

Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK
of CLEVELAND



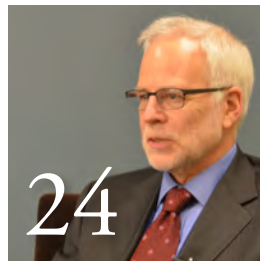
Past Performance, Future Results?

INSIDE:

Evolution of the Bank Examiner

Better Housing Policies

Interview with Barry Eichengreen



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PRESIDENT'S MESSAGE

Sandra Pianalto

President and Chief Executive Officer

Federal Reserve Bank of Cleveland



Opinions about the Federal Reserve's continued efforts to support the economic recovery are not hard to come by. Some people have told me that they believe the current policy path is too accommodative. Others have said they think we are not

being accommodative enough. As I have often said over the past few years, we are facing a very unusual and uncertain economic environment, so it is no surprise that views vary about the proper course of action.

In the decades ahead, economic historians will have ample opportunity to reflect on the Federal Reserve's recent actions. Yet even with the benefit of hindsight, it can still take many years of analysis and discussion for historians to arrive at a consensus on how to interpret such big events—and they may never reach a consensus at all. With all of this in mind, the Federal Reserve Bank of Cleveland recently hosted the conference, *Current Policy Under the Lens of Economic History*. We gathered some of the world's leading monetary, financial, and central-bank historians to apply their perspective and insights to current policy debates.

In this issue of *Forefront*, we highlight several presentations from the conference. We begin with the founding of the Federal Reserve in 1913 and its role as lender of last resort. Federal Reserve economists David Wheelock and Mark Carlson remind us how the central bank's response to the recent crisis drew important lessons from past episodes. Next, Vanderbilt University economist Peter Rousseau draws on the United States' circuitous road to achieving a monetary union for insight into the prospects for today's European Union.

Also in this issue is our interview with the conference's keynote speaker, Barry Eichengreen from the University of California, Berkeley, known for his research on the Great Depression. Eichengreen reminds us to be careful about applying lessons from the past to present situations, because conditions may have changed to the point where history is not a useful guide, or because focusing only on the "lessons" may detract from more pressing developments.

Finally, I would be remiss if I didn't mention the remarks of Carnegie Mellon University's Allan Meltzer, widely renowned as the world's leading Federal Reserve scholar. I attended his session and afterward told him that, although some of my opinions differed from his, I heard and appreciated the principles behind his remarks. Moreover, I believe that policy set in an echo chamber will most certainly not lead to the best outcomes. A robust and open discussion is an essential part of the policy-setting process.

Central banks worldwide, including the Federal Reserve, are taking innovative monetary policy actions that may influence the theory and practice of monetary policy in years to come. I believe that our accommodative monetary policy stance is keeping the US economy on the path of economic recovery, and is contributing to both US and worldwide economic growth. However, we are in uncharted waters. I am hopeful that history will above all bear out that we continually evaluated the risks associated with our policy actions, and that we always worked to promote a healthy economy for the nation. ■

The Myth of the Lock-in Effect

One story that made the media rounds during the recession and early recovery claimed that underwater homes—when people owe more than the property’s value—were deterring unemployed people from moving to get new jobs. People with negative equity could sell only at a loss, an option so unattractive that they refused to pull up stakes in search of work.

It was a good story with a catchy name, “the lock-in effect.” It seemed to help explain why joblessness persisted so stubbornly during the recovery’s first fitful years. And it seemed to support data showing that mobility was declining in the states with the most underwater homes.

But now a team of researchers is spoiling that story, perhaps once and for all. These economists, including the Cleveland Fed’s Yuliya Demyanyk, found conclusive evidence that negative home equity is not an important barrier to labor mobility. In fact, underwater homeowners are probably more likely to move than borrowers with equity in their homes.



Yuliya Demyanyk

“If a hypothetical unemployed, underwater homeowner gets a job offer, he is going to take it,” Demyanyk said.

The study was twofold. First, the researchers looked at credit-report data. The reports gave them enough longitudinal information about

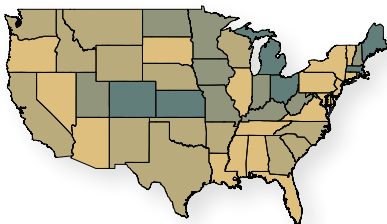
borrowers to infer whether they moved to new regions and whether falling home prices limited mobility—particularly for people with negative home equity.

Next, the researchers designed a theoretical model to replicate the experience of real-world homeowners. It churned out results suggesting that the findings—that underwater homeowners weren’t reluctant to move—were plausible. Key to the model is the idea that people would rather move to get a steady paycheck than stay in an underwater home in a place with no job prospects.

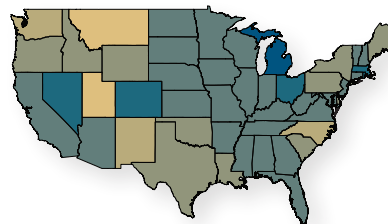
This paper is not the first to debunk the lock-in-effect story. Others, including work by the San Francisco Fed, have likewise found little evidence that people didn’t move during the recession because of the condition of their mortgages.

The Problem of Underwater Homes Increased During the Recession

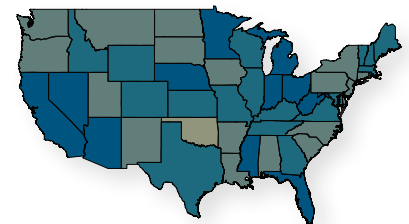
2007



2008



2009



Percent with negative equity



Note: Maps show only subprime mortgages, which are more likely to be underwater.

Source: TransUnion.

Read more



Yuliya Demyanyk, Dmytro Hryshko, María José Luengo-Prado, and Bent E. Sørensen. 2013. “Keeping the House or Moving for a Job.” Federal Reserve Bank of Cleveland, *Economic Commentary*. www.clevelandfed.org/research/commentary/2013/2013-09.cfm

More plausible is that Americans faced almost uniformly dismal employment options across the country—opportunities to move for good jobs were few and far between.

An implication for national policy-makers is that job creation efforts need not focus on the regions hit hardest by the housing bust. Consider that at the end of 2009, the underwater problem was concentrated in four “sand” states—Arizona, Florida, California, and Nevada—and in Michigan, all with negative equity rates topping 35 percent of total mortgages. If national policymakers thought about creating jobs only in those states out of fear that negative-equity borrowers wouldn’t move to other states for employment, they might be missing an opportunity to lift employment more broadly.

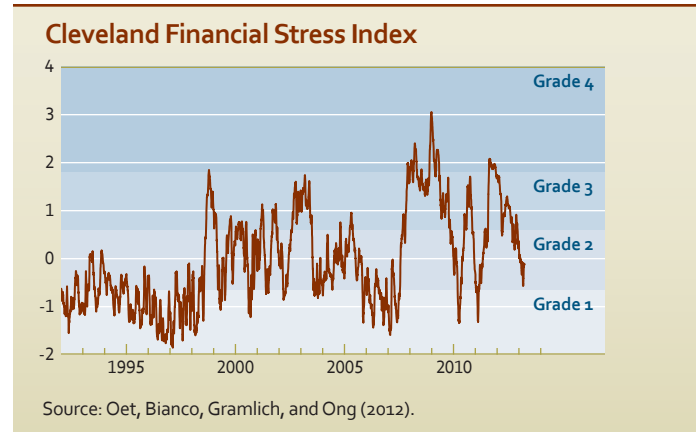
—Forefront Staff

A Daily Dose of Financial Stress (Measurement)

Since the end of the financial crisis, bank supervisors and regulators have been working furiously to develop new tools that will avert the next one. One of the most promising innovations is a “financial stress index.” The index tracks an array of data collected from public markets to help analysts pinpoint periods when financial market strains are growing acute. When the index gets too elevated, it may be time for supervisors to look more closely at specific companies and markets.

More than a dozen public indexes, produced around the globe, are now up and running. We introduced the Cleveland Financial Stress Index, or CFSI, in *Forefront* in 2011. It monitors stress in the financial system by tracking conditions in several different financial markets.

Cleveland Fed researchers have recently enhanced the CFSI with the addition of two new markets: real estate and securitization. These markets were, of course, key contributors to the depth and duration of the 2008 financial crisis, and incorporating them into the stress index improves the CFSI’s ability to detect emerging instability. (The CFSI already tracks the funding, credit, equity, and foreign exchange markets.)



A useful feature of the CFSI is its ability to show how much each market is contributing to overall stress. So far in 2013, for example, securitization markets are the leading culprit, while foreign exchange markets have been relatively benign.

And now, the CFSI is updated daily on our website. We encourage you to check it out, along with others available on the internet. (Google “financial stress index” to find them.) A quick scan of public indexes shows that financial stress is at fairly low levels in spring 2013, a welcome return to stability after the very high stress seen during the financial crisis. ■

—Doug Campbell

Use the index



www.clevelandfed.org/research/data/financial_stress_index

Sixty-third Congress of the United States of America;

At the Second Session,

Begun and held at the City of Washington on Monday, the first day of December, one thousand nine hundred and thirteen.

AN ACT

To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.

Past Performance, Future Results?

Economic History and a Thoughtful Look at Federal Reserve Policies

Wherever the word "bank" is used in this Act, the word shall be held to include State bank, banking association, and trust company, except where national bank is expressed.

History is only as useful as the lessons it imparts. With that in mind, the Federal Reserve Bank of Cleveland gathered some giants in the field of economic history to discuss their views.

The presenters at the conference, titled *Current Policy Under the Lens of Economic History: A Conference to Commemorate the Federal Reserve System's Centennial*, cast an analytical eye on the evolution of Fed policies over the past century.

This was no meeting of Fed partisans, per se, although many of the presenters hold or formerly held positions in the System. These were reflective economists who share a deep interest and sometimes concern about the abiding impact of central-bank policies. In studying the Fed's history, it's safe to say they hope to improve our economic future.

In this issue of *Forefront*, we provide highlights from a selection of presentations—covering the evolution of the Fed's role as lender of last resort, the long road to achieving a monetary union in the United States, and the reflections of a leading Federal Reserve historian.

Resources



Find the full agenda and papers presented at the centennial conference online at www.clevelandfed.org/research/conferences/2012/current_policy/agenda.cfm



Watch economists share their views on the Federal Reserve www.clevelandfed.org/about_us/annual_report/2012/adapting-evolving-learning.cfm.

The Fed's First (and Lasting) Job: Lender of Last Resorts

This is an edited and condensed version of the authors' remarks on December 14, 2012, at the Cleveland Fed's conference, Current Policy Under the Lens of Economic History.



David Wheelock
Federal Reserve
Bank of St. Louis



Mark Carlson
Federal Reserve
Board of Governors

The Federal Reserve was designed to be a lender of last resort. The year was 1913, and the concept of monetary policy had not yet been invented. But memories of the panic of 1907 were very fresh, and the authors of the Federal Reserve Act were clear that the Fed was intended to be a lender to banks.

The founders of the Fed considered a key defect of the US financial system to be the lack of an elastic currency; that is, a currency that was flexible and could adjust to meet both the ordinary demands of economic activity and the extraordinary demands associated with liquidity shocks. The Federal Reserve Act was designed to create an asset-backed currency and supply of reserves that would adjust automatically and flexibly to changes in the needs of trade. The primary mechanism by which the Fed would regulate currency and credit was the discount window.

