

Commentary: Central Banks and Financial Crises

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Buiter papers don't pull punches. They have attitude. They often feature an alluring mix of brilliant insights and outrageous statements. And they tend to be verbose. This tome displays all those traits. But since it runs 141 pages, I have about 6 seconds per page. So I must be selective. I will therefore concentrate on two big issues: Generically, what are the proper functions of a central bank? Specifically, has the Fed's performance in this crisis really been that bad? Starting with the second.

Does the Fed deserve such low marks?

Willem's critique of the Fed boils down to saying it was both too soft-hearted and extremely muddled in its thinking. Its attempts to avoid painful adjustments that were necessary, appropriate, and in many ways inevitable have planted moral hazard seeds all over the financial landscape. And its entire framework for conducting monetary policy is fundamentally wrong. Other than that, it did well!

Now, you have to give credit to a guy with the nerve to come here, with black bears on the outside and the FOMC on the inside, and be so critical of the Fed—which has earned kudos in the financial community. But those very kudos, Willem says, are symptomatic of a deep problem. In his words, “a key reason [for the policy errors] is

that the Fed listens to Wall Street and believes what it hears...the Fed is too close to the financial markets and leading financial institutions, and too responsive to their special pleadings, to make the right decisions for the economy as a whole” (pg. 599-600).

There is a valid point here. I am, after all, the one who warned that central banks must be as independent of the markets as they are of politics—that they must “listen to the markets” only in the sense that you *listen* to music, not in the sense that you *listen* to your mother—and that central banks sometimes fail to do so.¹ But has the Fed really done as badly as Willem says?

I think not. While the Fed’s performance has not been flawless, I think it’s been pretty good *under the circumstances*. Those last three words are important. Recent circumstances have been trying and, in many respects, unique. Unusual and exigent circumstances, to coin a phrase, require improvisation on the fly—and improvisation is rarely perfect. So I give the Fed high marks while Willem gives them low ones.

Let me illustrate the different grading standards with a short, apocryphal story that Willem may remember from his childhood in Holland (even though it’s based on an *American* story). One day, a little Dutch boy was walking home when he noticed a small leak in the dike that protected the town. He started to stick his finger in the hole. But then he remembered the moral hazard lessons he had learned in school. “Wait a minute,” he thought. “The companies that built this dike did a terrible job. They don’t deserve a bailout, and doing so would just encourage more shoddy construction. Besides, the foolish people who live here should never have built their homes on a flood plain.” So the boy continued on his way home. Before he arrived, the dike burst and everyone for miles around drowned—including the little Dutch boy.

Perhaps you’ve heard the Fed’s alternative version of the story. In this kinder, gentler version, the little Dutch boy, somewhat desperate and worried about the horrors of a flood, stuck his finger in the dike and held it there until help arrived. It was painful and not guaranteed to work—and the little boy would rather have been doing other

things. But he did it anyway. And all the people who lived behind the dike were saved from the error of their ways.

While you decide which version you prefer, I will take up three of Willem's six criticisms of the Fed's monetary policy framework. I don't have time for all six.

The risk management approach

First, methinks the gentleman doth protest too much about the difference between optimization with a quadratic loss function and the Fed's risk management approach, which allegedly focused exclusively on output while ignoring inflation. Many of you will recall that, at the 2005 Jackson Hole conference, some of us debated whether these two approaches were different *at all*.² I think they are different. But the truth is that, with a quadratic loss function, any shock that raises the unemployment forecast and lowers the inflation forecast should induce easier monetary policy. You don't need minimax or anything fancy to justify rate cuts.

Welcoming a recession?

Second, the spirit of Andrew Mellon apparently lives on in the person of Willem Buiter. Mellon's famous advice to President Hoover in 1931 was:

Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. It will purge the rottenness out of the system... . People will work harder, live a more moral life...and enterprising people will pick up the wrecks from less competent people.

Willem's advice to Chairman Bernanke in 2008 is that the U.S. economy needs a recession—and the sooner the better. Why? Because a recession is the only way to whittle the current account deficit down to size—you might say, to “purge the rottenness out of the system.” Is that really true? What about expenditure switching at approximate full employment? Isn't that what we did, approximately, during the Clinton years—using a policy mix of fiscal consolidation and easy money?

