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“Responding to Crises”

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For Panel I: Responding to Financial Crises: What Role for the Fed?

Federal Reserve Policy in the Face of Crises

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They say “there are no atheists in foxholes.” Perhaps, then, there are also no libertarians in crises. Even those in favor of sharply reducing the role of the government tend to agree that, for example, there is a valid Lender of Last Resort role for the central bank in the event of banking panics. But of course crises should not become an excuse for public policy that is hasty or ill-informed, or that serves primarily the interests of the policymakers themselves or of special interests. The response must be appropriate, careful, and informed by the longer term perspective offered by historical precedent and by an awareness of the dangers pointed out by the theory of moral hazard.

There are many different kinds of crises, not all of them strictly financial. I will organize my remarks around the following list: inflation crises, stock market crashes, bond market crashes, housing crashes, and various international crises, including the possibilities of a hard landing for the dollar, emerging market crises, oil shock, geopolitical crisis, and trade collapse. I will draw heavily on US historical examples from the last four decades. Those who forget history are condemned to listen to the rest of us repeating George Santayana.

Inflation crises

A prime lesson of the last four decades is that monetary policy needs to be proactive with respect to inflation. The Fed should respond to an observed increase in inflation by raising the nominal interest rate more than one-for-one – unless it was a predicted increase in inflation in which case the Fed should already have done so.¹

The classic **crisis in the value of the dollar** came, of course, in the 1970s. President Johnson in the 1960s increased spending rapidly on both the war in Vietnam and domestic programs, and was initially unwilling to raise taxes to pay for it – a pattern of which the last six years have been reminiscent. The resulting budget deficits were accommodated by easy monetary policy and led to rising inflation, a declining trade balance, and a widening deficit in the overall balance of payments. The situation continued under President Nixon, and came to a head with the devaluation of the dollar in 1971 and 1973. Arthur Burns gunned the money supply in 1972, evidently in order to insure the president's re-election, while wage-price controls (supposedly anathema to conservatives²) kept inflation temporarily under control. Of course inflation soon re-emerged more virulent than ever. In 1979, facing a crisis in the value of the dollar in terms of both goods and foreign currency, President Jimmy Carter appointed Paul Volcker Chairman, with the assignment of tightening monetary policy severely (supposedly anathema to liberals), in order to defeat inflation. Volcker duly accomplished the job.

¹ Poole (2002).

² The Chair of Nixon's Council of Economic Advisers, Paul McCracken, quietly resigned over the issue of wage-price controls. The only other time this has happened is when the first Chair of President Reagan's Council of Economic Advisers, Murray Weidenbaum, resigned over what he viewed as excessive spending (especially military). Frankel (2003b) documents this little-known history.

Ronald Reagan took office in 1981 and adopted another strongly expansionary fiscal policy. The supply-siders did not get the consequent boost to saving, investment and growth that they had been expecting. They blamed it on the Volcker Fed and its overly tight monetary policy. Bob Woodward's book *Maestro* documents how the Reagan-Bush Administrations pushed the Fed chairmen to lower interest rates, especially in election years.³ But the campaign did not succeed very well.⁴ The Reagan White House tried in 1986 to load the Fed Board with easy money types, who would outvote Volcker and lower interest rates.⁵ But before long they acquired the culture of the institution, and in the end took their jobs seriously, in what I call the Thomas à Beckett syndrome. The White House did succeed in making life unpleasant enough for Volcker that he asked not to be reappointed, prompting James Baker to exult "We got the son of a bitch!"⁶ But the successor, another hand-picked Republican, once again surprised the White House by doing the right thing. Alan Greenspan raised interest rates, far enough to cause the 1987 stock market crash and the 1990-91 recession, thereby costing President George H.W. Bush re-election in 1992. At least that is the way the Bush people saw it.⁷

³ Woodward (2000, pp.16-17 for 1984; pp. 52-54 for 1988; and pp. 78-82 for 1991-92). This is also how I remember 1984, when I was working at the Council of Economic Advisers for Martin Feldstein, Bill Poole and Bill Niskanen. I don't know if they remember it the same way.

⁴ A quiet cooperative approach between the Fed and the Administration, of the sort followed during the Clinton Administration is to be preferred, as Poole (2002) points out. Some (including Greenspan himself -- Woodward, 2000, p. 62) have suggested that political leaders who want low interest rates are less likely to get them if they are publicly seen to be pressuring the central bank, requiring the latter to hold firm so as to maintain its credibility.

