“Responding to Crises”

Jeffrey Frankel
Harpel Professor of Capital Formation and Growth
Kennedy School of Government
Harvard University

For Panel I: Responding to Financial Crises
Federal Reserve Policy in the Face of Crises
Cato Institute, 24th Annual Monetary Monetary
Conference, November 16, 2006
The question is not whether sometimes to intervene in crises, but how.

- E.g., banking panics.
- Response should be:
  - appropriate and careful.
  - informed by the lessons of historical precedent, statistics, and theory
    - particularly regarding the fallibility of well-intentioned government intervention, and
  - aware of the dangers of moral hazard.
Different sorts of crises

- Inflation crises
- Asset price crashes
  - stock market
  - bond market
  - housing market
- International crises, including possibilities of:
  - hard landing for the dollar
  - oil shock
  - emerging market crises
  - geopolitical crisis, and
  - trade collapse.
Inflation

Lesson for monetary policy from last four decades: be proactive with respect to inflation.

The Fed should respond to an increase in inflation by raising the nominal interest rate more than one-for-one. [1]

1970s: classic crisis in the value of the dollar

- Monetization of the fiscal expansion, esp. by Arthur Burns in 1972 election.
  => inflation, declining TB, BoP deficit
LBJ raised spending on Vietnam and domestically, initially rejecting adviser Ackley’s advice to raise taxes to pay for it.
Inflation in 1970s:

- was temporarily suppressed by Nixon-Burns wage-price controls,
  - supposedly anathema to conservatives,
  - prompting quiet resignation of CEA chair McCracken.
- re-emerged more virulent than ever
- was finally beaten by Carter-Volcker monetary contraction (1979 appointment, 1980-82 recessions)
  - Supposedly anathema to liberals
Nixon & Burns gunned the money supply in 1972 while wage-price controls gave temporary cover.
Paul McCracken, CEA chair, considered controls “sinful.”

Herb Stein, termed them “wicked.”
1980s: Reagan White House arm-twisted FRB for easy money

- Esp. in election years: 1984, 1988 (& 2001)
- Supply-siders blamed initial failure of Reaganomics on Volcker contraction
- Tried to stack the Board & outvote Volcker (1986)
- Ultimately it didn’t much work.
- But Volcker did leave in 1987:
  “We got the son of a bitch!” – James Baker.
The Reagan White House twisted Volcker’s arm to ease monetary policy, especially in election years.
But successor Greenspan was also blamed by Republicans for high rates leading to the:

- 1987 stock market crash
- 1990-91 recession, and
- loss of 1992 election by George HW Bush
- -- in the eyes of the Bush people.
“Did the Greenspan Fed err by providing too much liquidity in 2001-2004?”

- Probably yes – It kept rates too low too long.

- Did the White House in 2001 take Greenspan aside, raise 10-year-old grievances, and apply some heavy arm-twisting?
  - Hypothesis is pure speculation
  - but has the advantage of being able to explain:
    - the unusually easy monetary policy of 2001-04.
    - the Chairman’s warning (January 2001) that future budget surpluses would be too big for effective monetary operations unless something were done about it.
Did the 2nd Bush White House twist the Chairman’s arm, as the Reagan & 1st Bush White Houses had done?
What adverse consequences of Fed being behind the curve in 2004?

- Inflation out of control?
  - Probably not. I trust Bernanke.
Then what other legacy is there to fear from the low interest rates of 2001-04?

- Some of the biggest financial crashes and longest recessions have followed liquidity-fed booms that never showed up as goods inflation, but rather as asset inflation (BIS):
  - the 1920s boom which ended in the 1929 crash and the Great Depression,
  - Japan’s late-1980s boom that ended in an analogous stock & land market crash and decade of stagnation in the 1990s, and
  - East Asia’s boom that ended in the crises of 1997-98.
Possibility of sudden stock market correction goes on list of crises.

- Stock valuations are again unusually high.
- Obvious US precedents:
  - In both cases Greenspan responded with a sudden easing of liquidity;
  - which led to belief among market investors that they could relax in a high stock market because they held a “Greenspan put.”
- Obvious danger: moral hazard.
Possibility of bond market crash is especially worrisome

- It is puzzling why bond market spreads are so low – both the term premium & corporate spreads.
- Greenspan’s “conundrum” is still with us two years later: while short-term interest rates have risen more than 400 basis points, the 10-year bond rate has hardly risen at all.
- One reason: record purchases of US treasury bills by central banks in Asia & oil-exporters.
- But only a partial explanation
Another explanation: investors have not fully incorporated the fiscal outlook reflected in objective forecasts of the US budget deficit.
Best precedent for fiscal expansion that began in 2001?

- Reagan’s 1980s fiscal expansion is a good precedent; it too came from a president raising defense spending without being willing to pay for it.
  - Weidenbaum quietly resigned over spending.
  - Feldstein popularized “Twin deficits.”