In some respects, the Fed performed admirably in its early days. It virtually did away with the problems of the seasonal economy as the founders believed that a financial crisis was more likely to occur in times of seasonal tightness in the money and financial markets. The Federal Reserve's discount mechanism proved successful in accommodating those seasonal fluctuations in currency and credit demand.

Lessons from the Great Depression

There were no banking panics or serious financial crises during the first 15 years or so of the Fed's life. Then, in the 1930s, came the Great Depression. The literature on the Fed's failure to avert—and its inability to respond effectively to—the Great Depression is voluminous. An abbreviated summary includes:

- Milton Friedman and Anna Schwartz maintained that Fed policy went from “enlightened” to no light and allowed the money supply to fall by a third between 1929 and 1933.
- Barry Eichengreen and others focused on the role of the gold standard in transmitting the Great Depression in the United States and abroad.
- Allan Meltzer and others noted the Fed's failure to understand the difference between nominal and real interest rates and its reliance on misleading measures of bank reserves.
- Michael Bordo and others argued that there was a flaw in the Federal Reserve Act, which was made to fit the uniquely bifurcated regional structure of the US banking system. That system had strict limits on branch banking and, as many studies have shown, contributed to making the US banking system more vulnerable to shocks.

In response to the Great Depression, the Fed's lending powers were greatly expanded. Collateral restrictions were loosened. In 1932, the famous section 13.3 was added to the Federal Reserve Act to allow the Fed to lend directly to nonbank, private-sector entities in unusual and exigent circumstances. (Eventually, the Monetary Control Act of 1980 and the Federal Deposit Insurance Corporation Improvement Act of 1991 further loosened collateral requirements on the Fed's lending under section 13.3.) The Fed was given new powers to adjust reserve requirements and set margin requirements. Interest rate ceilings were also introduced.

Recently, many have maintained that the Fed's aggressive response to the financial crisis of 2007–08 threatens its ability to conduct an independent monetary policy. The Fed had the opposite problem in the 1930s. Its failure to respond adequately to the Great Depression caused an erosion of the Fed's independence and led to a centralization of power in the Board of Governors in the Banking Acts of 1933 and, especially, of 1935.

Several other significant changes to the banking and financial system came out of the Great Depression: the introduction of deposit insurance, the Glass–Steagall Act (separating investment and commercial banking), and the Securities and Exchange Commission. All the financial system's rules were changed; over the next 60 years, a new environment for the banking system was established.

Five formative episodes since World War II

In the postwar years, the Federal Reserve has been considerably more responsive to perceived threats to financial stability. Five episodes in particular helped establish some precedent for the Fed's response to the recent crisis. All five of these episodes were much milder than the financial crisis of 2007–08, and the Fed's response was less dramatic.

The Penn Central bankruptcy

In 1970, the Penn Central Company got into financial trouble after issuing a large amount of commercial paper, and went into bankruptcy. Its bankruptcy triggered a crisis in the nonfinancial commercial-paper market as this event raised questions about whether some other firms issuing commercial paper might also be insolvent. In response, the Federal Reserve encouraged banks to revive funding

to these firms. The Fed removed interest rate ceilings on large certificates of deposit, which enhanced the banks' ability to raise funds to make these loans. The Fed also encouraged banks to borrow from the discount window until they could raise new funds.

The result: success. A drop in the commercial-paper market was offset fairly quickly by a rise in commercial and industrial lending by banks.

The failure of Franklin National Bank

In the early 1970s, Franklin National got into financial difficulties, and its solvency was very much in doubt. There was a concern that its failure would trigger problems in the markets where it was most active — wholesale funding and foreign exchange. This was especially the case in the foreign exchange market, because Franklin's troubles coincided with the failure of Herstatt Bank in Germany. US regulators were keenly aware of disruptions in foreign exchange markets that failure had caused and Franklin's foreign exchange operations were larger than Herstatt Bank's.

In response, the Federal Reserve provided a considerable amount of discount window lending to replace the wholesale funding that Franklin National could no longer obtain. It assumed Franklin's foreign exchange book, stepping in between Franklin and its counterparties, and successfully wound it down. Efforts to resolve Franklin's situation were coordinated with other agencies. There was some tension in these markets but no full-scale collapse. Eventually, Franklin National was sold.

The Continental Illinois rescue

A large commercial industrial loan provider — in fact, the eighth-largest retail bank in the United States in the early 1980s — Continental Illinois National Bank financed a lot of its operations in the wholesale funding market. There was concern that Continental's failure would result in a loss of access to wholesale funding by many other large banks. The Federal Reserve provided discount window loans and committed itself to providing backstop funding for the bank. The Federal Deposit Insurance Corporation guaranteed all liabilities and eventually recapitalized the bank. There was tension in wholesale funding markets because of Continental's travails, but these markets recovered as the recapitalization plan was implemented.

The 1987 stock market crash

Equity market values plunged and triggered substantial margin calls on future exchanges, which greatly increased borrowing needs. The Chicago derivatives markets closed for a while; equity markets nearly did the same.

The central bank's response was swift. The day after the crash, the Fed announced it would serve as a liquidity backstop, which boosted confidence in the markets. It reduced the target federal funds rate and injected reserves through open market operations. Moreover, the Fed purposely operated in a very high-profile manner in successive days to promote investor confidence. During this episode, Fed officials engaged in a lot of jawboning to convince commercial banks to provide credit to one another and to facilitate settling payments. To be sure, many individuals and institutions worked to smooth things out after the crash—many firms stepped in to buy their own stock, which helped buoy the market—but the Fed's response was clearly supportive in restoring functioning in the equity markets.

The Long Term Capital Management rescue

A large, highly levered hedge fund, Long Term Capital (LTC) was on the wrong side of several trades in the wake of the Russian default. There were serious concerns about the direct exposure of other financial firms to LTC. There was also some concern that these institutions had trades that were the same as those held by LTC and that those firms would suffer if it were unwound in a disorderly fashion. Financial markets were already under strain from the Russian default and the continued turmoil from the East Asian crisis the preceding year; in response, the Federal Reserve provided its good offices to help coordinate a resolution and a recapitalization of LTC.

Lessons

The way the Fed responded to these previous episodes foreshadowed its recent response. For instance, the Fed had shown that it cares about severe disruptions in short-term lending markets, such as commercial paper, because instability in those markets could have economic implications. We observed this in the case of Penn Central, where the Fed was able to channel support through the commercial banking sector; in the most recent episode, support was more direct.

The Federal Reserve also established that extraordinary support to financial institutions was part of its toolkit, as it demonstrated in the Franklin National and Continental Illinois episodes. However, assistance to individual institutions was given to prevent deterioration in the functioning of broader markets. For example, Franklin National was assisted to prevent disruptions to the foreign exchange market.

The way the Fed responded to these previous episodes foreshadowed its recent response. For instance, its earlier responses showed that the Fed cares about severe disruptions in short-term lending markets, such as commercial paper, because instability in those markets could have economic implications.

When it comes to acting as lender of last resort, the Fed has used both direct and indirect lending. Why? The first lesson from these episodes is that counterparties matter. Open market operations are conducted with a small set of institutions. Providing liquidity through open market operations that will spread to the rest of the financial system requires that markets are functioning, especially funding markets and short-term markets, which are the least likely to be functioning during a crisis.

Second, an effective crisis response involves converting illiquid into liquid assets and increasing the supply of risk-free assets. The discount window in particular allows this conversion, but the Fed has also lent out securities from the System's open market account. Even if the Federal Reserve insulates itself from credit risk associated with a particular institution, these actions expand the supply of liquid securities.

The third and final lesson is the importance of the regulatory environment. It's been noted that the regulatory regime in the United States during the late 1880s through the early 1900s, which consisted of smaller unit banks, was particularly crisis-prone, especially when compared to Canada. After the Depression, the US financial system was constrained by Glass-Steagall, interest rate ceilings, and other regulations. Efforts to circumvent these rules contributed to an expansion of the shadow banking system. It is even more challenging for a central bank to operate alongside a large shadow banking system which, unlike depository institutions, does not interact with the Fed directly.



Joseph Haubrich, vice president and economist at the Cleveland Fed, comments on “The Fed’s First (and Lasting) Job: Lender of Last Resort.”

According to the Oxford English Dictionary, the phrase “lender of last resort” first appeared in print in R.G. Hawtrey’s *Art of Central Banking* (1932). In other words, people weren’t talking about a lender of last resort when the Federal Reserve was created; that started only with the onset of the Great Depression. Over the years, the phrase’s usage has ebbed and flowed, but it has never been a chart-topper. Still, when you read history, it’s good to keep in mind that an evolution of ideas is going on as well. There is the history, the development of a concept, and a way to describe what’s actually going on.

Wheelock and Carlson pose some interesting questions: Is the lender of last resort purely about the money supply? Can you inject liquidity pretty much any way you want and, if the quantity is high enough, can it defuse the crisis? On the other hand, when the financial markets aren’t working, you’ve got to be much more targeted and offer discount window lending to individual firms, a primary-dealer credit facility, or something along those lines. I would call this a discussion of the relative merits of open market operations and discount window lending, though that’s not quite right. But this is an essential theme to bring out, whether you agree with the authors’ conclusion or not.

One broader issue that the paper brings out nicely is the distinction between a run on a single bank and a systemic banking panic. What a lender of last resort should be doing depends vitally on the circumstances.

We don’t have a fully articulated theory of banking crises and how the lender of last resort should respond to them, but there are various concepts: Is the contagion like a fire or a flu that may spread to your house? Or is it more akin to finding out on TV that someone has gotten Mad Cow Disease: You won’t catch it from them, but you’re never going to eat a hamburger again.

Did you want to stop a financial panic because the entire system would be liquidated otherwise? Or were you merely bailing out a bank that had a lot of political influence? In the 1800s, you knew what was happening because you saw out-and-out panic and runs on the banks; in the quiet period through the middle of the twentieth century, it was harder to tell. But I think it is important to establish that the lender-of-last-resort reaction depends on what form the crisis takes.

If you’re going to judge what the Fed did, you probably should have a standard of comparison. I would like to see some notion of what the alternatives to lenders of last resorts are. In American history, both the US Treasury and private clearinghouse associations have acted as lenders in panics. What are the advantages and differences? Another comparison is not with history, but with theory. Granted, we don’t have a fully articulated theory of banking crises and how the lender of last resort should respond to them, but there are various concepts: Is the contagion like a fire or a flu that may spread to your house? Or is it more akin to finding out on TV that someone has gotten Mad Cow Disease: You won’t catch it from them, but you’re never going to eat a hamburger again.

A final observation—the central bank is embedded in a broader legal and financial system. The bank can do only what Congress has authorized. And what works depends critically on the financial system. Both of these conditions have changed often and significantly in recent decades. ■

How and Why the Fed Must Change in Its Second Century

This is an edited and condensed version of the author's remarks on December 14, 2012, at the Cleveland Fed's conference, Current Policy Under the Lens of Economic History.



Allan Meltzer
Carnegie Mellon University

The original Federal Reserve of 1914 had very little authority; it was bound by the gold standard and the real bills doctrine. It acted mainly when banks came to it, not when it went to the market. It was prevented by law from financing the Treasury.

But the Fed soon circumvented that by developing open market operations so that it could buy the government's bonds on the day of the sale. It had a series of semi-autonomous Reserve Banks with independent directors. Are the directors still independent? The Reserve Banks are certainly not semi-autonomous. All of those restrictions are gone. With crises, power has moved to the Board of Governors of the Federal Reserve System. From the very first, the argument was that the Board was political and the Reserve Banks were market oriented. But the Board's power has increased enormously, and the Reserve Banks' power has decreased commensurately.