⁵ Woodward (2000, p. 18-20).

⁶ Woodward (2000, p. 24).

⁷ Woodward (2000, p.196).

The organizers of this conference have asked us “*Did the Greenspan Fed err by providing too much liquidity in 2001-2004?*” My answer is “probably yes.” I await Woodward’s customary follow-up book, where we learn whether those who entered the White House in 2001 took Greenspan aside, raised 10-year-old grievances, and applied some heavy arm-twisting. This hypothesis is pure speculation, with no evidence behind it. It has the advantage of being able to explain the extraordinarily easy monetary policy of 2001-04.⁸ It could also explain the January 2001 warning in congressional testimony that future budget surpluses would be too big for effective monetary operations unless something were done about it, a statement that the Chairman’s previous wisdom and rectitude rendered otherwise inexplicable. But then perhaps Mr. Karl Rove and Vice President Richard Cheney, and their boss President George W. Bush, are true gentlemen who would not engage in the same sort of bare-knuckles tactics countenanced by the elder Bush or Ronald Reagan.

If the Fed erred in keeping interest rates so low so long after the 2001 recession, what cost are we paying? None yet; but dangers lie in the future. It is not that I am especially worried about inflation at the moment. Inflation has been low over the last decade. The core CPI inflation may bump up against 3%, but a return of the high inflation rates of the past is not at the top of my list of worries, in part because I trust the Bernanke Fed to respond appropriately.⁹

⁸ Some reduction of interest rates was certainly appropriate in response to the 2001 recession. The question is whether the cumulative easing went too far and last too long.

⁹ Incidentally, it is an interesting story how Ben Bernanke got to be Chairman, leaving aside the outstanding qualifications of his career as a monetary economist. By the time the vacancy in the Fed chairmanship came across the desk in the Oval Office, in October 2005, it was in the immediate aftermath of the FEMA and Harriet Miers debacles. As a result, loyalty, the lexicographically top criterion in so many earlier appointments, was

If not inflation, what cost do I fear might come from the extraordinarily easy monetary policy of 2001-04? As the Bank for International Settlements points out, some of the biggest financial crashes and some of the longest recession periods followed liquidity-fed booms that never did show up as goods inflation, but rather as asset inflation: the end of the 1920s boom in the 1929 crash and the Great Depression of the 1930s, the end of Japan's the late 1980s boom in an analogous stock and land market crash and decade of stagnation in the 1990s, and the East Asian crisis of 1997-98. So let me turn to the possibility of securities market crashes and other possible crises. These dangers could be interpreted as disruptive corrections that could arise in the future from excess liquidity and excessive asset inflation during the first half of this decade.

Securities market crises

As of November 2006, the **stock market** is again unusually high. A sudden correction there goes on the list of possible crises. The obvious US precedents are the stock market crashes of 1987 and 2000-2001. In both cases Greenspan responded with a sudden easing of liquidity. This led to a belief among market investors that they could relax in the face of a high stock market because they held a "Greenspan put." The

suddenly replaced by the criterion of choosing someone with a sufficiently short track record outside academia that he would raise no questions in confirmation hearings. My understanding is that otherwise Ben Bernanke would not have become Fed Chairman. In any case, the important point is that I trust him to do the right thing, which means that once again the White House may not get as easy a monetary policy over the next two years as it would like.

obvious danger is moral hazard. Better to seek to discourage the bubble ahead of time than to wait until it bursts to mop up.¹⁰

At the moment, I am more worried about a **bond market crash**. Academic economists always hesitate to second guess financial markets, but to me it is puzzling why bond market spreads are so low – both the term premium and the spreads of low-rated corporate bonds. Notwithstanding that it is still with us two years later, I think that Greenspan’s “conundrum” is still a conundrum: how can it be that during a period that short-term interest rates have risen more than 400 basis points, the 10-year bond rate has hardly risen at all? One reason, I think, is the record purchases of US treasury bills and other bonds by central banks in Asia and oil-exporting countries.¹¹ But I don’t think this can go on indefinitely. Another reason, I believe, is that investors have not fully incorporated the fiscal outlook, as reflected in objective forecasts of the likely future path of the US budget deficit, especially once Social Security and Medicare are included. The situation is as bad in other important countries, but that only makes the prospects for long-term interest rates worse.