- But 1967-72 Vietnam-era expansion fits even better:
  - (1) Monetary policy was accommodating then, as recently.
  - (2) The dollar’s international currency standing began a trend decline in the 1970s, which the Iraq-era expansion is now restarting.
€ could surpass $ as leading international reserve currency by 2022 – Chinn & Frankel (2006)
Possible new oil shock

- No shortage of potential causes
  - Military conflict with Iran impedes oil flow from the Gulf.
  - Saudi Arabia holds democratic elections.
  - Many others
What should be central banks’ responses to an oil shock?

- New reigning champion among monetary regimes is inflation-targeting.
- If interpreted literally, CPI targeting says oil importers should tighten sufficiently that currency appreciates and price of oil does not rise in domestic currency.
- This is precisely the wrong answer (adverse terms of trade shock calls for a real depreciation).
- It’s more transparent to make clear ex ante that the targeted price index consists of domestically produced goods, not imports.
Possible emerging market crises

- Sovereign spreads have been extraordinarily low.

- Markets’ evident high tolerance for risk could be due to easy money in first ½ of decade.
  - “Dollar carry trade,” as with securities, housing, commodities: $i \downarrow \Rightarrow$ money flows out.

- Despite the recent tightening phase among major central banks, it seems too soon for a repeat of 1982 and 1997 busts.
How to respond to emerging market crises?

- The usual: a tri-partite package of IMF-led rescue money, policy conditionality, and Private Sector Involvement.
- How to balance the need to moderate needless crashes (and geopolitical constraints) with the need to minimize moral hazard? Pick a major suitable case to draw a clear line by cutting off support.
  - Russia, August 1998. Clinton did pull the plug.
Possibility of reversal in growth of international trade.

- Unabated continuation of the famous globalization trend is not inevitable.
- Trade reversed from 1914 to 1944 due to fragmenting political forces:
  - war,
  - isolationism,
  - Smoot-Hawley tariff of 1930 and retaliation, and
  - division of the world into rival blocs and ideologies.
Some worrisome signs over last 6 years

- Sept. 11 terrorist attacks led to
  - tightened travel restrictions
  - US blocking of foreign acquisition of US facilities
  - foreign attempts to boycott US products...
- SARS outbreak led to quarantines of people and goods.
- Impacts were surprisingly brief, but worse could follow from, e.g., WMD terrorism or future avian flu epidemic.
- Less speculatively, collapse of the Doha Round is a bad sign. Beyond lost opportunity for trade liberalization, it may signal a more comprehensive end to what had been 60 years of a liberal global order under US-led multilateral institutions.
Republican presidents have been protectionist despite free trade rhetoric.

- judged not just by some politics-free ideal, but as compared to the record of Clinton.
- “Nixon shock” imposed a 10% surcharge on imports and embargoed essential foodstuffs to Japan.
- Ronald Reagan
  - e.g., “voluntary” export restraints on autos
  - Niskanen (1994) “…the administration imposed more new restraints on trade than any administration since Herbert Hoover”
- George W. Bush
  - tariffs on steel and lumber; sugar-distorted Australian FTA.
  - Bartlett (2006) now judges that it is George W. Bush who has been the most protectionist since Herbert Hoover.
A pattern: illiberal economic policies (GOP presidents) vs. intellectually honest and consistent libertarianism (e.g. Cato)

- Republicans are supposed to support small government; but federal employment rose under Presidents Nixon, Reagan and Bush, and shrank under President Clinton.

- The trend toward deregulation that most imagine began in the Reagan Administration? It actually began in the Carter Administration – in airlines, trucking, natural gas, and banking. Again, Niskanen (1994)
Budget deficits seem to rise when a Republican becomes President -- the solid line in Fig. 1.

- Just because Republicans cut taxes and Democrats raise them?

- Embarrassingly for the Republican presidents spending tends to go up when they take office (dotted line), much as the budget deficit does.
  - Hassett (2005): “spending growth under George W. Bush has been almost four times as high as it was during the same period of Bill Clinton's presidency.”
  - Bartlett (2005): “In light of Bush's big-spending ways, Bill Clinton now looks almost like another Calvin Coolidge.”
Fig. 1: US federal budget deficit and spending as shares of GDP
The “Starve the Beast hypothesis” ($t \downarrow \Rightarrow BD \uparrow \Rightarrow G\downarrow$) is rejected:

- Statistically -- Niskanen (2002).
- Historically – spending growth is only cut as part of a shared sacrifice regime.
- Logically -- if the alternative is the PAYGO approach of the 1990s.
Provocative claim: Republican Presidents have been the more *illiberal*

In practice, over the last 35 years, Presidents Nixon, Reagan and the Bushes supported

- more inflationary monetary policy,
- more protectionism
- more handouts for special interests (energy, agriculture, airlines...),
- bigger budget deficits,
- bigger government, and
- more moral hazard

than did Presidents Carter and Clinton.
Conclusion

- Reacting forcefully to crises is not enough.
- The response has to be well-informed, thoughtful, and appropriate to the problem at hand.
- Thoughtfulness does not thrive if smothered by
  - insincere laissez faire rhetoric,
  - political expediency,
  - an absence of free discussion of policy options, or
  - unwillingness to process new information when real-world developments diverge from the script that had been provided by presidential speech-writers.