August 26, 2008

Deep questions from Jackson Hole

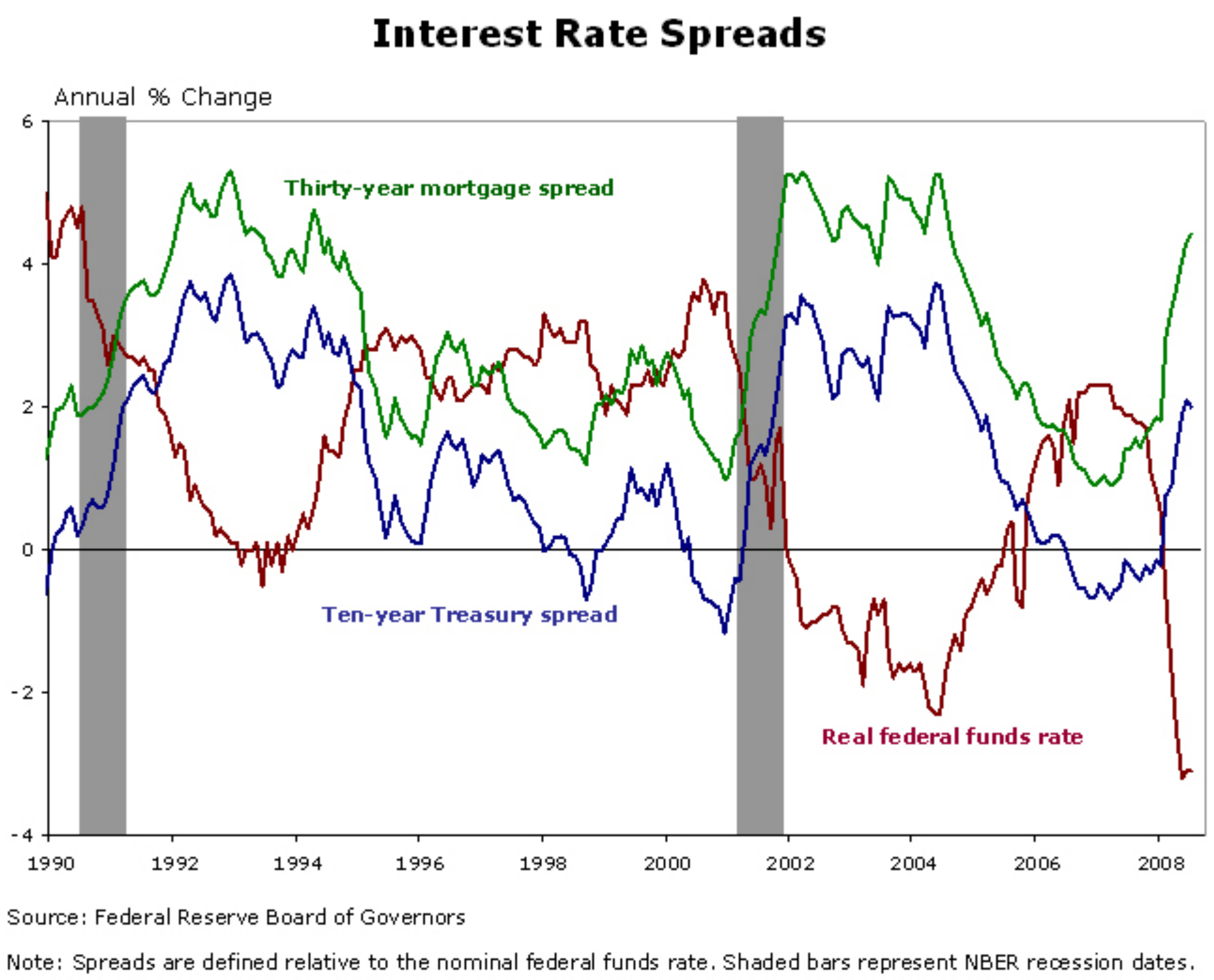
If one were to judge importance by press attention, the key events of this past weekend's annual Jackson Hole economic symposium hosted by the Federal Reserve Bank of Kansas City would be the bookend contributions of Fed Chairman Ben Bernanke's opening address and Willem Buiter's 141 pages worth of Fed criticism. Understandable, in the former case for obvious reasons and in the latter for the grand theoretical pleasure of Buiter's (shall we say) forthright critique and discussant Alan Blinder's equally forthright (and witty) defense of the Fed. (The session's tone is nicely captured in the reports of Sudeep Reddy from the Wall Street Journal and Bloomberg's John Fraher and Scott Lanman.) [*Broken link to the Bloomberg article fixed.*]

Though Professor Buiter's (of the London School of Economics and Political Science) assertions were certainly provocative, for me the truly thought-provoking aspect of the symposium was the collective effort to address some deep questions that still seek answers. There are a lot of them, but here are a few at the top of my list.