I have already discussed the 1967-72 precedent for the excessive fiscal expansion that began in 2001. It led to the crash of the Bretton Woods system (or accelerated it, if you believe that the Triffin dilemma would have done it in eventually anyway). The Reagan fiscal expansion of the 1980s is another good precedent – because it too came from a president pursuing a rapid increase in defense spending without being willing to

¹⁰ Other obvious precedents are the US crash of 1929 and the Japanese crash of the early 1990s. In these two cases the central banks erred in not responding by easing up. But in both cases one could argue that it would have been better to seek to dampen the preceding bubbles, rather than waiting for the accident to happen.

¹¹ One estimate is that such inflows have kept the 10-year US bond rate 90 basis points lower than it would otherwise be – Warnock and Warnock (2006).

raise taxes to pay for it. But so far, the Vietnam-era expansion is the better precedent. In the first place, monetary policy was accommodating then, as it has been in recent years. Second, it seems that the Iraq-era expansion is leading today to a resumption of the trend decline in the international reserve currency role of the dollar that began in the 1970s. If the deficits and depreciation continue unchecked, they may eventually see the euro overtake the dollar as leading international currency, much as the dollar overtook the pound 65 years ago.¹²

International crises

The **oil shock** of 2006 had obvious precedents in the oil shocks of 1974 and 1979. We seem to have weathered this one much better. But if there were to be a renewed increase in the oil price from today's already elevated levels, the impact would probably be more severe. There is no shortage of possible developments that could trigger a renewed oil shortage: for example shenanigans in Venezuela, Russia or Nigeria; or military conflict with Iran that could impact oil exports from the Persian Gulf. The worst oil nightmare would be if the Saudis made the mistake of taking seriously Bush rhetoric about democracy in the Mideast, and as a result the Islamicist majority came to power in the country that pretty much determines world oil prices.

What should the central bank's response be in the event of an oil shock? Some increase in nominal interest rates, but clearly not enough to prevent oil prices from rising in domestic terms. Yet the new reigning champion among monetary regimes – inflation targeting, by which is meant CPI targeting – would if taken literally have the undesirable

¹² Chinn and Frankel (2006) and Frankel (2006).

property that an oil-importing country should undertake so great a monetary contraction and currency appreciation that oil prices don't rise in domestic currency. Of course neither the academic proponents of inflation targeting nor the practitioners intend this response. They want to announce a special exception when an oil shock hits, or to focus on core CPI. But this entails a loss in transparency, and I thought transparency was supposed to be the entire point of announcing such a target. Better, in my view, to target explicitly a price index that does not include imports, but instead focuses on the prices of the goods that the country in question produces.

A hard landing for the dollar,¹³ in light of the magnitude of the US current account deficit, is one of the most likely sources of possible crises. My view is that, as in 1985, some dollar depreciation is desirable, but far better as part of a package that includes a new more responsible path for the US budget deficit and national savings. It could also be part of an IMF-brokered package that includes initiatives in foreign exchange policy from a set of Asian countries and Europe as well. But any such package would have to begin with leadership from the White House.

What if the dollar depreciation goes too far? Precedents for sharp dollar declines include 1978-79, 1985-87, and 1994-95. 1978-79 exacerbated stagflation, and required a fundamental shift in monetary policy, as already noted. In the two later episodes, G7-coordinated intervention largely succeeded in turning the dollar around on its own, notwithstanding that most economists' models and most central bankers' speeches say

¹³ An operational definition of a hard landing is a sharp fall in the value of the dollar accompanied by a sharp rise in interest rates.

that sterilized intervention has no effect.¹⁴ I have a feeling that next time more will be required.

Emerging Market Crises

Sovereign spreads have been extraordinarily low in emerging markets. Just as with low spreads in the US corporate bonds, the markets' evident high tolerance for risk in 2004 could be attributed to easy monetary policy. Two years later, after the withdrawal of monetary ease in the United States, it is a bit harder to explain. One possible explanation is that the ECB, Bank of Japan, and People's Bank of China are not as far advanced in their respective tightening phases. Another possible explanation is that the correction lags a couple years behind the initial rise in interest rates, as it did in 1980-82.

I don't expect a return of the emerging market crisis waves of 1982 and 1997 yet, perhaps not for another six years. But what should be the response, when it happens? The same as in those episodes: a tri-partite package of IMF-led rescue money, policy conditionality, and Private Sector Involvement.