Core or headline inflation?

Third, I still think the FOMC is correct to focus more on core than headline inflation. Let me explain with the aid of a quotation from Willem's paper and some charts from a forthcoming paper by Jeremy Rudd and me.³ Willem observes that, "Core inflation is relevant to the price stability leg of the Fed's mandate to the extent that it is a superior predictor of future headline inflation, over the horizon that the Fed can influence headline inflation" (pg. 559). Exactly right.⁴ Let's apply that idea.

Chart 1 depicts the simplest and most benign case: an energy price spike like OPEC II. The relative price of energy shoots up *but then falls back to where it began*. The right-hand panel, based on an estimated monthly pass-through model, shows that such a shock should, first, boost headline inflation way above core, but subsequently push headline well *below* core. The effects on both headline and core inflation beyond two years are negligible. It seems clear, then, that a rational central bank would focus on core inflation and ignore headline.

Chart 2 shows a less benign sort of energy shock: The relative price of energy jumps to a higher plateau *and remains there*. OPEC I was a concrete example. Once again, the right-hand panel shows that headline inflation leaps above core, but then converges quickly back to it. However, this time core and headline wind up permanently higher. They are also substantially identical after about seven months. So, over the relevant time horizon, it seems that the central bank should again concentrate on core, not headline.

Chart 3 depicts the nastiest case which, unfortunately, may apply to the years since 2002. Here the relative price of oil keeps on rising for years. As you can see, both headline and core inflation increase, and there is no tendency for headline to converge back to core. In this case, one can make a coherent argument that the central bank should focus on headline inflation.

So is Willem's criticism correct? Well maybe, but only with the wisdom of hindsight. When there are big surprises, you can be right