The Federal Reserve is engaged in debt management, credit allocation, and fiscal actions, especially in the mortgage market. Why are we doing all these things now? Maybe it's because fiscal policy is broken; that is, given the deficits, it's really hard to ask for much more spending. So the Congress, or parts of it, has taken the idea that it can use

credit allocation to do that. If you're going to use the banks to allocate credit to the poor and disadvantaged, who will give credit to keep the economy growing, to take risks for investment? Is that going to be done somewhere, or do we not care about that?

A look back

We've been here before. In wartime, in postwar debt management, in policy coordination, and in activities in the 1960s. Former Chairman William McChesney Martin's view was that the Fed was independent within the government. He explained many times what that meant. It meant that the Congress and the president adopted a budget and the Fed helped finance it. That was policy coordination. He didn't like policy coordination, but he followed it almost until the very end of his term in office.

Fed history shows many errors. There was the Great Depression, the Great Inflation, and the contributions to the recent crisis. A large literature points out the acquiescence or support of many other failures. There were other errors — failure to raise the Regulation Q (bank interest rate) ceilings, which tore up a good part of the investment of the mortgage banking system; and a failure to distinguish real and nominal interest rates.

In the 1970s, the Fed failed to make the distinction between real and nominal rates. This failure led the Fed to believe that interest rates were very high, when in fact real interest rates were mostly negative. Milton Friedman, in his 1968 address to the American Economic Association, observed that there were differences between monetary and real variables and it was important to keep that in mind. But the Fed was slow to act on Friedman's advice and through the 1970s it kept trying to improve the economy by inflating. In the 1970s, the Phillips curve underestimated inflation 16 quarters in a row.

Then came Chairman Paul Volcker, who offered the anti-Phillips curve. Publicly, internally, in testimony, and over and over, Volcker said the way to lower unemployment is to lower expected inflation. That lesson has been lost again.

Volcker pointed out that in the 1970s, inflation and unemployment declined together. He said people were presuming there was a tradeoff between inflation and unemployment. But he looked at the data and saw that the unemployment rate went up as the inflation rate went up, and he believed the unemployment rate would come down as the inflation rate came down. He preached that message over and over again to his staff and to anyone within hearing range. And he was right. That is what happened.

Once again, the Fed is failing to distinguish between real and nominal problems. One of the real problems is the uncertainty that comes from the fact that businesses cannot discount their cash flow. How can you discount your cash flow if you don't know what the tax rate is going to be, or how to estimate health care costs, energy costs, or labor costs? So what are businesses doing? To the extent that they invest, much of the investment goes into labor-saving capital—computers and robotics. Productivity is good, and that's what keeps the inflation rate down. It isn't the unemployment rate–inflation rate tradeoff. It's the fact that we have high—or at least reasonable—productivity growth in most of the quarters. As long as that's true, inflation will be kept under control. When it isn't true, inflation will break out.

Now, excess reserves are \$2.9 trillion. They sit idle on banks' balance sheets. Along with that, corporate balance sheets have hundreds of billions of dollars of idle money. What can anyone believe is the value of adding more excess reserves? It's going to create problems for the future; those problems are real, not monetary.

In 100 years of Federal Reserve policy, there are two long runs of success. One is 1923 to 1928. Another is 1985 to 2003. There are no comparable periods under discretionary policy. Following rules, or quasi-rules, the Fed managed to achieve what it never achieved by discretion for any long period of time: that is, low inflation and relatively stable growth, punctuated by mild recessions.

Why is that so? One of the Fed's main mistakes that we see very visibly now is excessive concentration on near-term events and on unreliable forecasts. There's not much agreement among the members about the forecasts. But more important than lack of agreement is a neglect of longer-term consequences. From 1926 until 1986, you do not find in the minutes, except for the Volcker period, a statement that says, "if we take this action today, where will we be a year from now?" It's all about where we will be next quarter. Should we raise the funds rate an eighth or a quarter? Should we lower it? About such things, there can be lots of discussion. But that discussion almost never says, where will we be a year from now?

One thing that is certainly true of US—and probably other countries'—data is that it's full of temporary, random changes that are very hard to distinguish from the underlying trends at the time they occur. You have to wait to see what the permanent effects are going to be. Operating on these short-term measures is usually not a good idea, yet the Fed does that all the time, including the present time.

A proposal

To escape the consequences of its errors, the Fed needs to adopt a rule or a quasi-rule. There's not going to be a rule that is going to work under all circumstances. Deviations from the rule have to be permitted—under restrained circumstances. You don't give the Fed the unlimited, unrestrained authority that it has now; you make it subject to a rule. There are some who would prefer a rule for price stability. But a rule that had a dual mandate might be operational, provided the Fed followed it, and would be more readily accepted in the Congress.

There would be two reports if there were deviations. One would explain why they deviated. The other would offer their resignations. The administration could accept the resignations or it could accept the explanation. This would close the gap between accountability and responsibility.

How do we get back to stability? People at the Fed say not to worry about inflation because all they have to do is raise the interest rate. That's correct but too simple. First, there's always a political reaction to an increase in interest rates. But more importantly, at the current moment we have a huge debt with an average maturity that is under five years. Even worse, 28 percent of the debt is under one year; 40 percent is less than two years. And that's just the Treasury debt. It doesn't include Fannie Mae, Freddie Mac, and a whole variety of other institutions. Within two years, the budget deficit—just as a result of raising interest rates by 3 percentage points, that is, back to some normal rate—increases by at least \$36 billion for each 1 percentage point increase in the interest rate. Three points—more than \$100 billion. Think about the political repercussions in a Congress that is having difficulty agreeing on any cuts in the budget.

Finally, there is international coordination. An international monetary stability pact: major currencies—the euro, the dollar, the yen, and perhaps the renminbi—should accept a common inflation rate of zero to 2 percent.

There would be no enforcement mechanism; there would just be commitment. Anyone who wished to have what no one could have at the moment—that is, stable exchange rates and low inflation—could voluntarily peg to one or more of those currencies. They get the public good that has been missing since the breakdown of the Bretton Woods system. There would be no meetings, no coordination actions. Like the gold standard, there would be market enforcement.

There would be two reports if there were deviations. One would explain why they deviated. The other would offer their resignations.

Would that be perfect? Hardly. Would it be better? Probably so. It permits changes in relative productivity to alter real exchange rates. The dollar, the euro, the yen—they would not have a fixed exchange rate. They would have a fixed inflation rate so that real exchange rates would be allowed to change in the face of productivity and other changes. It gives countries the opportunity to choose both low inflation and stable exchange rates. What about us? What do we get from it? We get the benefit of low inflation and stable exchange rates with all those countries that choose to peg to the 0 to 2 percent inflation rate. That proposal restores badly needed discipline to the monetary system.

The case for a rule to bind the Fed

A monetary rule is important for many reasons. But one of the most important is this: From 1789, the beginning of the federal system, to 1930, the United States ran budget surpluses in two-thirds of all nonwar years. Since 1930, only two presidents—Eisenhower and Clinton—achieved back-to-back surpluses. We won't go back to small government, but we can go back to more stability. Our future growth depends on it. The presence of a monetary rule enhances the effectiveness of a fiscal rule that balances the budget.

We need a rule that gives people in a democratic country what they most want: low inflation and greater economic stability. That's where we must go in the second century. That's where the Fed has failed itself, failed us, and failed the world.



Mark Sniderman, executive vice president and chief policy officer at the Cleveland Fed, comments on "How and Why the Fed Must Change in Its Second Century."

Allan Meltzer is certainly correct in noting that the Federal Reserve's practice of monetary policy has fallen short of ideal on several occasions during its 100-year history.

The Great Depression and the Great Inflation of the 1970s represent at least two such episodes. How history will judge monetary policy during the current period remains to be seen. Being the careful economic historian that he is, Meltzer probably understands that it is too soon to know how effective the combination of large-scale asset purchases and forward guidance on interest rates will prove to be, and how the economy will perform during the eventual renormalization of monetary policy.

In the meanwhile, it is important to separate facts and evidence-based conclusions from opinion. For example, Meltzer asserts that the reason inflation has been so low during the past few years—despite an enormous increase in the monetary base—is that productivity growth has been reasonably good. Notwithstanding the fact that it is unusual to hear a monetarist appeal to productivity growth as the primary factor influencing inflation, the fact is that productivity growth during the past few years has not been particularly unusual. Although productivity growth was about 3 percent in 2009 and 2010, coming off of the severe recession, its growth in 2011 and 2012 was less than 1 percent. Productivity growth was much stronger during the decade before the last recession than it has been since, and yet inflation was greater than it is now.

Meltzer also asserts that monetary policy is extremely short-term focused, with little discussion about what the economy might look like even one year ahead. To address this situation, Meltzer would have the Federal Reserve be subject to a rule, explain its performance, and offer up resignations if the rule is violated. These criticisms would have had more validity a few decades ago than they do today, in light of the significant changes in the conduct of monetary policy that have taken place since.

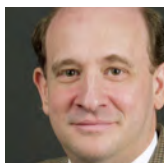
Today, the Federal Open Market Committee (FOMC) publishes press statements after its meetings, releases minutes within three weeks of its meetings, and provides a summary of its economic projections each quarter, including a distribution of the participants' expectations of the timing of the federal funds rate's liftoff from the zero bound. The FOMC has been making extensive use of forward guidance to help the public understand how it intends to respond to changes in the economic outlook. Last year, the FOMC published the principles that will guide its exit from nontraditional monetary policy; earlier this year, it established explicit numerical objectives for its congressionally mandated objectives of price stability and maximum employment. And, contrary to the complaint that the FOMC resists following a rule, or quasi-rule, it has recently indicated that it expects short-term interest rates to remain at exceptionally low levels at least as long as the unemployment rate is above 6 ½ percent and the inflation rate is no greater than 2 ½ percent. That sounds like a quasi-rule to me!

One final point on the subject of accountability in a democracy: I would note that the Federal Reserve chairman regularly testifies to Congress about the economy and monetary policy. In addition, every other year the term of one Federal Reserve Board governor expires, and every four years the position of Federal Reserve Board chairman comes up for appointment. In our democracy, there are ample opportunities for Congress and the president to change the FOMC's voting roster if they are not satisfied with the decisions being made.

Despite my differences of opinion with Meltzer on some of his specific points, he is right to remind us how important it is for monetary policymakers to set feasible objectives, to explain clearly what they are doing, and to make decisions in the short term that are conducive to longer-term success. With the stakes so enormous, and the situation so novel, opinions on what has been done and what should be done are varied and sometimes heated. The Federal Reserve is always listening to what people have to say about the events of the moment. It will be interesting to learn what economic historians will say about these times 25 years from now, on the Federal Reserve's 125th anniversary. ■

What Can US History Tell Us About the European Union's Prospects for Survival?

Forefront summarizes Vanderbilt University's Peter Rousseau's remarks on December 14, 2012, at the Cleveland Fed's conference *Current Policy Under the Lens of Economic History*.



Original remarks by
Peter Rousseau
Vanderbilt University

Some have argued that the European Union can't survive as a mere monetary alliance that shares no more than a currency and a central bank. It needs to be a full-fledged political union, the argument goes, a single European country with both fiscal and monetary powers.