When the Clinton Administration took the international leadership to organize rescue packages for Mexico (1994), Korea (1997), Russia (1998), and other emerging markets, the Republicans attacked it for fostering moral hazard. Thus when the Bush Administration came to office, it adopted tough "no bailout" language. It is true that wise leadership of the international financial system requires balancing the desirability of cushioning crises where countries merit help, against the need to limit moral hazard. But

¹⁴ Dominguez and Frankel (1993) provides history, econometric support, and references.

the Bush White House was soon bailing out every crisis country that came along, having changed its mind when it realized to its apparent surprise that defaults might have some unpleasant consequences. It was following the cycle of the Reagan Administration, which talked tough at first when the international debt crisis hit in 1982, but which then participated in comprehensive IMF-led bailouts of countries in Latin America and elsewhere that had far worse macroeconomic fundamentals than those bailed out in the late 1990s.

In September 2003, the Bush White House even pushed the IMF, against its better judgment, to continue lending to a new Argentine president who was not willing to concede the standard conditions. At least in some earlier controversial bailouts where as in Argentina the agreed macroeconomic conditions were more likely to be missed than not, there were plausible geopolitical rationales. The last package for Russia in the spring of 1998 could be justified by nuclear geopolitics, and Turkey in 2001 by its position in the Muslim world. Even the ill-fated package that Bush agreed to for Argentina itself in 2001 could be defended with the argument that if the country that had enacted so many good reforms in the 1990s went into a sharp recession, Latin America's other reformers would lose heart.

No such rationale remained for the 2003 decision to continue IMF lending to Argentina. Buenos Aires no longer stood for reform by then, and in any case the country's economic collapse had already occurred. Argentina's lack of strategic significance is summed up by Henry Kissinger's description of the country as a dagger pointed at the heart of Antarctica. Contagion to other countries was not a big worry at the moment either, because interest rates and spreads were unusually low internationally and

the global economy on the upswing. Argentina's new government was unwilling even to "talk the talk" of appropriate policy reforms, or to negotiate with the international financial community in good faith. The point was not whether this strategy has worked out to be in the country's interest. The point rather is that this was the best opportunity to make an example of a scofflaw in order to discourage future moral hazard. Instead, from the global viewpoint a dangerous precedent has now been set—that the IMF will lend merely to prevent a threatened default on earlier IMF loans. I infer that First Deputy Managing Director Anne Krueger was unhappy about the lenient treatment of Argentina. But the political campaign for the IMF to bail out the land of the tango was led by none other than the United States. (In the January vote of the IMF Executive Board, eight of 24 executive directors -- including three G-7 partners -- refused to go along with U.S. support for disbursement of the first tranche of money, an extremely rare split in the ranks of the global economic leadership.) This is ironic in that the US Administration was the one who installed Krueger in her job as number two at the Fund job three years ago, at a time when it presumably believed its own rhetoric about free market discipline. As it has turned out, President Bush lacked the fortitude that Clinton and his Treasury showed in the summer of 1998 when they finally told Russia that enough was enough, precipitating that country's devaluation and default but demonstrating clearly that there were limits to the largesse of the G-7 and IMF – a spectacle that put an edifying dent into the moral hazard of international financial markets that had been confidently predicting unlimited bailouts.

Global Recession

A **decline in the housing market** has long been prophesized due to the magnitude of the preceding run-up. It is now already well underway. I will note only that the boom-bust cycle is consistent with the hypothesis that excessive liquidity exacerbated the upswing, and that the 2004-06 increase in interest rates precipitated the reversal. This story can be told for the other markets as well. Low interest rates during 2001-04 sent money into everything else: stocks, bonds, real estate, agricultural and mineral products and emerging markets. Call it the carry trade. So far, on this list only real estate has clearly reversed. But any of the others might follow.

Another possible kind of shock is **geopolitical**: military confrontation with North Korea, or the Islamicist majority coming to power in nuclear Pakistan, or a new terrorist attack in the West nuclear or radiological weapons. The odds of such things happening in any given year are probably less than 10 per cent. But when you multiply out the odds of getting through the next several years without *either* a geopolitical shock of this magnitude *or* a further sharp increase in oil prices, *or* a hard landing for the dollar *or* a crash in securities prices, the odds of smooth sailing are not that good. In any case, the risk seems high.¹⁵

I will conclude with the possibility of a **collapse in international trade**. The globalization trend is not necessarily inevitable. From 1914 to 1944 international trade shrank sharply due to fragmenting political forces: war, isolationism, the Smoot-Hawley

¹⁵ I earlier mentioned that the zero or negative term premium in bonds is puzzling. But two related questions are more puzzling: How can corporate spreads be so low? How can the implied volatility in options prices be so low? Perhaps investors are judging risk solely from the statistics of recent history, and not from a forward-looking consideration of the risks facing the economy.

tariff of 1930 and other countries' retaliation, and the division of the world into rival blocs and ideologies. It could happen again.

