignore the errors of perhaps the single most powerful actor in the world economy today, the U.S. Federal Reserve.[2] The chapters in this book offer some much-needed perspective by shifting the focus back to the Federal Reserve. These essays conclude that the wide swings in the economic activity could not have occurred without the destabilizing policies of the Federal Reserve.

Former Federal Reserve Chairman William McChesney Martin once famously quipped that it was the central bank's job to take away the punch bowl

1. A notable exception is John Taylor in his 2009 book, *Getting Off Track: How Government Actions Caused, Prolonged, and Worsened the Financial Crisis* (Stanford: Hoover Institution Press, 2009).

2. For example, the Financial Crisis Inquiry Commission concluded that a host of governance, ethics, and market failures were key contributors to the financial crisis but that "excess liquidity did not need to cause a crisis." (See Financial Crisis Inquiry Commission, "Conclusion of the Financial Crisis Inquiry Commission," 2011, 12, http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_conclusions.pdf.)

just as the party is getting good. The essays in this book show that rather than follow this advice, the Federal Reserve spiked the punch bowl and then kicked the hung-over economy out to the street at the worst possible time. Monetary policy was strengthening the business cycle instead of leaning against it during the 2000s.

The context for this "leaning with the wind" rather than against it by the Federal Reserve begins with the expansion that followed the 2001 recession. Though centered on housing, this expansion grew and pulled in many different parties including builders, subprime borrowers, mortgage originators, investment bankers, rating agencies, and investors from around the world. It also elevated the importance of structured finance and the shadow banking system. The pace of the expansion accelerated and soon it became the Great Boom of the 2000s. Like other big booms before, it was characterized by excessive leverage, mispricing of risk, soaring asset prices, and a pervasive "it's different this time" optimism. By 2007, however, the Great Boom had ended. It was soon followed by financial stress and the beginning of what was initially a mild recession. By late 2008, the financial stress had turned into a severe financial crisis that froze up credit markets and led to a sharp decline in the stock market. Similarly, by late 2008, the mild recession had mutated into one of the sharpest economic downturns since the Great Depression. This Great Recession was characterized by a dramatic collapse in spending and double-digit unemployment.

Chapters by Lawrence H. White, David Beckworth, Diego Espinosa, and Chris Crowe show that the leaning with the wind began when the Federal Reserve failed to tighten monetary policy sooner in the 2002–2004 period. The economic recovery was well underway by that time and yet monetary policy remained extremely accommodative throughout this period. As a result, the recovery that followed the 2001 recession got turned into the Great Boom. Chapters by Scott Sumner, Jeffrey Rogers Hummel, Bill Woolsey, and Nicholas Rowe show that when the economy began contracting in 2008, the Federal Reserve once again leaned with the wind by effectively tightening monetary policy. This response turned what was initially a mild recession into the Great Recession.

Going forward, what can be done to avoid repeating these monetary policy mistakes? Chapters by Joshua Hendrickson, William R. White, Laurence Kotlikoff, and George Selgin address this question. They acknowledge as a

starting point that monetary policy should do a better job stabilizing nominal spending in a rule-based fashion. Several chapters even make the case for a nominal income-targeting rule. One implication of these chapters is that had the Federal Reserve been stabilizing nominal spending the Great Boom and the Great Recession of the 2000s may have never happened. Other chapters, however, question if stabilizing nominal spending is enough, or if it is even possible, given our current institutional arrangements for monetary policy. These essays, therefore, call for other reforms that aim to reduce the procyclical tendencies of the financial system while other chapters call for alternative monetary institutional arrangements altogether. Given the ongoing interest in reforming the Federal Reserve, these chapters provide a good starting point for considering how to do it and more generally how to maintain macroeconomic stability.

Creating the Great Boom

The chapters of the book are divided into three parts. The first explains how the Federal Reserve helped to create the Great Boom of the 2000s. Lawrence H. White begins with an overview of the U.S. monetary policy during the early-to-mid 2000s and how it contributed to the housing boom. It is well known that the Federal Reserve kept its target federal funds rate extremely low over this period. White shows that not only was it low, but that it was low relative to the Taylor Rule and a measure of the neutral federal funds rate. In other words, the Federal Reserve kept interest rates lower than what was warranted by economic fundamentals. White demonstrates that this sustained easing of monetary policy was systematically related to various measures of the housing boom. He also shows that the Fed's monetary policy influenced the types of mortgages originated during the housing boom and that the misaligned incentives in the financial system amplified the effects of monetary easing.