The model often cited for this vision is the United States. Prominent economists have held up Treasury Secretary Alexander Hamilton's Federalist Financial Revolution as a guide. The Federalists favored a strong central government joined with a strong central bank—not exactly the institutional arrangement currently used in Europe, which has 27 independent member states.

But a careful reading of US history clouds this argument. Peter Rousseau, a Vanderbilt University economist, points out that America's political and monetary union was not accomplished neatly or easily. As Rousseau sees it, America's political and monetary unions evolved side by side. And, in a way, that suggests better prospects for the EU than others have predicted.

"The monetary union was, in fact, a work in progress for quite a while following the Federalist Financial Revolution," Rousseau said. "A bit of optimism would say that if the United States took about a century to form its monetary union after forming its political union, perhaps today's European Union will find its way in less time."

The Federalist recipe

In 1790, the United States had recently emerged from the Revolutionary War and was saddled with enormous debt. A political union to be sure, the young nation lacked a well-functioning monetary union.

Treasury Secretary Alexander Hamilton famously developed a plan for rescheduling and paying off the nation's debt and established a single unit of account, the dollar. Soon after, a precursor of the Federal Reserve, the Bank of the United States, was created to serve as the nation's fiscal agent and to hold government deposits. Along with a banking system, these developments gave the United States the features of a modern financial system.

Moreover, the policies put in place in 1790 are credited with kick-starting growth over the nation's first 40 years. The system facilitated financial development and established the mechanisms that eventually led to the creation of the Federal Reserve in 1913.

Rousseau's main point is that it's misleadingly simple to argue that a political union is a precondition for monetary stability.

Rousseau says that he wants to take "nothing away from Hamilton and the Federalists in the start of putting the nation on the right path for financial and economic development." But this was hardly the end of the story. The Bank of the United States was seen by some as "top-heavy," Rousseau says, with its power too concentrated in a narrow Northeastern base. Its charter was allowed to expire in 1811, partly because of these concerns.

Jacksonian ideals

Though the Second Bank of the United States was chartered in 1816, it also came under fire for failing to decentralize the process of money creation. In 1832, President Andrew Jackson vetoed legislation to renew the Second Bank's charter when it was to expire in 1836. And in 1833 and 1834, he withdrew the government's deposits from the Second Bank.

Jacksonian ideals led to what was known as the "free banking" period. It saw a significant expansion of banking through free banks (those required to secure notes with government debt) in the Midwest and charter banks (which could back notes with other assets) in the rest of the country.

Rousseau notes that the immediate results of Jackson's actions were not good for the economy; they led to one of the nation's most serious financial crises and economic downturns (1837-43). But they did reflect what we now recognize as an American principle of honoring local authority. Jackson hoped for less-centralized control of reserves and money creation, perhaps because he thought independent lending decisions would be better for economic growth outside the major population centers.

Moreover, Jacksonian principles are evident in the roots of the Federal Reserve. As Rousseau observes, the Fed was formed as a quasi-public bank with power distributed among 12 regional branches (or Reserve Banks, such as the Federal Reserve Bank of Cleveland). At the same time, some Hamiltonian principles were definitely preserved, in that Hamilton had also created branches for the First Bank and avoided the problem of these branches issuing non-uniform currencies.

"The system the Fed inherited was really one that had evolved over time," Rousseau says. "It wasn't one where a political union is put in place, monetary union follows, and the path is set from there. It's one where there is an organic evolution of a system drawing on the best features of the original Federalist vision and the populist democratic vision."

Implications for the EU

Where does that leave the European Union? Rousseau's main point is that it's misleadingly simple to argue that a political union is a precondition for monetary stability. US history shows it was much more complicated than that. Rousseau believes it is likely that Europe will take steps and missteps on the road but will eventually bring about both a monetary and a political union. And, although it probably won't happen very quickly, it almost certainly will happen in less time than the United States took to reach the same goal.



Ellis Tallman, senior economic advisor at the Cleveland Fed, comments on “What Can US History Tell Us About the European Union?”

Peter Rousseau proposes that political and monetary union in the United States required nearly a century to take hold. He compares Jacksonian banking with the present Eurozone situation and concludes that strident demands for political union in the Eurozone are short-sighted—that political and monetary unions take time to evolve and stabilize. Overall, his well-reasoned discussion is difficult to disagree with.

Rousseau’s work highlights the era of Andrew Jackson—a president known to be hostile to eastern financial and banking interests—to describe what he deems an important contribution to the evolution of the US monetary system. It is unusual for an economic historian to imply that Jackson’s veto of the charter renewal for the Second Bank of the United States was productive. Rousseau’s assertion is especially surprising because he has made other significant contributions to our understanding of how Jackson’s actions—the veto of the Second Bank Charter and the “Specie Circular”—magnified the severity of the financial Panic of 1837.

Rousseau provides a reasonable argument in support of the benefits of Jacksonian banking, but he fails to offer the alternative view in a counterexample.

But the argument in this paper is an expansive one that focuses on the attributes of a monetary, banking, and financial system in a Jacksonian perspective. Roughly speaking, the Jacksonian banking system aimed to “democratize” capital and access to it. It may have taken a “revolutionary” action (or perhaps a “reactionary” force against concentrated capital of the elites) to produce a banking system more accessible to the population within the regions lacking in capital.

Rousseau provides a reasonable argument in support of the benefits of Jacksonian banking, but he fails to offer the alternative view in a counterexample. In a discussion of a counterfactual question like, What would US banking have looked like if the Second Bank of the United States had been rechartered?, one is hard-pressed to provide evidence on the key points of Rousseau’s argument that western expansion benefited from dispersed and localized banking.

The key differences between the European Monetary Union presently and the United States in the nineteenth century center on timing. In the US, political union—with the exception of 1861–65—was established at the time of the adoption of the monetary unit. In the Euro area, monetary union has taken hold before political union. Rousseau’s perspective that the Euro area will evolve toward a successful monetary and political union is a reasoned one. I would be pleased to see his predictions unfold, but I am less sanguine about the prospects of that outcome. ■

The Evolution of the “Bank Examiner”



Stephen Ong
Vice President
Supervision and Regulation

Here is a favorite old story among bank examiners:

There once was a banker who, faced with a “surprise” bank examination, didn’t seem surprised at all. He had all his bank’s records ready and in perfect order and seemed fully prepared for the pop exam. Asked if he knew of the examiners’ approaching visit, the banker smiled and confessed, “The manager of the hotel down the street told me.”

Of course, this tale comes from the times when bank examinations were conducted on a surprise basis, and a team of out-of-town examiners would arrive at a bank in the late afternoon, just before closing time. The team would count the cash in tellers’ drawers and assess the physical security of the bank premises. Enough cash? Check. Secure building? Check.

Back in those days, a bank examiner’s role was limited to performing reviews at a particular point in time such as close of business on a certain day. The job was also very entity-based; that is, the exam concentrated solely on the bank itself. At that time, banks primarily made plain vanilla loans to businesses and consumers. If they had enough cash on hand and their books showed no irregularities, they would probably pass the exam. Given the simplicity of banking activities at that time, this approach was sufficient and endured from the onset of examinations in the 1940s to the early 1980s.

Since then, the job of supervising banks has evolved and continues to do so. Where we once had basic bank examiners, we now have the much more complex role of “financial system supervisors.” While financial system supervisors are still responsible for supervising individual banks, this new and expanded role is meant to better guard the financial system, not just the banks, against future crises.

This is a brief history of that evolution, plus a glimpse into what the future might hold.

The traditional bank examiner becomes extinct

One might argue that the traditional bank examiner had become obsolete by the 1990s. By then, annual point-in-time examinations could no longer identify risks in a timely way. The pace of change in the banking industry had accelerated, largely because of technology.

Offsite monitoring techniques were developed to augment point-in-time examinations. This ongoing supervision required more frequent, sophisticated analysis of bank financial reports. At larger, more complex banks, teams of examiners were assigned to the ongoing supervision of specific firms. This ongoing supervision enabled more timely identification of changes in bank strategies and activities that could result in greater risk. The role of the bank examiner had evolved to that of a “bank supervisor,” who not only examined the banks but also monitored them continually.

The Gramm–Leach–Bliley Act of 1999 empowered banking organizations to engage in a wider array of financial activities. The line between banks and nonbank financial firms began to blur, and bank supervisors had to adapt accordingly. They were required to view these organizations differently and assess a broader range of potential risks. By necessity, the bank supervisor had evolved into a “financial institution supervisor,” still engaged in continuous supervision of a single firm but recognizing that the single firm was no longer a traditional bank.

Lessons learned from the financial crisis

Before the financial crisis of 2007–08, supervisors focused primarily on the safety and soundness of the individual entities they were responsible for. Risks that spilled over from a bank or were transferred to the rest of the financial system were not closely monitored. Unfortunately, as the financial crisis revealed, these risks often made their way back onto the books of the banks.

Subprime residential mortgage loans are a good example. Many of the supervised financial institutions that originated these loans used an “originate and sell” business model. In this model, the financial institution made the subprime loans, but instead of keeping them on their own books, they sold them to a third party. The third party then packaged the loans into asset-backed securities and sold them to

investors in the financial markets. From the perspective of the originating institution, it had earned fee income from originating and selling the loans, but the risks had been transferred from their firm to somewhere in the marketplace. The supervisors, who likewise focused on the risks on the banks’ books, were satisfied that the risks associated with the subprime loans had been transferred out of the financial institutions they were supervising.

It has become clear that a solely entity-based approach to supervision is not enough to ensure financial stability.

Unfortunately, the risks did not disappear. Rather, they were transferred into another instrument—in this case, into an asset-backed security—and spread throughout the financial markets. Supervisors did not monitor the risks from the subprime mortgage loans closely once they were off the books of the firms they were supervising. These risks began to build, and remained collectively unmonitored in the financial system.

Further disguising these risks were the sophisticated methods used to package loans into complex financial instruments. The risks embedded in these instruments were often not easy to identify or fully understand. In many cases, financial institutions purchased securities collateralized by the same subprime loans that had been sold into the marketplace, thus bringing the risks back onto the bank’s books.

Following the crisis, it has become clear that a solely entity-based approach to supervision is not enough to ensure financial stability. In addition to identifying and monitoring risk within an individual firm, supervisors must also be alert to risks that exist more broadly in the financial system; these risks may ultimately find their way back onto the originating firm’s books, sometimes in very creative forms. In this way, financial institution supervisors evolved into “financial system supervisors,” who are engaged in the ongoing supervision of individual financial institutions *and* focused on the overall risks in the financial system.



- Ongoing supervision
- Focus on risks in financial institutions
- Focus on risks across groups of financial institutions and in the financial system
- Forward-looking risk identification



- Ongoing supervision
- Focus on risks in financial institutions



- Ongoing supervision
- Focus on risks in bank



- Point-in-time examination
- Focus on risks in bank

Financial system supervisors: A new approach

Financial system supervision has two dimensions: scope and time.

Scope

Scope refers to the range of supervised entities, instruments, and practices. The evolution of the financial system, particularly the interconnectedness of financial institutions, requires a broader scope and a more collective assessment of risks across firms.

An important tool for making this assessment is the horizontal review, which supervisors use to assess risk across a population of firms. First, supervisors identify a specific activity or area of risk. Then, they conduct reviews simultaneously at all firms and aggregate the results to provide a “macroprudential” view of the activity or risk exposure. This collective view allows supervisors to determine how the activity or risk may broadly affect an entire population of firms and the stability of the financial system.