The last six years have seen some worrisome developments. The September 11 terrorist attacks led to tightened travel restrictions (visas and airport searches), foreign attempts to boycott US products, US blocking of foreign acquisition of US facilities, and so forth. The SARS outbreak led to quarantines of people and goods. SARS passed, and the impact of September 11 on trade volumes was surprisingly brief. Nevertheless, to take a scary example, if there were to be new terrorist attacks with nuclear weapons, the effects could be far more severe, crippling trans-border transactions, from containerized cargo to the movement of persons. The same is true of a future avian flu epidemic or other contagious disease. The collapse of the Doha Round is a bad sign. Beyond the lost opportunity for further trade liberalization, it may signal a more comprehensive end to what had been 60 years of a US-led multilateral order of liberal institutions.

Illiberal Economic Policies

This is my first time at the Cato conference, and I identify Cato with intellectually honest and consistent libertarianism. So I will take the occasion to give voice to a pattern that seems to me to have emerged in the last quarter-century of American economic policy. The question, to be blunt, concerns which of the two major political parties deviates the farthest in practice from good neoliberal economics. I won't say Democrats are neoliberals or 19th century liberals. For one thing, the word liberal has become too identified with big government. For another thing, Democratic Congressmen are, if anything, more misguidedly resistant to free trade than Republicans. But I will put

forward the deliberately provocative claim that Republican Presidents have been the more *illiberal*: in practice, over the last 35 years, Presidents Nixon, Reagan and (the second) Bush supported more inflationary monetary policy, bigger government, bigger budget deficits, more handouts for special interests (energy, agriculture, airlines...), and more moral hazard than did Carter and Clinton. Because our current president uses small-government rhetoric, the public somehow often fails to notice that his policy actions are more nearly the opposite of this philosophy.

Republicans are supposed to support small government; but federal employment rose under Presidents Nixon, Reagan and Bush, and shrank under President Clinton. Particularly eye-catching is the way the budget deficit goes up when a Republican becomes President, as shown by the line in Figure 1. One might think this was just because Republicans cut taxes and Democrats raise them. Embarrassingly for the Republican presidents, however, national spending, like the budget deficit, goes up when they take office.¹⁶

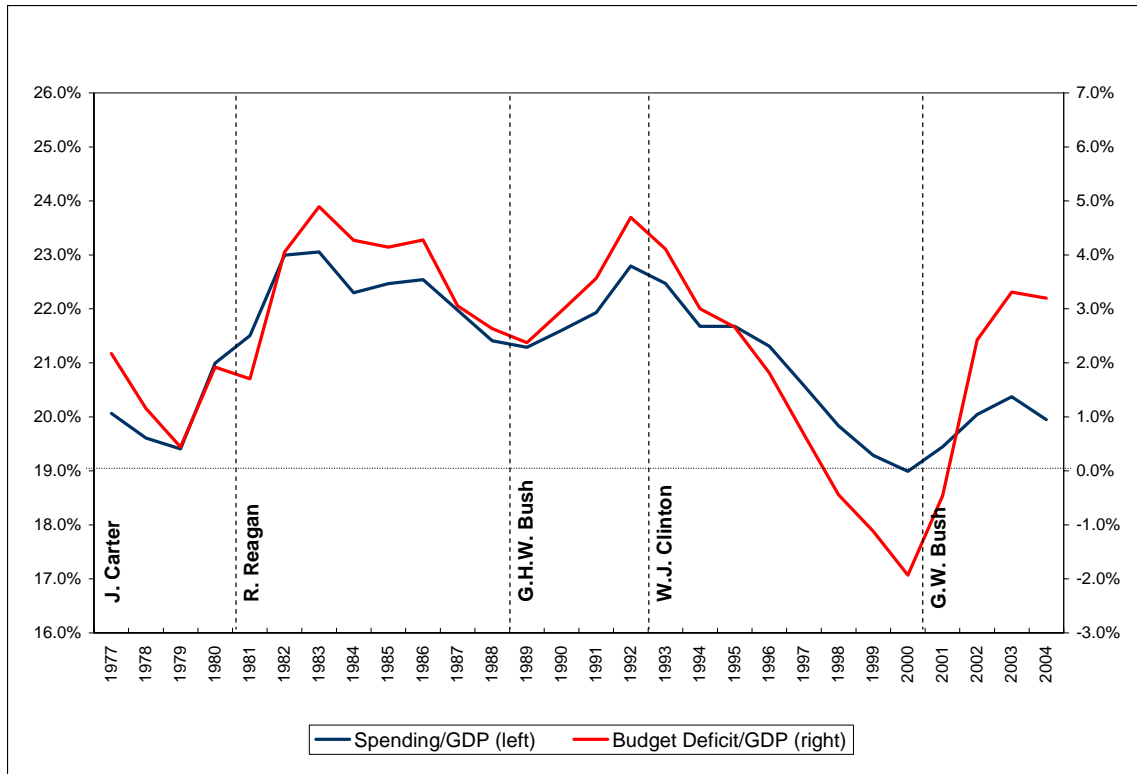
When large deficits materialized in the Reagan and Bush administrations, a new rationale for tax cuts was adopted: the Starve the Beast hypothesis.¹⁷ The argument is that budget deficits would put downward pressure on government spending, more effectively than the alternative. But the alternative seems to me to be the regime that was in place during the 1990s, with its spending caps and Pay As You Go restrictions. History shows that the Starve the Beast claim does not describe actual spending behavior.

