

Commentary: Rethinking Monetary Policy in Light of the Crisis

Alan S. Blinder

A fine effort by Charlie Bean and his colleagues has produced a very nice paper that is perfect for this symposium. I hope you'll all read it. In thinking about monetary policy going forward, the paper touches many of the right bases, saying intelligent things about each. In my 15 minutes, I won't try to take up every issue dealt with in the paper. Regarding what I omit, suffice it to say that I agree with most of his judgments. In my limited time here, I want to focus on a subset of the issues and see if I can goad Charlie into going a bit further on a few by posing a few questions that sound like, "Don't you agree?"

On bursting bubbles

I start with the issue of whether central bankers should try either to burst or lean against asset-price bubbles. The authors are obviously more sympathetic to "leaning against the bubble" than to "cleaning up after." Yet their econometric estimates find that keeping the short rate too low was "more Rosencrantz than Hamlet" when it came to creating housing bubbles in both the United States and the United Kingdom. Yes, higher rates would have led to smaller bubbles in both countries, but not much smaller. If reasonable increases in short rates would have made only modest dents in the bubbles, it follows that it would have taken *huge* increases to stop the bubbles. That conclusion seems right to me, though I have an idea that John Taylor will soon object.

However, I think Bean *et al.* give short shrift to two very important arguments *against* bubble-bursting. The first is that the central bank has *no informational advantage* over market participants in detecting a bubble. The second is that the central bank has *no instruments that are*

well-targeted at bursting bubbles without killing the economy. This is the first place where I'd like to push Charlie a bit further.

Specifically, one can see the dim outlines of a consensus on bubble-bursting emerging. According to this consensus, there are “two” types of bubbles (really a continuum). For equity-like bubbles with relatively little debt finance, such as the tech stock bubble at the end of the 1990s, the best policy is still the one both Alan Greenspan (2002) and Ben Bernanke (2002) recommended: mopping up after. But for debt-financed bubbles, especially if they are importantly bank-financed, it makes sense to intervene early to limit the bubble, though that intervention should probably be more with supervisory weapons than with monetary policy. I have promoted this distinction (Blinder, 2008); so has Rick Mishkin (2008); and so—although more circumspectly (as befits a central bank chief)—has Chairman Bernanke (2010).

What's the rationale for this dual approach? In the case of bubbles financed by bank-financed lending, but *not* in the case of equity bubbles, the central bank *does* have considerable informational advantages over the private sector; and it *does* have weapons to target straight at the bubble—*provided it is also a bank supervisor*. So my question for Charlie is: Do you agree?

This question also leads straight to the next issue:

Should the central bank be a bank supervisor?

As the British know better than anyone, there is a long-standing debate over the proper role of the central bank in bank supervision—or in financial supervision more broadly. The Bank of England, of course, lost its supervision and regulation (“sup and reg”) powers under the Labor government, and is now getting them back from the Tories. In this country, the Fed's sup and reg authority has recently been greatly enhanced by the Dodd-Frank Act. (For that reason, Pat Parkinson should be here.)

Regarding bubble control, the authors note that “one really needs another instrument that impacts more directly on credit growth and asset price inflation than do interest rates” (p. 18). But that’s exactly what sup and reg can provide. They mention, as an example, pro-cyclical capital buffers. That idea has great merit, but it’s not quite to the point. They also mention imposing higher regulatory risk weights when there is “an excessive shift into riskier forms of lending.” That’s also nice, if you can do it successfully. But let’s remember that, not very long ago, home mortgage lending was considered one of the safest forms of lending. Finally, they mention imposing direct constraints on the terms or availability of credit, such as higher loan-to-value ratios. That’s where I stand up and cheer.

But I’d like to add a fourth item to their list of anti-bubble weapons: howling and scowling by bank regulators. An arched eyebrow from a regulator—not to mention a stern lecture, a strongly-worded supervisory letter, or a ratings downgrade—can have profound effects on a bank’s willingness to engage in risky lending. So “leaning against the bubble” in this way is something that a central bank armed with sup and reg powers can do quite effectively. It’s a shame that America’s bank regulators did not do it before the subprime mortgage debacle got out of hand.

Precisely this sort of thinking has led me, the U.S. Congress (in the Dodd-Frank Act), and many others to advocate that the central bank be designated the primary supervisor of all systemically-important financial institutions (“SIFIs”). Charlie, you may not want to pile on the FSA, but do you agree?

Financial stability as a third goal of the central bank

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Giving the central bank these responsibilities is closely related to giving it a third goal (in addition to low inflation and high employment)—specifically, responsibility for maintaining financial stability.