How do you know "loose" monetary policy when you see it?
Charles Calomiris—whose paper received attention at Free exchange, and is summarized by the author himself at Vox—says it is the real (or inflation-expectations adjusted) federal funds rate. I suspect that conforms to the definition favored by many, but the significance of defining the stance of monetary policy in this way was hammered home by Tobias Adrian and Hyun Song Shin:

> …some key tenets of current central bank thinking [have] emphasized the importance of managing *expectations* of future short rates, rather than the current level of the target rate *per se*. In contrast, our results suggest that the target rate itself matters for the real economy through its role in the supply of credit and funding conditions in the capital market.

There is a fair amount at stake in understanding which of these views is correct:



Source: Federal Reserve Board of Governors

Note: Spreads are defined relative to the nominal federal funds rate. Shaded bars represent NBER recession dates.

Are longer-term interest rates relatively high while the real federal funds rate is so low because policy is quite loose and inflation expectations are rising? Or are the elevated long-term rates a sign that policy is really restrictive? Or is the picture just a symptom of a combination of currently weak returns to capital (keeping short-term rates low), the prospect of better times ahead (and higher long-run returns to capital), and a return to more realistic pricing of risk, all of which would be consistent with the proposition current policy is neither too easy nor too tight? The question is not academic.

Is there crisis after subprime?
A primary component of Calomiris' thesis is (in the words of his Vox piece) "loose monetary policy, which generated a global saving glut." That global saving glut connection would come up again, most prominently in MIT professor Bengt Holmstrom's discussion of

the contribution by Gary Gorton (itself an essential read if you have any questions at all about the way subprime markets work, or what they have to do with SIVs, CDOs, and ABXs).   The starting point of Holmstrom's argument—a variation on earlier themes from Ben Bernanke (for the general audience) and Ricardo Caballero, Emmanuel Farhi, and Pierre-Olivier Gourinchas (for the economists in the crowd)—goes something like this: Surplus saving in emerging economies has driven up the demand for liquid assets. Liquidity being a specialty of the United States in particular, the excess demand drives down interest rates here, stimulates spending, and expands deficits on the country's current account.

The story, I believe, goes back to the late 1990s. One important difference between then and now is that the liquid assets most in demand at the close of the past decade were highly concentrated in long-term Treasury securities. Another is the fact that the related private-asset appreciation in the late 1990s was manifested in equity markets. After the tech-stock bust, however, the fundamental global imbalances remained and found a new home in debt created by the subprime housing market. As Professor Holmstrom and others noted, collateralized debt markets, based as they are on leverage and low levels of information flows, are much more complicated animals than equity markets.

The question that remains is obvious. What is there to stop the next crisis if global imbalances persist? And if they do, is "better" monetary policy—whatever that might be —a sufficient condition for avoiding future problems?

Which leads me to…

Is there a better way to prepare for future bouts of financial market turmoil?
One answer—shared by many at the symposium—is that we can do so imperfectly at best, and that ultimately governments or markets or both just have to clean up the mess afterward. That approach feels a bit costly at the moment, so it seems a prudent thing to explore proactive measures that may at least mitigate the impact when problems arise. On this front, the biggest buzz of the symposium was probably generated by Anil Kashyap, Jerome Stein, and Raghuram Rajan, who proposed the development of "insurance policies" that would infuse the banking sector with fresh capital when they need it most. I've run on too long now, so for further elaboration I will refer you again to Sudeep Reddy – or to the paper itself.

A related reading PS: You will find more on the Chairman's speech at Free exchange, at Calculated Risk (here and here), and at the William J. Polley blog. On Professor Buiter's session you will find no shortage of commentary. The Daily Reckoning, naked capitalism, Economic Policy Journal, and Equity Check provide what I am sure is just a sampling.

August 26, 2008 in Federal Reserve and Monetary Policy, Interest Rates | Permalink