An example: In 2010, supervisors at the Federal Reserve looked at incentive compensation practices at the largest US banking organizations. The review assessed incentive or bonus programs and looked for those that encouraged employees to take risks that went beyond a firm’s risk tolerance or could result in substantial risk to the financial system.

The results of the review helped supervisors develop principles for incentive compensation practices at financial firms that promote a more appropriate consideration of risk and alignment with safe and sound practices. Horizontal reviews have also been conducted in capital planning and adequacy, mortgage servicing, and other operational areas. Each review resulted in an aggregate view of risks to the financial system from these practices and updated supervisory guidance for financial firms.

Beyond horizontal reviews, supervisors are looking closely at issues like the “shadow banking system,” which has introduced a host of instruments and activities that may pose risks to the financial system. Even though many of these activities originate or reside outside supervised banking organizations, shadow banking activities can introduce risks to the financial system that may ultimately affect banking organizations.

Time

Time is the other dimension in which approaches have evolved. Traditionally, supervisors judged the condition of a financial institution according to information gathered on a particular date. This is useful, but only to a point; at best, it provides a rearview mirror assessment. A better approach includes a forward-looking perspective to understand how well an institution might hold up in a variety of scenarios.

Toward that end, supervisors increasingly use simulation models to replicate the inter-relations among various balance-sheet and income-statement accounts of a financial institution. Assumptions related to risk exposure, earnings performance, expense levels, and other factors are used as bases for these models, and the outputs are factored into the assessment of a financial firm's overall condition. The simulation models complement the historical trend and point-in-time perspectives of traditional supervisory approaches.

A high-profile use of simulation techniques was first deployed in 2009. Comprehensive capital assessment reviews have included various scenarios and assumptions related to macroeconomic factors that influence the performance of banking organizations. These simulation models give supervisors a better understanding of the potential losses that financial firms may experience in the future, should any of the assumed scenarios occur (including very high unemployment or a severe economic downturn). Given the potential loss exposure revealed by the scenarios, firms were required to maintain adequate levels of capital to absorb the potential losses. In this way, simulation models help the financial system prepare for the worst in ways that rearview assessments cannot.

Need for interdisciplinary collaboration

Today's financial system supervisors require a specialized set of skills. As financial activities and transactions grow more complex and sophisticated, supervisors must also have—or have access to—more complex and sophisticated skills and techniques to assess these activities. As a result, conducting supervisory reviews effectively requires greater collaboration within the Federal Reserve System among supervisors, economists, quantitative analysts, and other specialists.

The big question, of course, is whether all these changes will offer better protection from future financial crises.

Capital planning exercises, for example, required collaboration by several specialty groups. Supervisors assessed the financial institution's risk management practices. Quantitative analysts developed and assessed the various simulation models to determine adequate capital levels. Economists developed the economic scenarios on which the simulations were based and assessed the economic assumptions made by the financial institutions themselves. Finally, risk specialists quantified risk exposures and their effect on required capital cushions. This multidisciplinary approach was valuable, not only in terms of determining the horizontal review findings, but also in terms of reviewing the findings from multiple perspectives.

The big question, of course, is whether all these changes offer better protection from future financial crises. While that is a difficult question to answer with absolute certainty, we can say that a broad focus on financial stability was clearly missing in the run-up to the 2008 financial crisis. The tools financial system supervisors are now armed with are precisely the sort that could have helped mitigate the effects of that crisis. From detection of stress building in the financial system to enforcement of higher capital requirements, supervisors now possess important perspectives and tools they lacked last time. It should make a difference.

And next?

Gone are the days when bank examiners could limit their focus to the activities of a single bank. The examiner who famously showed up at Bailey's Savings and Loan in the classic film *It's a Wonderful Life* would feel wholly unequipped to do the modern-day job of supervising financial institutions and the financial system. Only a commitment to continuous evolution in the way we supervise will ensure that today's supervisors don't feel similarly ill-equipped. The safety and soundness of our financial system depends on it. ■



Speech

Watch video and read President Pianalto's speech on financial stability regulation at www.clevelandfed.org/for_the_public/news_and_media/speeches

Better Housing Policies



Thomas J. Fitzpatrick IV
Economist

Housing markets across the United States are showing signs of real stability. From prices to new construction to sales—all are improving from their recessionary lows. That's good news for the economic recovery.

But fallout from the housing crisis remains. Many communities bear scars, which won't easily fade, from rampant foreclosures and vacant properties. Fortunately, efforts to restore the health of the housing sector remain as well.

Ohio is one state that is watching these efforts closely. Some of its older industrial cities are struggling with housing troubles whose roots predate the recent crisis. These weak markets require policies tailored to fit their specific needs.

At the heart of Ohio's housing woes are two long-running trends: decades of population loss and economic stagnation in many of Ohio's older industrial cities. These have given rise to a supply of housing in excess of local demand, too much of which stand vacant and abandoned, and to spillover effects from a foreclosure rate that was elevated long before the recent recession. Together, these developments make Ohio a special case that does not fit neatly into the more familiar boom-bust narrative observed on a national scale.

In a new report, my colleagues and I lay out some of the main findings from the Federal Reserve Bank of Cleveland's years of research and outreach with Ohio bankers, community development practitioners, and other market participants. Our white paper is an Ohio-centric companion to the nationally focused housing market report issued by the Federal Reserve Board of Governors in January 2012, and we offer it in the same spirit—as providing a framework for weighing the pros and cons of programs aimed at stabilizing the housing sector. Over the winter and spring, we sought feedback from policymakers and housing

market experts. With their help in refining some particulars, we hope that our analysis can help inform more effective housing policies for Ohioans.

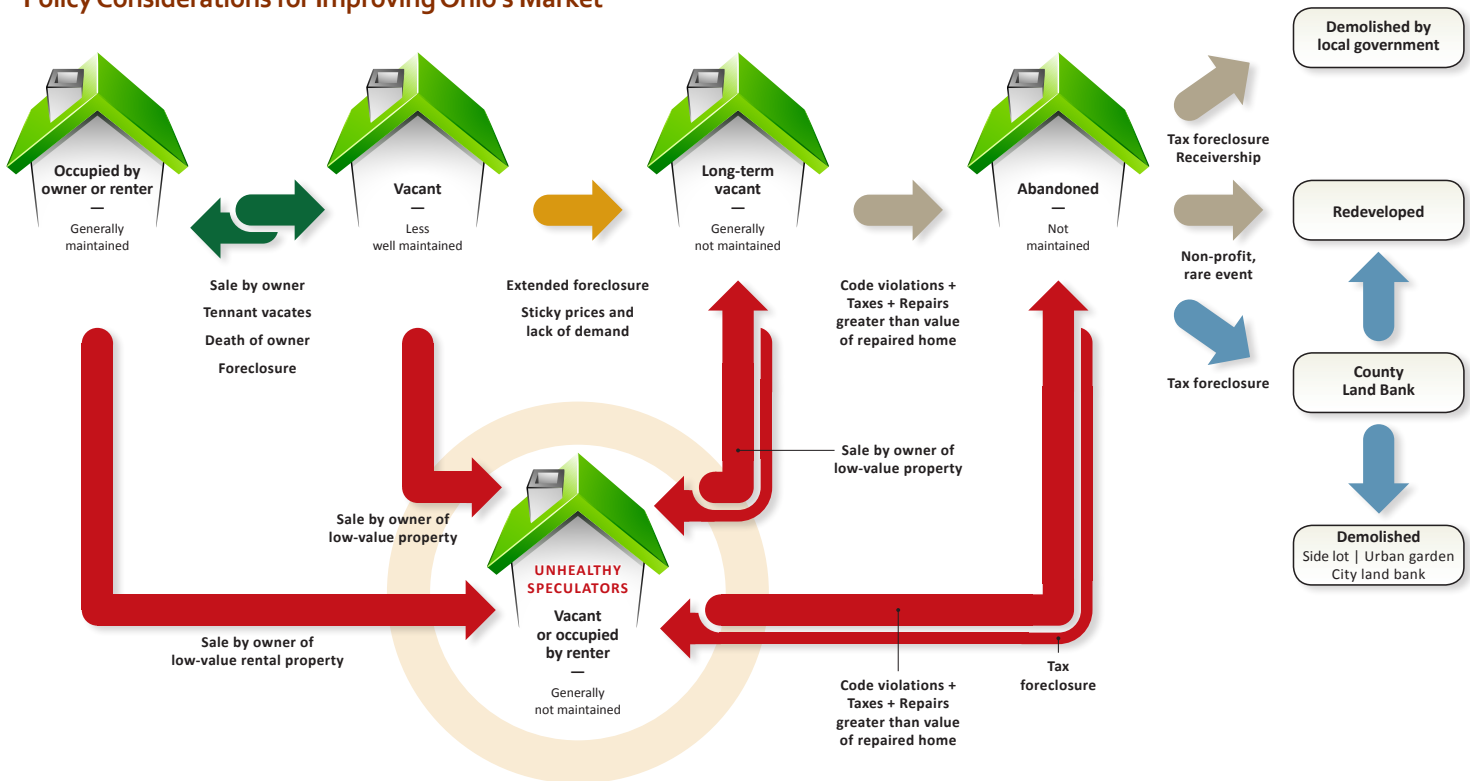
The Cleveland Reserve Bank's research and outreach have pointed to five policy areas that merit careful consideration in Ohio:

1. Foreclosure fast track for vacant and abandoned properties: It takes too long—an average of one to two years—for mortgage loans to go from delinquency through the foreclosure process in Ohio. When the home is vacant and abandoned, efforts to protect homeowners with lengthy foreclosure processes may unintentionally create costs with no corresponding benefits. These “deadweight losses” resulting from a drawn-out process include legal costs, physical damage to properties, crime, and downward pressure on neighboring property prices. Many states have moved to speed up the mortgage foreclosure process in cases where the owner has abandoned the home.

2. Elimination of minimum-bid requirements: Ohio law currently requires minimum bids of at least two-thirds of a foreclosed property's appraised value at the first auction. Although this may tamp down some unhealthy speculation at foreclosure auctions, it may also price some well-meaning property rehabbers out of the market. There are ways to offset the tradeoff between opening auctions to more investors and inadvertently encouraging unhealthy speculation. Eliminating the minimum-bid requirements could also enhance market efficiency by lowering transaction costs and reducing the amount of time properties sit empty.

3. Addressing harmful speculation: In extremely low-value housing markets, some entities engage in “harmful speculation”—the purchase of distressed property with no intent to invest in improvements or paying property taxes. Two features of Ohio law help this business model to persist: the ability to become the new owner of property through a corporation without being registered to do business in this state, which hampers the ability of code enforcement officials to pursue the owner for violations; and the ability to transfer the property without paying back

Policy Considerations for Improving Ohio's Market



taxes or correcting code violations. Requiring registration with the Secretary of State or the payment of back taxes or code violations before low-value properties could transfer to new owners could go a long way to empowering local governments to tackle this problem, and carefully crafted exemptions could prevent it from unduly delaying property transfers.

4. Expanded access to land banks: Nonprofit land banks have done significant work since the 2009 legislation that established their missions of acquiring, remediating, and putting into productive use vacant and abandoned properties. Demolition by land banks can help restore the balance between housing supply and demand. Our research shows that the high supply of housing relative to demand is the underlying cause of vacancy and abandonment. By expanding access, land banks could be available to any Ohio county that can make good use of them.