Chart 1

Effect of a temporary spike in energy prices

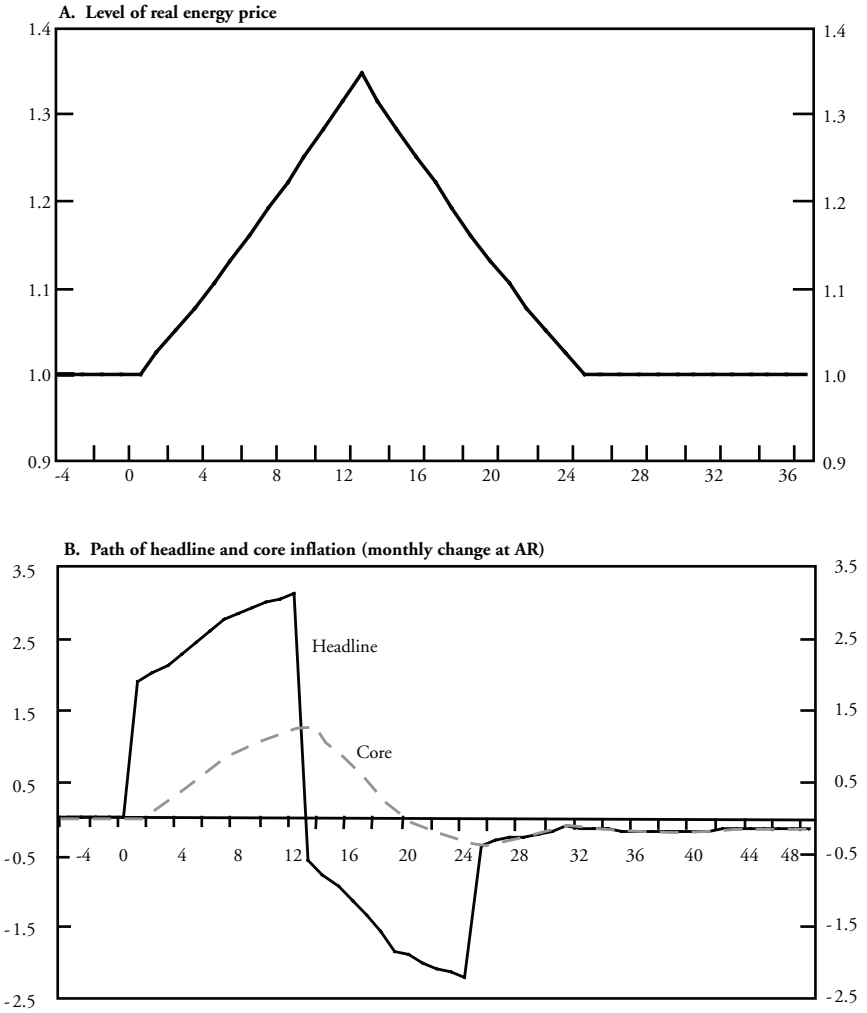


Chart 2

Effect of a permanent jump in energy prices

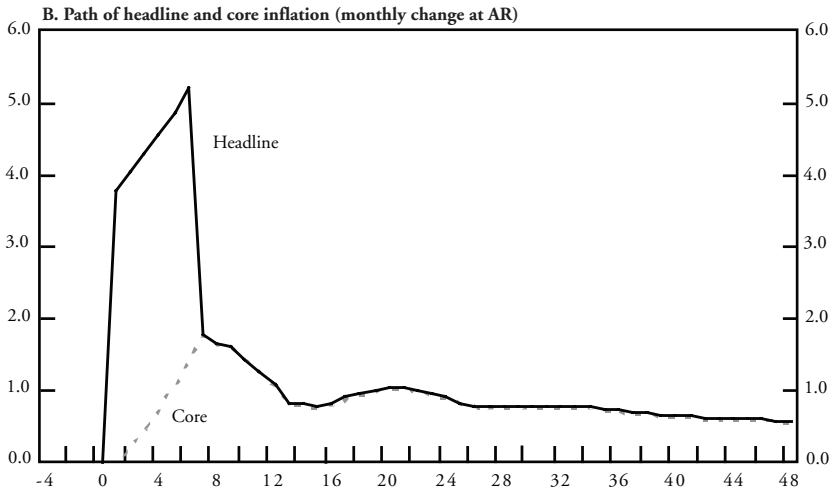
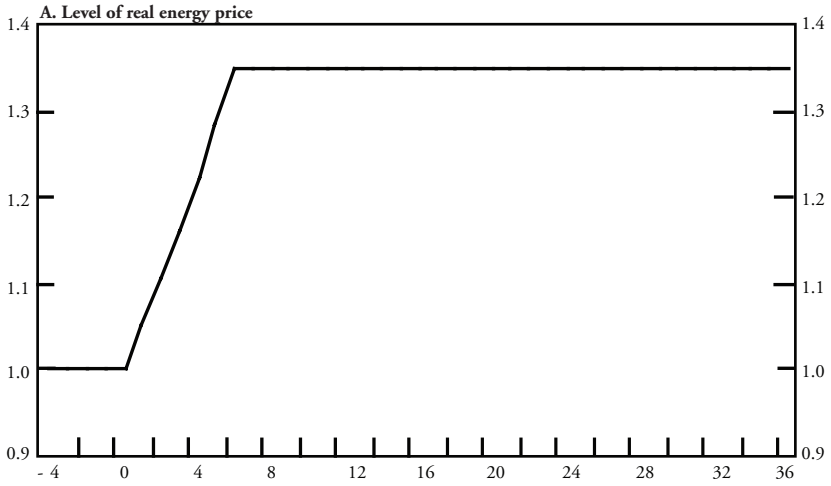
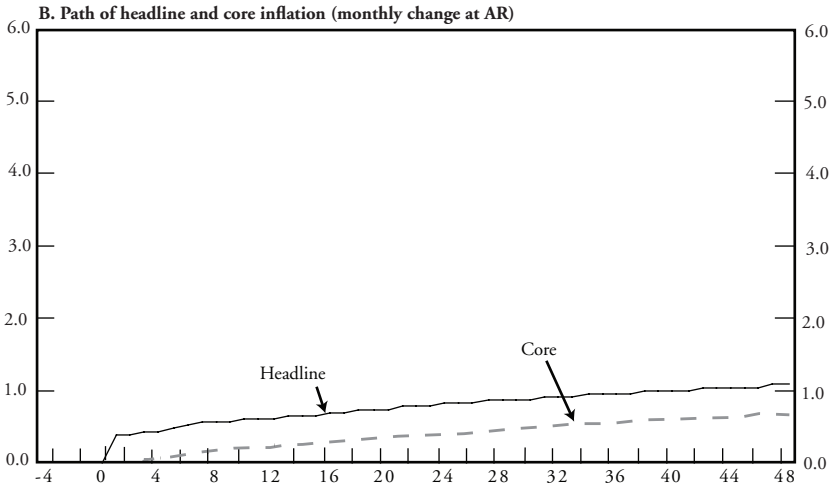
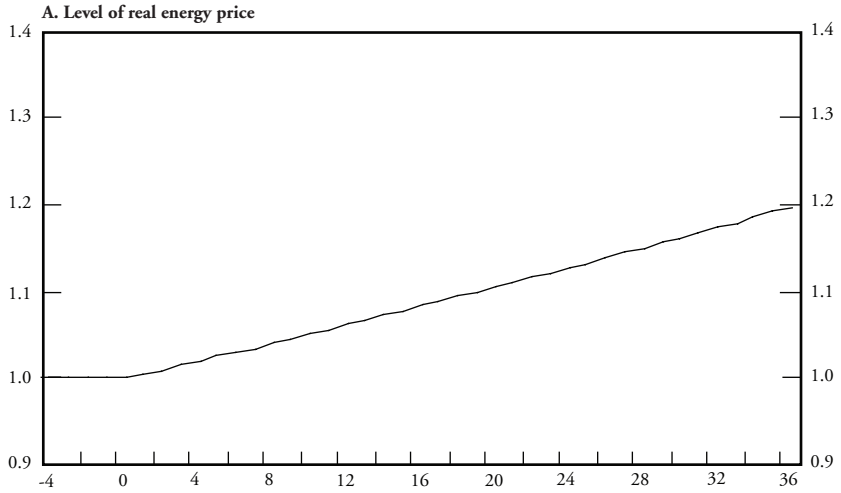