A natural question that follows from the first chapter is why did the Federal Reserve keep monetary conditions so easy for so long? David Beckworth explains that it was because monetary authorities failed to properly handle the productivity boom during that time. Total factor productivity (TFP) growth averaged 2.5 percent a year between 2002 and 2004, a vast increase over the average 0.9-percent growth for the preceding thirty years. He notes that such rapid gains in

TFP growth put downward pressure on the price level, expanded the capacity of the economy, and put upward pressure on the neutral federal funds rate. The Federal Reserve, however, saw the resulting disinflation and excess economic capacity as symptoms of continuing slack in aggregate demand. It feared raising the federal funds rate. As a result, the Federal Reserve loosened monetary policy and helped turn a beneficial productivity boom into a housing boom. Ironically, the Federal Reserve understood that the productivity boom was contributing to the disinflationary pressures and the growing economic capacity. The Federal Reserve, however, could not get past its fear of these developments to make the proper policy calls.

Diego Espinosa next shows that the Federal Reserve's policy not only enabled the housing boom, but it also helped bring about many of the problems in the financial system. In particular, he shows that the low-interest rate policy coupled with the expectation that it would persist signaled to investors there was a new carry-trade game in town. One could now borrow at predictably low, short-term interest rates and invest in higher-yielding long-term assets. All else equal, investors wanted to invest in relatively safe higher-yielding assets to ensure a predictable spread. The financial system responded to the increased demand for such safe assets by securitizing more mortgages, including subprime ones, through the process of structured finance. The surge in subprime lending and the growth of the shadow banking system, therefore, was tied to the Federal Reserve's accommodative monetary policy.

One critique of the view that U.S. monetary policy was a key driver of the U.S. housing boom is that the global housing market was booming too. How could the Federal Reserve be responsible for a phenomenon that was happening across the globe? Given this critique, many observers point to the saving glut hypothesis as an alternative explanation. This view holds that excess savings coming from emerging economies and oil exporters depressed interest rates globally and fueled the boom. David Beckworth and Chris Crowe respond to this critique by arguing that a more likely explanation is that the Federal Reserve is a monetary superpower with global influence. They show that the rise in global liquidity, the drop in global interest rates, and the buildup of foreign reserves during the early-to-mid 2000s can be explained by monetary policy in the United States. They also show that some of the saving glut is nothing more than U.S. monetary policy being recycled back into the U.S. economy.

Creating the Great Recession

The second part of the book examines the role the Federal Reserve had in creating the Great Recession of the 2000s. As noted above, the recession that started in December 2007 turned virulent by the end of 2008. Why did this happen? Scott Sumner explains it as a failure by most macroeconomists to see what was really happening to the economy. The standard view at this time was that the severe financial crisis in late 2008 made the recession worse, that monetary policy had been very accommodative, and that the zero interest rate bound was preventing the Federal Reserve from providing any more monetary stimulus. Sumner shows that this understanding was wrong. Monetary policy actually was tightening throughout much of 2008 and putting pressure on financial markets. This tightening was the main culprit behind the eruption of the financial crisis and worsening of the recession in late 2008. Sumner argues that had monetary authorities understood they were tightening, and that monetary policy was not limited by the zero bound, they could have prevented the Great Recession. This would have been possible if they had been paying attention to and targeting expected nominal GDP growth.

Jeffrey Rogers Hummel reaches a similar conclusion on the origins of the Great Recession in his comparison of Ben Bernanke and Milton Friedman. Hummel shows that the reason why the Federal Reserve allowed monetary policy to tighten during much of 2008 had to do with Bernanke's nonmonetary view of financial crises. For him, financial crises are an aggregate supply problem and are best dealt with by the Federal Reserve's lender of last resort role. Consequently, the Federal Reserve created numerous liquidity facilities between August 2007 and August 2008 to prop up the financial system. Milton Friedman, on the other hand, viewed financial crises as the result of monetary policy failing to respond to aggregate demand shocks. Therefore he probably would have been aghast to have seen the Federal Reserve ignore the precipitous decline in velocity in 2007 and 2008 while its attention was diverted to saving the financial system. Hummel notes that another problem with Bernanke's view is that it required the Federal Reserve to engage in the lender-of-last-resort role on a scale so large that it effectively turned the central bank into a central planner of credit.

How monetary policy caused the Great Recession is further explored by William Woolsey in his chapter on monetary disequilibrium. He shows that

what happened in 2008 was the emergence of a pronounced excess money demand problem that was not attended to by the Federal Reserve. Since money lacks its own market but is traded on all other markets, any shock to the supply or demand of it will be disruptive to the entire economy. Given the severity of the excess money demand shock and that it was ignored, it is not surprising then that the economic downturn got turned into the Great Recession. Woolsey also shows that many of the problems associated with the Great Recession such as the liquidity trap, the paradox of thrift, and impaired household balance sheets are nothing more than a manifestation of the excess money demand problem. This chapter shows that to really understand what happened in the Great Recession, one must first understand monetary disequilibrium.