5. Improved data collection and access: Good data help inform decisions made in the public, private, and nonprofit sectors. Understanding Ohio's housing markets is especially difficult because of the dearth of standardized,

electronically stored data. Across Ohio counties, data storage practices are determined by inertia and budget constraints. With reliable data, policymakers, businesses, and community development practitioners can better identify what works and what doesn't, allowing them to allocate resources more efficiently. The payoff from a small investment in housing data standardization could be substantial.

Numerous and interconnected, housing issues can be addressed only through sustained and carefully considered programs. Understanding the tradeoffs inherent in any policy is a good first step. ■

Recommended reading



Read the full paper, "Policy Considerations for Improving Ohio's Housing Markets," at www.clevelandfed.org/community_development/publications/special_reports/20130522_index.cfm

Read the paper issued by the Board of Governors of the Federal Reserve System, "The U.S. Housing Market: Current Conditions and Policy Considerations," at www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf

What is the *Beige Book*?

You may have seen media stories that mention the Federal Reserve's *Beige Book*, a periodic report on economic conditions around the country. But most people probably have never laid eyes on the book itself, or know what's really in it. *Forefront* talks to Bob Sadowski, a senior economic analyst who has primary responsibility for producing the Cleveland Fed's contribution to the *Beige Book*.

Forefront: *Let's start with the question that is no doubt uppermost in everybody's mind: Why is it called the "Beige" Book? Why not some other color?*

Sadowski: When the report was first published in 1970, it was called the *Red Book* because that was the color of its cover. In 1983, the report's format was changed to what we see today, and its name became the *Beige Book*. A few years ago, the Federal Reserve converted the publication to an all-electronic format, but the name stuck. By the way, its formal title is *Summary of Commentary on Current Economic Conditions*.

Forefront: *The Beige Book is published eight times a year. How do you ensure that the Cleveland Fed's contribution is an accurate representation of business and industry in the region?*

Sadowski: We cover six industry sectors—manufacturing, real estate, retail sales, banking, energy, and freight transportation. Having a representative sample from each sector is critical if we're to give the Board of Governors substantive information. To accomplish this, we use three primary sources: *Beige Book* contacts, boards of directors, and business advisory councils in the Fourth District. Every one of them is a business owner or senior manager, and their firms range in size from micro to Fortune 500.

Forefront: *You say you "cover" these sectors, but how do you collect the information?*

Sadowski: During any *Beige Book* cycle, we will have spoken with at least 150 knowledgeable people about their views on demand, expectations, investment, prices, labor, and any other topic of concern to them. Six of the Bank's research analysts call these contacts every cycle (six-week period) to get their views on business conditions and the economy at large. The Fourth District has a board of directors in each of its offices: Cleveland, Cincinnati, and Pittsburgh. Every board meeting includes an economic discussion in which directors respond to our questions about the economy or participate in a go-round in which they present their views on business conditions. People are often surprised to learn that the Cleveland board convenes 28 times a year.

We also have business advisory councils in Cincinnati, Cleveland, Columbus, Dayton, Erie, Lexington, Pittsburgh, and Wheeling, which meet either twice or three times a year. For each meeting, we in the Research Department of the Cleveland Fed prepare economic questions that members respond to in a roundtable discussion. Members of business advisory councils are specifically selected to include representatives



Forefront talks to the Cleveland Fed's Bob Sadowski, senior economic analyst, about the *Beige Book*.

from outside the six industry sectors on which we report. On top of all this, Bank executives frequently meet with business leaders across the District in informal one-on-one discussions in which participants express their views on business conditions.

Forefront: *The Federal Reserve is known for paying a lot of attention to data, but the Beige Book contains no numbers. Of what value is the information contained in it?*

Sadowski: Both data and anecdotal information have their strengths and shortcomings. Data represents a snapshot of a specific variable over a short period of time; it's subject to revision, sometimes to a substantial degree. As a result, we seek to round out our regional economic analysis with anecdotal information. These anecdotes may point to the beginning of a trend that is not yet apparent in the data. They may also fill in gaps, that is, explain the why of the numbers. Here's a quote that should put things in perspective: "Anecdotal information brings the Committee [Federal Open Market Committee, or FOMC] qualitative judgments and insights that the aggregative statistics will always lack."—George Mitchell, Fed Governor, 1961–75.

Forefront: *So do anecdotes gleaned from the Beige Book surveys end up getting discussed around the FOMC table?*

Sadowski: The simple answer to your question is yes, but let me elaborate. Economists at the Cleveland Fed, and across the Federal Reserve System, pore over data, conduct research, and create models for economic forecasting. However, the economy inevitably changes and evolves in ways that cannot be captured precisely with any mathematical model. Very often, the official data that is available is just not

current enough for a forward-looking enterprise like monetary policy. This is where judgment comes into play, shaped in part by the anecdotal information we receive.

As I mentioned earlier, data tells you what is going on in the economy, while anecdotes help you understand the *why* behind the *what*. This interplay of data, models, and judgment about current events is vital to how the economists and president of the Cleveland Fed structure their economic forecasts. Multiply this process many times over, among all the FOMC participants, and the result is that each person brings his or her own forecast to the meeting. One last thing—the agenda for every FOMC meeting includes a go-round, in which each FOMC participant gives his or her outlook for the national economy. As part of their commentary, the 12 Federal Reserve Bank presidents also present information on economic developments in their respective regions.

Forefront: *I'm looking at the March Beige Book, in which we report that business activity rose at a "modest" pace in the Fourth District. Later, we note that coal production has declined "moderately." Any tips on how to differentiate between "modest" and "moderate"?*

Sadowski: Throughout the *Beige Book*, you'll see these descriptors, plus many others, that are used to weigh the increase or decrease in an economic variable or the economy as a whole. All districts use them to some extent. Since the weight is subjective, we don't formally assign a range of values to any descriptor. Remember that we talk with contacts from many different industries within the same sector.

During any *Beige Book* cycle, we will have spoken with at least 150 knowledgeable people about their views on demand, expectations, investment, prices, labor, and any other topic of concern to them.

A 5 percent rise in new orders in one industry may be interpreted differently than the same percentage increase in another industry. Your readers may be interested in knowing that after completing the *Beige Book* draft, each district fills out a checklist, which is used to help evaluate the change in sectors and some variables over time. As part of this checklist, the following weights are used: no change, slight (mild), modest (slow), moderate (average), strong (robust), and very strong (rapid).

Forefront: *Have you used any other descriptors on occasions when the customary ones don't quite fit the bill?*

Sadowski: No, not really. I think those six are more than enough! Careful readers of the *Beige Book* (yes, it does have some readers apart from the FOMC) might have noticed that the word "robust" is starting to be used a little more frequently as we work our way through the recovery. Hopefully, we'll be able to use the words "very strong" in the near future. ■

Recommended reading



Incredible as it seems, the *Beige Book* is free! Find it eight times a year at www.federalreserve.gov/monetarypolicy/beigebook

Interview with Barry Eichengreen

To some, the term “economic historian” conjures up images of an academic whose only interests lie deep in the past; an armchair scholar who holds forth on days long ago but has no insights about the present. Barry Eichengreen provides a useful corrective to that stereotype. For, as much as Eichengreen has studied episodes in economic history, he seems more attuned to connecting the past to the present. At the same time, he is mindful that “lessons” have a way of taking on lives of their own. What’s taken as given among economic historians today may be wholly rejected in the future.

Barry Eichengreen is the George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley, his hometown. He is known as an expert on monetary systems and global finance. He has authored more than a dozen books and many more academic papers on topics from the Great Depression to the recent financial crisis.

Eichengreen was a keynote speaker at the Federal Reserve Bank of Cleveland’s research conference Current Policy Under the Lens of Economic History in December 2012. Mark Sniderman, the Cleveland Fed’s executive vice president and chief policy officer, interviewed Eichengreen during his visit. An edited transcript follows.

Sniderman: *It's an honor to talk with you. You're here at this conference to discuss the uses and misuses of economic history. Can you give us an example of how people inaccurately apply lessons from the past to the recent financial crisis?*

Eichengreen: The honor is mine.

Whenever I say “lessons,” please understand the word to be surrounded by quotation marks. My point is that “lessons,” when drawn mechanically, have considerable capacity to mislead. For example, one “lesson” from the literature on the Great Depression was how disruptive serious banking crises can be. That, in a nutshell, is why the Fed and its fellow regulators paid such close attention to the banking system in the run-up to the recent crisis. But that “lesson” of history was, in part, what allowed them to overlook what was happening in the shadow banking system, as our system of lightly regulated near-banks is known.

How did they miss it? One answer is that there was effectively no shadow banking system to speak of in the 1930s. We learned to pay close attention to what was going on in the banking system, narrowly defined. That bias may have been part of what led policy-makers to miss what was going on in other parts of the financial system.

Another example, this one from Europe, is the “lesson” that there is necessarily such a thing as expansionary fiscal consolidation. Europeans, when arguing that such a thing exists, look to the experience of the Netherlands and Ireland in the 1980s, when those countries cut their budget deficits without experiencing extended recessions. Both countries were able to consolidate but continue to grow, leading contemporary observers to argue that the same should be true in Europe today. But reasoning from that historical case to today misleads because the circumstances at both the country and global level were very

different. Ireland and the Netherlands were small. They were consolidating in a period when the world economy was growing. These facts allowed them to substitute external demand for domestic demand. In addition, unlike European countries today, they had their own monetary policies, allowing them to step down the exchange rate, enhance the competitiveness of their exports at one fell swoop, and avoid extended recessions. But it does not follow from their experience that the same is necessarily possible today. Everyone in Europe is consolidating simultaneously. Most nations lack their own independent exchange rate and monetary policies. And the world economy is not growing robustly.

A third “lesson” of history capable equally of informing and misinforming policy would be the belief in Germany that hyperinflation is always and everywhere just around the corner. Whenever the European Central Bank does something unconventional, like its program of Outright Monetary Transactions, there are warnings in the German press that this is about to unleash the hounds of inflation. This presumption reflects the “lesson” of history, taught in German schools, that there is no such thing as a little inflation. It reflects the searing impact of the hyperinflation of the 1920s, in other words. From a distance, it's interesting and more than a little peculiar that those textbooks fail to mention the high unemployment rate in the 1930s and how that also had highly damaging political and social consequences.

The larger question is whether it is productive to think in terms of “history lessons.” Economic theory has no lessons; instead, it simply offers a way of systematically structuring how we think about the world. The same is true of history.

Eventually, we came to realize that we were facing not just a US crisis but a global crisis. But there was an extended period when many observers, in Europe in particular, thought that their economies were immune.

Sniderman: *Let's pick up on a couple of your comments about the Great Depression and hyperinflation in Germany. Today, some people in the United States have the same concerns. They look at the expansion of the monetary base and worry about inflation. Do you find it surprising that people are still fighting about whether big inflation is just around the corner because of US monetary policy, and is it appropriate to think about that in the context of the unemployment situation as well?*

Eichengreen: I don't find it surprising that the conduct of monetary policy is contested. Debate and disagreement are healthy. Fiat money is a complicated concept; not everyone trusts it.

But while it's important to think about inflation risks, it's also important to worry about the permanent damage to potential output that might result from an extended period of subpar growth. To be sure, reasonable people can question whether the Fed possesses tools suitable for addressing this problem. But it's important to have that conversation.

Sniderman: *Maybe just one more question in this direction because so much of your research has centered on the Great Depression. Surely you've been thinking about some of the similarities and differences between that period and this one. Have you come to any conclusions about that?*

Eichengreen: My work on the Depression highlighted its international dimension. It emphasized the role of the gold standard and other international linkages in the onset of the Depression, and it emphasized the role that abandoning the gold standard and changing the international monetary regime played in bringing it to an end.

