

Unconventional Monetary Policy: Comment on John C. Williams

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John Williams' insightful paper deals with the proper conduct of monetary policy under the protracted adverse conditions of the kind that the United States has experienced since 2006. Although we might hope such conditions won't happen again for many years, Williams presents historic evidence that deep and persistent declines in aggregate demand are unfortunately likely to recur. So it is important that we learn from the recent experience and consider alternative policies.

The downturn that began in December 2007 was not only deeper and longer than the usual recession but was also different in its origin and its structure in ways that did and should affect the appropriate policy response. The downturn was not caused by temporarily high real interest rates aimed at taming inflation. It therefore could not be reversed by the usual Fed policy of rate reduction. Even at a near zero federal funds rate, the recession persisted.

The downturn was caused by mispricing the risks of a wide range of assets. Individuals bought overpriced homes and banks gave high loan-to-value mortgages on those homes to individuals who would be unable to repay them. House prices began to collapse in the summer of 2006, causing a massive fall in household wealth and in residential construction. Lower interest rates could not reverse the downturn by stimulating housing construction because house prices had much further to fall.

Banks and other portfolio investors bought overpriced tranches of securitized subprime mortgages that collapsed in value, signaling the general overpricing of risky securities. In many cases, banks and other financial institutions could not determine the value of their portfolio assets because of a lack of willing buyers and sellers. Banks therefore didn't know the value of their own capital and could not judge the solvency of potential counterparties. The financial market became dysfunctional and credit dried up.¹

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¹ See my discussion of this at the Federal Reserve's 2007 Jackson Hole Conference (Feldstein 2007a).

The Federal Reserve and the Treasury reacted boldly to revive financial markets with a combination of asset purchases and guarantees that went far beyond monetary policy. Although these actions succeeded in ending the financial collapse, they did not reverse the economic downturn.

The Federal Reserve also cut the fed funds rate to near zero in late 2008, too late in my judgment to satisfy Williams' first policy suggestion to "act aggressively in cutting rates when deflation or a sharp decline in output threatens." (page 7) That advice would have implied cutting rates in 2006 when the house price bubble began to burst. The federal funds rate was still nearly five percent a year later in the fall of 2007.

In analyzing the challenges in 2007 and 2008 it is important to go beyond simulations using the "fat tails" implied by the historic data that John Williams presents. Traditional macroeconomic models cannot begin to capture the nature of the problems in 2007 because they lack well-specified financial sectors, let alone the special features of the tranching securitization of mortgages and the widespread presence of off balance sheet special investment vehicles. Moreover, future crises may not share these same features.

Although this meeting is about monetary policy, it would be wrong to ignore the role of fiscal policy in dealing with the type of deep and persistent collapse associated with the zero lower bound (ZLB) problem. The conventional wisdom among most economists before 2007 was that cyclical fluctuations should be managed solely by monetary policy because countercyclical fiscal policy is generally too slow to react within the time frame of the typical recession downturn. But in 2007 and 2008 several of us concluded that the combination of the sustained downturn and the ineffectiveness of conventional monetary policy implied the need for a fiscal stimulus.²

Unfortunately, the Bush tax cut of 2008 was totally ineffective: a small one-time rebate that was almost entirely saved (Feldstein 2008). The 2009 Obama "stimulus" plan probably dampened the downturn but was too small and not concentrated on increasing government spending. Even if every deficit dollar had added a dollar to GDP, a sizeable GDP gap would have remained and fed a downward multiplier.

So with an inadequate fiscal policy, the Fed was the only hope for stimulating the economy. And with the fed funds rate at the ZLB, the Fed shifted to the unconventional monetary policy of future guidance of the short rate and large scale asset purchases (LSAPs) of government bonds and mortgage-backed securities.

Williams provides a very useful review of the evolution of the short rate guidance and concludes that "explicit forward guidance can effectively anchor interest rate

² See for example my article (Feldstein 2007b) and the Hamilton project paper by Elmendorf and Furman (2008).

expectations out two years.” (page 10) But why is a two-year anchoring economically significant? The usefulness of forward guidance would be more persuasive if it could reduce the longer rates that are relevant for mortgages and equity prices.

Williams reminds us that standard simplified textbook theory implies that LSAPs would not affect asset prices and interest rates. We now know that is wrong. The Fed’s massive purchases of Treasury bonds and mortgage backed securities drove the yield on 10-year Treasuries to just 1.7 percent in May of 2013, an impact consistent with the evidence Williams summarizes in his Table 1. The announcement of a plan to end the purchase program was enough to drive that rate back to 3.0 percent.

Williams quotes research by Chung et al (2012) to the effect that the \$600 billion bond purchase in QE2 lowered the unemployment rate by one-quarter of one percent but he is candid in concluding that there is “a great deal of uncertainty about the magnitude of these effects and their impact on the overall economy.” (page 13)

Missing in all of this analysis is a discussion of balancing the potential output gains from LSAPs against the risks generated by sustaining abnormally low long-term interest rates. Those risks include: (1) potential price bubbles in equities, land, and other assets; (2) portfolio risks as investors reach for yield with junk bonds, emerging market debt, uncovered options, etc.; (3) creditor risks as lenders make loans to less qualified borrowers, covenant light loans and bonds, long term mortgage loans at insufficient interest rates, etc; and (4) long term inflation risk as commercial banks acquire a large portfolio of low yielding assets at the Federal Reserve that could be converted to commercial loans.

In his conclusion, Williams asks whether LSAPs should be a standard tool when short rates are at the ZLB. I think it is at best too soon to tell. We will know more when we see the outcome of the risks that have been created. And if the economy now expands at a healthy pace, we won’t know what the risk outcomes would have been in a weaker economy. What is clear to me is that a balanced and effective fiscal policy should be part of the response when the economy is stuck with excess capacity at the ZLB (Feldstein, 2013).

Williams also asks whether it would be better to target nominal GDP, or the price level, or an inflation rate higher than two percent. I think any of those would be a mistake. Although inflation is not a problem now, the time will come when the Fed will want to limit or reverse inflationary pressures. Experience and theory both teach us that is easier to do if the public understands that the Federal Reserve is committed to a consistent policy of low inflation. Flirting with other more ambiguous goals can only weaken future public support when the Fed needs it most.

References

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