Excess money demand problems did not stop at the U.S. border. As Nicholas Rowe shows, the heightened demand for liquidity went global in 2008. Why it went global speaks to the very nature of what liquidity is and why it matters. Rowe explains that liquidity is the ability to turn an asset into purchasing power quickly, and the asset with the most liquidity is money. During the financial crises, the demand for liquidity and thus money increased. Not all money, however, has the same liquidity. The U.S. dollar with its reserve currency status is the most liquid currency. It is the money for all other monies. Consequently, when the global demand for liquidity spiked in late 2008 only one central bank, the Federal Reserve, was capable of responding. Eventually it did provide dollars through currency swaps to other major central banks, but not before economic conditions had already been adversely affected. Rowe notes that, although the Great Recession is over, the global demand for dollars is still strong in places like Asia. This means the Fed must continue to provide these dollars or face an excess dollar demand that could drive the U.S. economy into recession.

Creating a Better Monetary System

The last set of chapters explores what can be done to avoid the boom-bust cycle in the future. Josh Hendrickson begins this section by making the case for a more rules-based approach to monetary policy. He specially calls for a nominal income-targeting rule as a way to improve macroeconomic stability. He explains the great virtue of nominal income targeting is that it forces the

Federal Reserve to systematically respond to aggregate demand shocks while ignoring aggregate supply shocks. This focuses the Fed's attention on stabilizing total current dollar spending, while allowing it to ignore aggregate supply-driven changes in the price level. Hendrickson also compares nominal income targeting to the popular Taylor Rule. While they are very similar, a nominal income target is far easier to implement in real time. Nominal income targeting only requires one to know the current dollar value of the economy. A Taylor rule, on the other hand, requires knowledge of the appropriate inflation rate, the output gap, and the neutral federal funds rate. All of these are hard to measure with a lag, let alone in real time. Hendrickson concludes that a nominal income target would do much to reduce macroeconomic volatility going forward.

Though sympathetic to nominal income targeting, William R. White wonders whether it is sufficient to prevent credit booms from emerging. He makes the case that focusing too narrowly on aggregate demand stabilization could cause the Federal Reserve to ignore the inherent procyclicality of the financial system. Credit booms would be allowed to emerge, leading to a buildup of economic imbalances. When such economic imbalances burst, it would require the central bank to "clean up" afterwards to keep aggregate demand stable. White is concerned that such cleanups can create their own set of problems as seen in the housing boom that was fueled by the Federal Reserve's attempt to clean up after the stock market tanked in the early 2000s. He, therefore, believes that monetary authorities should not just lean against the business cycle, but against credit cycles. This could be done by adopting what he calls a "macrofinancial stability framework" for policy.

Laurence J. Kotlikoff is even more skeptical that the Federal Reserve can maintain macroeconomic stability given our current institutional arrangements. In particular, he believes that our current financial system is rigged for failure since it so easy for financial institutions to gamble with other people's money. As long as banks and other financial intermediaries have the expectation that gains will be privatized and losses socialized, they will continue to misuse creditors' funds. Kotlikoff believes the entire financial system needs to be reformed along the lines of limited-purpose banking. In this system every financial intermediary would operate strictly as a mutual fund company and live under a common set of rules. There would be two main types of mutual funds: a cash mutual fund

that provides checking account services and other mutual funds that would provide investment opportunities. Under such a system, checking accounts would be 100-percent backed by highly liquid assets. This means the Federal Reserve would gain complete control over the money supply and, in principle, be able to better stabilize aggregate demand.

George Selgin closes the book by asking whether any of these reforms can truly maintain macroeconomic stability as long as there is a U.S. central bank. Selgin shows that central banks in general are inherently destabilizing by comparing them to how monetary conditions would evolve in their absence. In such a system, banks would issue banknotes that would be fractionally backed by some kind of reserve. Historically, this reserve was specie, but in the modern context it could be the U.S. monetary base. Banknotes would circulate much like checks do today and be cleared by banks returning rivals' banknotes directly to them or through a central clearinghouse. Any net dues owed by one bank to another would be settled by transferring reserves. This interbank clearing of banknotes and the resulting transfer of reserves would prevent private banks from issuing too many banknotes given the existing level of money demand. If money demand suddenly changed, then banks would know from the level of interbank clearings whether to increase or decrease the amount of banknotes. In the aggregate, this would result in a stable level of total current dollar spending. Central banks are fundamentally destabilizing, explains Selgin, because they are not subject to the discipline and knowledge created by such interbank clearings. Without this information, then, the Federal Reserve will never know enough to truly stabilize aggregate demand.

The Federal Reserve was more than just a bit player over the past decade. The essays in this book make a strong case that U.S. monetary policy took what would have been an ordinary business cycle and turned it into the Great Boom and the Great Recession. The other contributing factors to the business cycle at this time—including financial innovation, a global saving glut, poor governance, industry structure, housing policy, and misaligned creditor incentives—were of lesser importance. Yes, these developments all came together to form a perfect global financial storm. But a global financial storm needs a global economic force strong enough to catalyze it. This book points to that force being the Federal Reserve.

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