Barry Eichengreen

Position

George C. Pardee and Helen N. Pardee Professor of Economics and Political Science, University of California, Berkeley

Other Positions

Research associate, National Bureau of Economic Research; research fellow, Centre for Economic Policy in London, England; past president, Economic History Association

Former Positions

Senior policy advisor, International Monetary Fund

Education

Yale University, MA, MP, and PhD in economics
University of California, Santa Cruz, AB

Selected Publications

The World Economy after the Global Crisis: A New Economic Order for the 21st Century, co-edited with Bokyeong Park. 2012. London: World Scientific Studies in International Economics Co. Pte. Ltd.

Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System. 2011. New York, NY: Oxford University Press.

“Is Household Debt Overhang Holding Back Consumption?” 2012. *Brookings Papers on Economic Activity* (Spring).

“Financial Crises and the Multilateral Response: What the Historical Record Shows” (with Bergljot Barkbu and Ashoka Mody). *Journal of International Economics*, 88(2): 422-35.

“Economic History and Economic Policy.” 2012. *Journal of Economic History*, 72(2): 289-307.

“Bretton Woods and the Great Inflation,” with Michael Bordo. 2008. NBER Working Paper 14532 (December).

As a student, I was struck by the tendency in much of the literature on the Depression to treat the US essentially as a closed economy. Not surprisingly, perhaps, I was then struck by the tendency in 2007 to think about what was happening then as a US subprime crisis. Eventually, we came to realize that we were facing not just a US crisis but a global crisis. But there was an extended period during when many observers, in Europe in particular, thought that their economies were immune. They viewed what was happening as an exclusively American problem. They didn't realize that what happened in the United States doesn't stay in the United States. They didn't realize that European banks, which rely heavily on dollar funding, were tightly linked to US economic and financial conditions. One of the first bits of research I did when comparing the Great Depression with the global credit crisis, together with Kevin O'Rourke, was to construct indicators of GDP, industrial production, trade, and stock market valuations worldwide and to show that, when viewed globally, the current crisis was every bit as severe as that of the 1930s.

Sniderman: *Given that many European countries are sharing our financial distress, what changes in the international monetary regime, if any, would be helpful? Could that avenue for thinking of solutions be as important this time around as it was the last time?*

Eichengreen: One of the few constants in the historical record is dissatisfaction with the status quo. When exchange rates were fixed, Milton Friedman wrote that flexible rates would be better. When rates became flexible, others like Ron McKinnon argued that it would be better if we returned to pegs. The truth is that there are tradeoffs between fixed and flexible rates and, more generally, in the design of any international monetary system. Exchange rate commitments limit the autonomy of national monetary policymakers, which can be a good thing if that autonomy is being misused. But it can be a bad thing if that autonomy is needed to address pressing economic problems. The reality is that there is no such thing as the perfect exchange rate regime. Or, as Jeffrey Frankel put it, no one exchange rate regime is suitable for all times and places.

That said, there has tended to be movement over time in the direction of greater flexibility and greater discretion for policymakers. This reflects the fact that the mandate for central banks has grown more complex—necessarily,

I would argue, given the growing complexity of the economy. An implication of that more complex mandate is the need for more discretion and judgment in the conduct of monetary policy—and a more flexible exchange rate to allow that discretion to be exercised.

Sniderman: *I'd be interested in knowing whether you thought this crisis would have played out differently in the European Union if the individual countries still had their own currencies. Has the euro, per se, been an element in the problems that Europe is having, much as a regime fixed to gold was a problem during the Great Depression?*

Eichengreen: Europe is a special case, as your question acknowledges. Europeans have their own distinctive history and they have drawn their own distinctive “lessons” from it. They looked at the experience of the 1930s and concluded that what we would now call currency warfare, that is, beggar-thy-neighbor exchange-rate policies, were part of what created tensions leading to World War II. The desire to make Europe a more peaceful place led to the creation of the European Union. And integral to that initiative was the effort to stabilize exchange rates, first on an ad hoc basis and then by moving to the euro.

Whether things will play out as anticipated is, as always, an open question. We now know that the move to monetary union was premature. Monetary union requires at least limited banking union. Banking union requires at least limited fiscal union. And fiscal union requires at least limited political union. The members of the euro zone are now moving as fast as they can, which admittedly is not all that fast, to retrofit their monetary union to include a banking union, a fiscal union, and some form of political union. Time will tell whether or not they succeed.

But even if hindsight tells us that moving to a monetary union in 1999 was premature, it is important to understand that history doesn't always run in reverse. The Europeans now will have to make their monetary union work. If they don't, they'll pay a high price.

Sniderman: *Let me pose a very speculative question. Would you say that if the Europeans had understood from the beginning what might be required to make all this work, they might not have embarked on the experiment; but because they did it as they did, there's a greater likelihood that they'll do what's necessary to make the euro system endure? Is that how you're conjecturing things will play out?*

Eichengreen: If I may, allow me to refer back to the early literature on the euro. In 1992, in adopting the Maastricht Treaty, the members of the European Union committed to forming a monetary union. That elicited a flurry of scholarship. An article I wrote about that time with Tamim Bayoumi looked at whether a large euro area or a small euro area was better. We concluded that a small euro area centered on France, Germany, and the Benelux countries made more sense. So one mistake the Europeans made, which was predictable perhaps on political grounds, though no more excusable, was to opt for a large euro area.



I had another article in the *Journal of Economic Literature* in which I devoted several pages to the need for a banking union; on the importance, if you're going to have a single currency, single financial market, and integrated banking system, of also having common bank supervision, regulation, and resolution. European leaders, in their wisdom, thought that they could force the pace. They thought that by moving to monetary union they could force their members to agree to banking union more quickly. More quickly didn't necessarily mean overnight; they thought that they would have a couple of decades to complete the process. Unfortunately, they were sideswiped by the 2007–08 crisis. What they thought would be a few decades turned out to be one, and they're now grappling with the consequences.

Sniderman: *You've written about the dollar's role as a global currency and a reserve currency, and you have some thoughts on where that's all headed. Maybe you could elaborate on that.*

Eichengreen: A first point, frequently overlooked, is that there has regularly been more than one consequential international currency. In the late nineteenth century, there was not only the pound sterling but also the French franc and the German mark. In the 1920s, there was both the dollar and the pound sterling. The second half of the twentieth century is the historical anomaly, the one period when there

was only one global currency because there was only one large country with liquid financial markets open to the rest of the world—the United States. The dollar dominated in this period simply because there were no alternatives.

I didn't anticipate the severity and interactability of the euro crisis. All I can say in my defense is that no one did.

But this cannot remain the case forever. The US will not be able to provide safe and liquid assets in the quantity required by the rest of the world for an indefinite period. Emerging markets will continue to emerge. Other countries will continue to catch up to the technological leader, which is still, happily, the United States. The US currently accounts for about 25 percent of the global economy. Ten years from now, that fraction might be 20 percent, and 20 years from now it is apt to be less. The US Treasury's ability to stand behind a stock of Treasury bonds, which currently constitute the single largest share of foreign central banks' reserves and international liquidity generally, will grow more limited relative to the scale of the world economy. There will have to be alternatives.

In the book I wrote on this subject a couple of years ago, *Exorbitant Privilege: The Rise and Fall of the Dollar and the Future of the International Monetary System*, I pointed to the euro and the Chinese renminbi as the plausible alternatives. I argued that both could conceivably be significant rivals to the dollar by 2020. The dollar might well remain number one as invoicing currency and currency for trade settlements, and as a vehicle for private investment in central bank reserves, but the euro and renminbi could be nipping at its heels.

In the fullness of time I've grown more pessimistic about the prospects of those rivals. Back in 2010, when my book went off to the publisher, I didn't anticipate the severity and intractability of the euro crisis. All I can say in my defense is that no one did. And I underestimated how much work the Chinese will have to do in order to successfully internationalize their currency. They are still moving in that direction; they've taken steps to encourage firms to use the renminbi for trade invoicing and settlements, and now they are liberalizing access to their financial markets, if gradually. But they have a deeper problem. Every reserve currency in history has been the currency of a political democracy or a republic of one sort or another. Admittedly, the United States and Britain are only two observations, which doesn't exactly leave many degrees of freedom for testing this hypothesis. But if you go back before the dollar and sterling, the leading international currencies were those of the Dutch Republic, the Republic of Venice, and the Republic of Genoa. These cases are similarly consistent with the hypothesis.

The question is why. The answer is that international investors, including central banks, are willing to hold the assets only of governments that are subject to checks and balances that limit the likelihood of their acting opportunistically. Political democracy and republican forms of governance are two obvious sources of such checks and balances. In other words, China will have to demonstrate that its central government is subject to limits on arbitrary action—that political decentralization, the greater power of nongovernmental organizations, or some other mechanism that places limits on arbitrary action—before foreign investors, both official and private, are fully comfortable about holding its currency.

I therefore worry not so much about these rivals dethroning the dollar as I do about the US losing the capacity to provide safe, liquid assets on the requisite scale before adequate alternatives emerge. Switzerland is not big enough to provide safe and liquid assets on the requisite scale; neither is Norway, nor Canada, nor Australia. Currently we may be swimming in a world awash with liquidity, but we shouldn't lose sight of the danger that, say, 10 years from now there won't be enough international liquidity to grease the wheels of twenty-first-century globalization.

Sniderman: *It sounds to me as though you're also trying to say that the United States should actually become comfortable with, perhaps even welcome, this development, because its absence creates some risks for us.*

Eichengreen: I am. The United States benefits from the existence of a robust, integrated global economy. But globalization, in turn, requires liquidity. And the US, by itself, can't satisfy the global economy's international liquidity needs. So the shift toward a multipolar global monetary and financial system is something that we should welcome. It will be good for us, and it will be good for the global economy. To the extent that we have to pay a couple more basis points when we sell Treasury debt because we don't have a captive market in the form of foreign central banks, that's not a prohibitive cost.

Sniderman: *And how has the financial crisis itself affected the timetable and the movement? It sounds like in some sense it's retarding it.*

Eichengreen: The crisis is clearly slowing the shift away from dollar dominance. When the subprime crisis broke, a lot of people thought the dollar would fall dramatically and that the People's Bank of China might liquidate its dollar security holdings.

What we discovered is that, in a crisis, there's nothing that individuals, governments, and central banks value more than liquidity. And the single most liquid market in the world is the market for US Treasury bonds. When Lehman Brothers failed, as a result of US policy, everybody rushed toward the dollar rather than away. When Congress had its peculiar debate in August 2011 over raising the debt ceiling, everybody rushed toward the dollar rather than away. That fact may be ironic, but it's true.

And a second effect of the crisis was to retard the emergence of the euro on the global stage. That too supports the continuing dominance of the dollar.

Sniderman: *Economists and policy-makers have always missed things. Are there ways in which economic historians can help current policymakers not to be satisfied with the "lessons" of history and get them to think more generally about these issues?*

Eichengreen: It's important to make the distinction between two questions—Could we have done better at anticipating the crisis? and, Could we have done better at responding to it? On the first question, I would insist that it's too much to expect economists or economic historians to accurately forecast complex contingent events like financial crises. In the 1990s, I did some work on currency crises, instances when exchange rates collapse, with Charles Wyplosz and Andrew Rose. We found that what works on historical data, in other words, what works *in* sample doesn't also work *out* of sample. We were out-of-consensus skeptics about the usefulness of leading indicators of currency crises, and I think subsequent experience has borne out our view. Paul Samuelson made the comment that economists have predicted 13 out of the last seven crises. In other words, there's type 1 error as well as type 2 error [the problem of false positives as well as false negatives].