First, a preliminary point: The authors address the ghost-of-Andrew-Mellon criticism that central banks like the Fed actually contributed to the bubble by succeeding too well in their macro stabilization mission. In the United States, that attitude led to criticisms of, first, “the Greenspan put,” and later “the Bernanke put.” Yes, I guess the Fed’s success (and the BoE’s), led market participants to believe they were living in a safer world than they actually were—and thereby contributed to bubbly behavior. But I agree with Charlie that “it would clearly be a mistake to conclude that policy should aim to induce fluctuations in the macro-economy in order to prevent financial market participants becoming too confident about the outlook” (p. 7). To do otherwise would, I think, be irresponsible—and probably, in the Fed’s case, illegal.

But let me raise a related question: If we assign the Fed or any other central bank an additional goal, financial stability, besides the usual low inflation and high employment, what kind of loss function should it have? Should we simply add a third argument, with another λ weight, thereby implying smooth marginal tradeoffs between, say, financial stability and employment? That doesn’t seem right. The financial stability variable may be hard or impossible to measure. It may also jump discontinuously, as it seemed to do several times during the financial crisis. Furthermore, one might legitimately wonder how a central bank can pursue either “maximum employment” or “stable prices” in a seriously unstable financial environment. All this makes me wonder whether the right loss function is actually lexicographic, with financial stability logically prior to the other goals. Do you agree, Charlie?

By the way, this seems a good question to address in the context of macro models—if you have models capable of addressing it. Which brings me to ...

A methodological digression

Maybe it's part of the secret oath at the Bank of England, but the authors seem to appraise every claim by its consistency with the New Keynesian model, and evaluate every idea by how it would work in the New Keynesian model. Now, I realize Keynes was British. But *New Keynes* isn't. And let's remember that in the New Keynesian model, among other things:

- Everything is done by rational *representative* agents. (Here's something to puzzle over on your plane ride home: Try imagining a bubble in a world where everyone does the same thing.)
- Consumer demand is driven by the real interest rate, not by current income. (We know the reverse is true, empirically.)
- Firms have to win a lottery to change their prices. (I refer, of course, to Calvo pricing.)
- There is only one interest rate. (Hence, there are no “spreads” of any kind.)
- There are no financial intermediaries (which makes Gertler's recent work so welcome).

Bean *et al.* mention Hyman Minsky in passing. I can't help thinking that a *New Minskyian* model would be a far better vehicle than a New Keynesian model for exploring questions relating to financial stability and macro-prudential regulation.¹ Do you agree?

The zero lower bound and quantitative easing

Recent events have pushed this once-obscure topic to the forefront of monetary policy debates. Bean *et al.* want to stuff quantitative easing (“QE”) back into the closet once the system normalizes. They are probably right, but it will take a while. For example, the FOMC recently took the first baby step back on the QE road at its August 10, 2010 meeting. I'll also venture a

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prediction—as long as you recognize it as a prediction from *me*, not endorsed either by Chairman Bernanke or by our host, President Hoenig: The QE done on August 10th won't be the FOMC's last.

According to the authors (p. 8), once you approach the zero lower bound on nominal short rates, there are two main options for pushing longer-term interest rates down further. The central bank can use stronger “central bank talk” as a commitment device (which is *not* QE). Or it can reduce “the spreads of longer-term interest rates over expected policy rates through asset purchases financed by money creation” (which *is* QE).

Regarding the second option, the authors ignore what, to me, is the key distinction among different types of QE: Does the policy seek to reduce *term premia*, which is the case they take up, or does it seek to reduce *risk premia*, which is what most of the Fed's efforts have focused on. In fact, one major distinction between the Bank of Japan's QE program in the years 2002-2006 and the Fed's since 2008, is that the BOJ bought almost exclusively JGBs while the Fed bought mostly private assets.²

In a financial panic, two things seem obvious to me—though both are researchable questions that should be researched:

1. Basis point for basis point, narrowing risk spreads will pack more economic punch than flattening the yield curve. (Doing the latter, by the way, also makes it harder for banks to recapitalize themselves.)

2. Given the sizes and liquidity of the respective markets, the central bank can probably move risk spreads—especially those in less liquid markets--more easily than it can move Treasury bond rates.

But here I won't ask the Deputy Governor of the Bank of England whether he agrees because the BoE's QE program concentrated on purchasing government debt, not on purchasing private assets.

By the way, these two questions underscore one reason for the earlier methodological digression. I, personally, would not want to seek answers to questions like these within the Procrustean bed of the New Keynesian model.

References

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¹ John Geanakoplos (this volume) sketches such a model. I do not mean to denigrate the New Keynesian model for the purposes for which it was designed: creating a tractable analytical model with sluggish price adjustment that can address a variety of theoretical questions about *conventional* monetary policy, that is, about interest rate policy. It has proven its usefulness for such purposes many times.

² For further elaboration on this distinction, see Blinder (2010).