Chart 3 Effect of a steady rise in energy prices



ex ante but wrong *ex post*. It is well known that the Fed does not attempt to forecast the price of oil but uses futures prices instead. It is also well known that futures prices underestimated subsequent actual prices consistently throughout the period, regularly forecasting either flat or declining oil prices. Thus the Fed inherited and acted upon the markets' mistakes—a forgivable sin, in my book. Remember also that no relative price can rise without limit. Oil prices are finally plateauing or coming down, which will restore the case for core.

While I could spend more time defending the FOMC against Willem's many charges, I think I've now said enough to ingratiate myself to our hosts. So let's proceed to the more generic issues.

What should a central bank do?

On our first day in central banking kindergarten, we all learned that a central bank has four basic functions:

1. to conduct macroeconomic stabilization policy, or perhaps just to create low and stable inflation; let's call this "monetary policy proper;"
2. to preserve financial stability, which sometimes means acting as lender of last resort;
3. to safeguard what is often called the financial "plumbing"; and
4. to supervise and regulate banks.

Willem doesn't much care for this list. In previous incarnations, he has argued that the central bank should pursue price stability *and nothing else*, including no responsibility for either unemployment or financial stability.⁵ But here he changes his mind and focuses on the lender of last resort (LOLR) function, number 2 on the list. In doing so, he ignores the plumbing issue entirely; he argues that central banks should not supervise banks; and he even suggests—heavens to Betsy!—transferring responsibility for monetary policy decisions elsewhere. I respectfully disagree on all counts.

Monetary policy proper

On the second day of central banking kindergarten, we all learn that most central banks have multiple monetary policy instruments, including the policy interest rate (in the U.S., the federal funds rate) and lending to banks, which itself includes price (in the U.S., the discount rate), any sort of quantity rationing (including “moral suasion”), and the LOLR function. Willem muses about separating the responsibility for interest rate from this other stuff, which would be quite a radical step.

Why? He explains that while the central bank will “have to *implement* the official policy rate decision...it does not have to make the interest rate *decision*” because it is “not at all self-evident” that the same skills and knowledge are needed to set the interest rate as to manage liquidity (pg. 530). “Not at all self-evident” seems a pretty thin basis for such a momentous change.