Coming to the recent crisis, it's apparent with hindsight that many economists — and here I by no means exonerate economic historians — were too quick to buy into the idea that there was such a thing as the Great Moderation. That was the idea that through better regulation, improved monetary policy, and the development of automatic fiscal stabilizers, we had learned to limit the volatility of the business cycle. If we'd paid more attention to history, we would have recalled an earlier period when people made the same argument: They attributed the financial crises of the nineteenth century to the volatility of credit markets; they believed that the founding of the Fed had eliminated that problem and that the business cycle had been tamed. They concluded that the higher level of asset prices observed in the late 1920s was fully justified by the advent of a more stable economy. They may have called it the New Age rather than the Great Moderation, but the underlying idea, not to say the underlying fallacy, was the same.

A further observation relevant to understanding the role of the discipline in the recent crisis is that we haven't done a great job as a profession of integrating macroeconomics and finance. There have been heroic efforts to do so over the years, starting with the pioneering work of Franco Modigliani and James Tobin. But neither scholarly work nor the models used by the Federal Reserve System adequately capture, even today, how financial developments and the real economy interact. When things started to go wrong financially in 2007–08, the consequences were not fully anticipated by policymakers and those who advised them — to put an understated gloss on the point. I can think of at least two prominent policymakers, who I will resist the temptation to name, who famously asserted in 2007 that the impact of declining home prices would be “contained.” It turned out that we didn't understand how



declining housing prices were linked to the financial system through collateralized debt obligations and other financial derivatives, or how those instruments were, in turn, linked to important financial institutions. So much for containment.

Sniderman: I suppose one of the challenges that the use of economic history presents is the selectivity of adoption. And here I have in mind things like going back to the Great Depression to learn “lessons.” It’s often been said, based on some of the scholarship of the Great Depression and the role of the Fed, that the “lesson” the Fed should learn is to act aggressively, to act early, and not to withdraw accommodation prematurely. And that is the framework the Fed has chosen to adopt. At the same time, others draw “lessons” from other parts of US economic history and say, “You can’t imagine that this amount of liquidity creation, balance sheet expansion, etc. would not lead to a great inflation.” If people of different viewpoints choose places in history where they say, “History teaches us X,” and use them to buttress their view of the appropriate response, I suppose there’s no way around that other than trying, as you said earlier, to point out whether these comparisons are truly apt or not.

Eichengreen: A considerable literature in political science and foreign policy addresses this question. Famous examples would be President Truman and Korea on the one hand, and President Kennedy and the Cuban Missile Crisis on the other. Ernest May, the Harvard political scientist,

Economists reason from theory while historians reason from a mass of facts. Economic historians do both.

argued that Truman thought only in terms of Munich, Munich having been the searing political event of his generation. Given the perspective this created, Truman was predisposed to see the North Koreans and Chinese as crossing a red line and to react aggressively. Kennedy, on the other hand, was less preoccupied by Munich. He had historians like Arthur Schlesinger advising him. Those advisors encouraged him to develop and consider a portfolio of analogies and test their aptness — in other words, their “fitness” to the circumstances. One should look not only at Munich, Schlesinger and others suggested, but also at Sarajevo. It is important to look at a variety of other precedents for current circumstances, to think which conforms best to the current situation, and to take that fit into account when you’re using history to frame a response.

I think there was a tendency, when things were falling down around our ears in 2008, to refer instinctively to the Great Depression. What Munich was for Truman, the Great Depression is for monetary economists. It’s at least possible that the tendency to compare the two events and to frame the response to the current crisis in terms of the need “to avoid another Great Depression” was conducive to overreaction. In fairness, economic historians did point to other analogies. There was the 1907 financial crisis. There was the 1873 crisis. It would have been better, in any case, to have developed a fuller and more rounded portfolio of precedents and analogies and to have used it to inform the policy response. Of course, that would have required policymakers to have some training in economic history.

Sniderman: *This probably brings us back full circle. We started with the uses and misuses of economic history and we've been talking about economic history throughout the conversation. I think it might be helpful to hear your perspective on what economic history and economic historians are. Why not just an economist who works in history or a historian who works on topics of economics? What does the term "economic history" mean, and what does the professional discipline of economic historian connote to you?*

Eichengreen: As the name suggests, one is neither fish nor fowl; neither economist nor historian. This makes the economic historian a trespasser in other people's disciplines, to invoke the phrase coined by the late Albert Hirschman. Historians reason by induction while economists are deductive. Economists reason from theory while historians reason from a mass of facts. Economic historians do both. Economists are in the business of simplifying; their strategic instrument is the simplifying assumption. The role of the economic historian is to say "Not so fast, there's context here.

Your model leaves out important aspects of the problem, not only economic but social, political, and institutional aspects—creating the danger of providing a misleading guide to policy."

Sniderman: *Do you think that, in training PhD economists, there's a missed opportunity to stress the value and usefulness of economic history? Over the years, economics has become increasingly quantitative and math-focused. From the nature of the discussion we've had, it is clear that you don't approach economic history as sort of a side interest of "Let's study the history of things," but rather a disciplined way of integrating economic theory into the context of historical episodes. Is that way of thinking about economic history appreciated as much as it could be?*

Eichengreen: I should emphasize that the opportunity is not entirely missed. Some top PhD programs require an economic history course of their PhD students, the University of California, Berkeley, being one.

The best way of demonstrating the value of economic history to an economist, I would argue, is by doing economic history. So when we teach economic history to PhD students in economics in Berkeley, we don't spend much time talking about the value of history. Instead, we teach articles and address problems, and leave it to the students, as it were, to figure how this style of work might be applied to their own research. For every self-identifying economic historian we produce, we have several PhD students who have a historical chapter, or a historical essay, or a historical aspect to their dissertations. That's a measure of success.

Sniderman: *Well, thank you very much. I've enjoyed it.*

Eichengreen: Thank you. So have I. ■



Watch video clips from this interview

www.clevelandfed.org/forefront



Recommended reading

Tamim Bayoumi and Barry Eichengreen. 1993. "Shocking Aspects of European Monetary Unification," in Francisco Torres and Francesco Giavazzi (eds), *Adjustment and Growth in the European Monetary Union*, Cambridge: Cambridge University Press, 193-240.

Barry Eichengreen. 1993. "European Monetary Unification," *Journal of Economic Literature*, American Economic Association, 1321-57. www.jstor.org/stable/2728243

P O L I C Y S U M M I T



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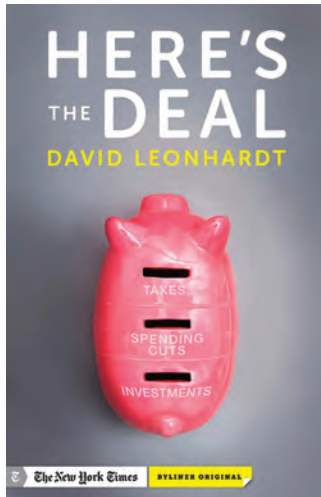
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Book Review



Here's the Deal

by David Leonhardt
A New York Times/Byliner Original



Reviewed by
Doug Campbell
Editor

There is so much noise over the federal budget situation that it's difficult to think clearly on the subject. One wants to have a considered view—this is the nation's future, after all. But too often, voices from polar ends of the political spectrum drown out clarity.

Indisputable facts are really hard to find. For example, until this spring one factoid that served to put extra urgency into the deficit-reducing campaign was this nugget from Harvard University economists Carmen Reinhart and Kenneth Rogoff: They found that once countries see their debt cross over 90 percent of GDP, economic growth stalls.

Turns out this fact is in dispute. Reinhart and Rogoff had made an error in their calculations. The “90 percent threshold” that some commentators had cited as crucial evidence that the United States must engage in immediate deficit-reduction efforts was effectively discredited. Depending on whose version you believe, it was either an “academic kerfuffle” or a major ideological blow to those calling for severe budget cuts, or “austerity.”

In one sense, though, the hubbub over what has become known as the Reinhart–Rogoff episode distracts from the core issue—that the United States really is on an unsustainable, long-term fiscal path. At the same time, as the Federal Reserve has noted, recent budget cuts have been a drag on the economy. How can we get to a place where we can hold a reasonable discussion about how to accomplish long-term fiscal sustainability without derailing the still-nascent recovery?

Policy papers galore have appeared with recommendations. But a less academic and more readable overview of the big picture is presented in *Here's the Deal* by *New York Times* reporter David Leonhardt. Released in e-book form only, this volume delivers the basic facts underpinning the debate in less than an afternoon's reading time. One may disagree with Leonhardt's messages on the most efficient use of tax dollars, but it's more of a stretch to quarrel with his fundamental assertion that the deficit problem won't fix itself—we have to take action, painful as it may be.

More than statistics, the value of Leonhardt's effort is in its perspective. His overarching, most compelling argument is that reducing the deficit for the sake of reducing the deficit is misguided. To the extent that large deficits impede growth, then they must be addressed. Ultimately, though, the goal for policymakers should be economic growth. A third of the way in, Leonhardt lays out the central question: "Does the country have the right balance between spending on the present and spending on the future?" Leonhardt's argument is that the way things are currently set to shake out, the balance is tipped toward too little spending on the present and too much on the future. Right now, the amount of federal spending dedicated to everything besides military, health care, and Social Security is at its lowest percentage of GDP in 60 years.

He debunks the talking point that Social Security and Medicare are really self-financing because they are (mostly) funded through dedicated taxes, and thus don't deserve the scrutiny they are receiving. "The federal government is one entity, financed by one group of investors," Leonhardt points out. "When foreign lenders buy American debt, they don't stop to ask which programs they are funding." He asks whether it makes sense that older Americans should be spared in deficit-reduction sacrifices, given that federal spending on the elderly is actually more likely to rise in future years, and given that completely forgoing "youthful" spending in the form of investments in education and research is sure to come back to haunt the nation.

Leonhardt suggests the contours of a long-term plan that includes compromises many special interest groups will resist. In the process, he makes a broad call for public investments in infrastructure and innovation—a necessary role for government because private investment in such

efforts may be lacking, to the extent that only a fraction of the payoff to those investments will flow to the investors and inventors. Investments in education are likewise an essential role for public dollars, and they are more likely to help reduce future deficits (via economic growth) than expand them.

[Leonhardt's] overarching, most compelling argument is that reducing the deficit for the sake of reducing the deficit is misguided.

Now, in a highly combative political environment, these proposals might seem naïve. Good luck getting Congress to agree on this array of compromises! Yet that doesn't change the fact that Leonhardt's message is perfectly reasonable. When judged purely on merit, the ideas are definitely worth considering. Even if you disagree, the clear framework that Leonhardt lays out for thinking about the nation's long-term fiscal situation is worth the price of *Here's the Deal*.

Incidentally, Reinhart and Rogoff play a small part in introducing Leonhardt's narrative. He references the 90 percent figure as motivation for his opening argument that "the federal debt—the accumulation of prior deficit—remains worrisomely high." The 90 percent threshold may be controversial, but the fundamental observation that the nation's debt poses a legitimate threat to long-term economic growth is not seriously contested. Should there be future editions of *Here's the Deal*, Leonhardt won't have to search very long to find any number of substitute references to support that point. ■

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