¹⁶ As Hassett (2005) observes, “spending growth under George W. Bush has been almost four times as high as it was during the same period of Bill Clinton's presidency.” Bartlett (2005) agrees: “In light of Bush's big-spending ways, Bill Clinton now looks almost like another Calvin Coolidge.”

¹⁷ This rationale had already been developed in *Wall Street Journal* op-eds by Milton Friedman in the first episode; and G.Becker, E.Lazear & K.Murphy in the second.

Spending as a share of GDP (the darker line in Figure 1) tends to be reduced under a budgetary discipline regime of “shared sacrifice” that simultaneously raises tax revenue (the regime in effect during the 1990s); spending is not cut under a Starve the Beast regime that cuts taxes (as was done in the 1980s and the current decade).¹⁸

Figure 1: US federal budget deficit and spending as shares of GDP



The gap between rhetoric and reality is not limited to macroeconomic policy. Republican presidents have been big on free trade rhetoric. But their actions have in fact been protectionist, judged not just by some politics-free ideal, but as compared to the

¹⁸ The Starve the Beast hypothesis is tested and statistically rejected by Niskanen (2002, pp. 184-188).

record of Clinton.¹⁹ Highlights include George W. Bush's tariffs on steel and lumber, Ronald Reagan's "voluntary" export restraints on autos²⁰, and the September 1971 "Nixon shock" which imposed a 10% surcharge on imports and embargoed essential foodstuffs to Japan.²¹ The trend toward deregulation that most imagine began in the Reagan Administration? It actually began in the Carter Administration – in airlines, trucking, natural gas, and banking. These characterizations are shared by many economists from across the political spectrum.²²

It is impossible to predict what the nature of the next crisis will be—monetary, financial, geopolitical... — or when it will occur. Most crises do call for some sort of government response. But reacting strongly is not enough. The response has to be well-informed, thoughtful, and appropriate to the problem at hand. Such thoughtfulness does not thrive if smothered by insincere laissez faire rhetoric, or by political expediency, or by an unwillingness to process new information.

¹⁹ Accomplishments include the passage of the NAFTA, legislation, agreement with China on accession to the WTO, and saying "no" to steel. Lawrence (2002).

²⁰ Consider a quote referring to Ronald Reagan's trade policy from a Member of his Council of Economic Advisers, Bill Niskanen "...the administration imposed more new restraints on trade than any administration since Herbert Hoover" (p. 628, in Feldstein, 1994). Bartlett (2006) now judges that George W. Bush has been the most protectionist since Herbert Hoover.

²¹ This was part of the same New Economic Policy announced in that included the wage price controls and the abandonment of the Bretton Woods monetary system.

²² Again, Niskanen (p. 441, in Feldstein, 1994): "Despite [its] initial commitment, the Reagan administration made few proposals for new deregulatory legislation, and it did not manage the deregulation that had been previously approved especially well."

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