On behalf of all the current and past central bankers in the room, may I suggest that it *is* self-evident that the lender of last resort should also set the interest rate? Reason #1: Emergency liquidity provision occasionally becomes an integral and vital part of monetary policy just as they taught us in central banking kindergarten. Having the Fed set the discount rate while someone else sets the funds rate is akin to putting two sets of hands on the steering wheel. Reason #2: Aren't we really concerned about financial stability because of what financial *instability* might do to the overall economy? Who, after all, cares about even wild gyrations in small, idiosyncratic financial markets that have negligible macro impacts? Reason #3: If we take interest rate setting away from the central bank, to whom shall we give it? To a decisionmaking body without the means to execute its decision? To an agency that will almost certainly be less independent than the central bank?

Safeguarding the financial plumbing

To my way of thinking, but apparently not to Willem's, one reason central banks have LOLR powers is precisely to enable them to keep the plumbing working during crises. And indeed, central banks

throughout history have used the window lending for precisely this purpose. I submit that this connection is also self-evident.

Bank supervision

I come, finally, to the most controversial function. Whether or not the central bank should supervise banks has been vigorously debated for years now, and there are arguments on both sides. Or perhaps I should say there *were* arguments on both sides until the Northern Rock debacle showed us what can happen when a central bank doesn't know what's happening inside a bank to which it might be called upon to lend. Yet, somehow, Willem reaches the opposite conclusion. Why? Because he claims that "cognitive regulatory capture" led the Fed astray. Yet he himself acknowledges that "institution-specific knowledge...made the Fed an effective lender of last resort" (pg. 613). I could rest my case on that statement. It would seem peculiar to leave the lender of last resort ignorant of the creditworthiness of potential borrowers.

Market maker of last resort

While Willem generally wants to clip the central bank's wings, he does want to expand the LOLR function to what he calls acting as the MMLR. I don't much care for the name, since market making normally means buying and selling to smooth or profit from price fluctuations. But what Willem *means* by MMLR makes sense: "during times when systemically important financial markets have become disorderly and illiquid...the market maker of last resort either buys outright...or accepts as collateral...systemically important financial instruments that have become illiquid" (pg. 525).

Ironically, that description fits the Fed's recent lending policies to a tee. However, Willem raises two legitimate criticisms. First, the Fed values the collateral it takes at prices provided by the clearing banks—which seems rather too trusting. I agree. Second, the Fed has ignored Bagehot's advice to charge a penalty rate. Lending below market is like making a fiscal transfer—which Willem justifiably questions. But I part company when he argues that central banks should lend *only* at appropriate risk-adjusted rates. Because the LOLR serves a

social purpose broader than profit maximization, it is easy to justify expected risk-adjusted losses in an emergency.

In sum, while there is surely room for improvement around the edges, I don't believe that either the structure or framework of U.S. monetary policy needs the kind of wholesale overhaul that Willem recommends. Cosmetic surgery, maybe. But not a lobotomy.

Endnotes

¹See Alan S. Blinder, *Central Banking in Theory and Practice* (MIT Press, 1998), pp. 59-62, which was expanded upon in Alan S. Blinder, *The Quiet Revolution* (Yale, 2004), Chapter 3. These first of these books was the Robbins Lectures given at the LSE in 1996, which were in turn based on my Marshall Lectures, given at Cambridge in 1995 and hosted by Professor Willem Buiter!

² See Alan S. Blinder and Ricardo Reis, “Understanding the Greenspan Standard”, in Federal Reserve Bank of Kansas City, *The Greenspan Era: Lessons for the Future* (proceedings of the August 2005 Jackson Hole conference), pp. 11-96 and the ensuing discussion.

³Alan S. Blinder and Jeremy Rudd, “The Supply-Shock Explanation of the Great Stagflation Revisited”, paper under preparation for the NBER conference on The Great Inflation, September 2008.

⁴Neither Buiter nor I mean to imply that past inflation is the *only* variable relevant to forecasting future inflation.

⁵Willem Buiter, “Rethinking Inflation Targeting and Central Bank Independence,” inaugural lecture, London School of Economics, October 2006.