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Monetary Policy Flexibility: Solution or Problem?

William Poole
Senior Fellow, Cato Institute
and
Distinguished Scholar in Residence, University of Delaware

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My remarks today will concentrate on U.S. experience, which I know far better than experience elsewhere. I will concentrate on policies to avoid a crisis rather than manage one. Without doubt, during a crisis a degree of flexibility is essential, because the particulars of every crisis are inevitably different. That said, a consistent approach to handling a crisis is essential to help shape market expectations in a constructive way. I do not want to dwell on the matter, but will point out that permitting Lehman to fail after bailing out Bear Stearns and the uncertain handling of the Troubled Asset Relief Program (TARP) exacerbated the crisis in the United States.

In thinking about what happened, I start with this question: How could we all have missed the coming of the financial crisis? I do not recall warnings from any senior policy makers, either publicly or internally in the United States, that the entire financial system was vulnerable to extreme crisis. I was a senior policymaker in the Federal Reserve until some months after the crisis had broken. I attended every meeting of the Federal Open Market Committee from March 1998 to January 2008 and read the steady stream of staff briefings and papers. At the St. Louis Fed, I had an excellent research department to provide analysis and insight. My colleagues around the Federal Reserve System frequently sent me interesting papers to read. The fact is that we all missed the coming crisis.

I know that “we all missed” is somewhat an exaggeration, but the fact remains that the analysis that seems so obvious today was simply not discussed before the crisis. There were abstract discussions of crises, but that is not what I have in mind. Here is my sketch of what happened.

- 1) By early 2006, house prices had been bid to excessive levels. However, we believed that the probability of a significant decline on a national average basis was remote. This was the view within the Federal Reserve System, among most private economists and among most portfolio managers.
- 2) We did not understand how leveraged a large number of households were, or at least the significance of that leverage for the potential for financial crisis. We did not understand the extent to which household defaults would lead to widespread foreclosures.
- 3) We did not understand how leveraged many financial institutions holding mortgage-related assets were. Moreover, as unemployment rose, so also did defaults on auto and credit card loans. The business contraction damaged cash flow on many commercial real estate projects, creating further losses on bank balance sheets.
- 4) We did not understand how many of the portfolios of mortgage assets, which have long maturities, were financed by short-maturity liabilities and minimal capital.
- 5) We did not understand that these risky portfolios were not just scattered through the U.S. economy but were widespread throughout the world economy. These were not isolated weak portfolios; they were everywhere.

The vulnerabilities seem so obvious today that I continue to wonder how I and everyone else missed the peril. The housing bubble was quite different in this respect from the dot-com stock market bubble of the late 1990s. Alan Greenspan had warned of “irrational exuberance” in the stock market and his warning was repeated endlessly, although not by him. After his initial attempt, he did not believe that the warning would be effective. Of course, that warning did not

prevent the stock market from inflating unreasonably, but it does show that policymakers were aware of the risk.

U.S. monetary policymakers were not totally oblivious to the risk of financial crisis. I gave many speeches, starting in December 2002, warning of the danger posed by Fannie Mae and Freddie Mac. Much more importantly, Alan Greenspan worked both behind the scenes and publicly to get Congress to reform Fannie and Freddie. In my speeches, I argued that Fannie and Freddie had portfolios that were riskier than they appeared, especially given their very thin capital positions. If one of them were to stumble, the consequence would be a worldwide financial crisis of immense proportions. In the event, the government placed the two firms into conservatorship and full federal control in September 2008, before their failure could cause a financial crisis.

The crisis has been extraordinarily costly. What should be done to avoid a repeat in the future? Tougher regulation? A monetary policy that pricks asset price bubbles? Policies to alter the incentive for leverage? I will discuss these in turn.

Tougher Regulation

I am struck by how few specifics typically accompany calls for regulatory reform. One common approach is to require more capital. The form additional capital would take matters enormously. The only form that provides deep market discipline is subordinated debt. This idea has been discussed for many years. My version of the plan can be found in a recent article in the *Financial Analysts Journal*.

Here is a brief sketch of the plan. Every firm with a bank charter would be required to maintain subordinated debt outstanding equal to 10 percent of its total liabilities. The debt would

consist of bonds with original maturity of 10 years. When an issue of sub debt matures, the bank could, at its option, convert the debt to equity at a conversion rate set in the bond indenture. That provision permits the bank to conserve capital rather than pay out cash when a bond matures. However, the bank would have to sell a new issue of sub debt to replace the maturing issue, or would have to shrink so that the remaining sub debt outstanding was 10 percent of liabilities.

This sub debt requirement would be tough regulation. It has the advantage of being market based; a bank unable to roll over maturing sub debt would have to manage its own restructuring. That is a major advantage over having regulators decide how to restructure a bank in trouble. Unfortunately, calls for tougher regulation do not usually go this far. Those advocating tougher regulation do not want regulation this tough.

Why not? For one thing, regulators, regulated firms and Congress prefer discretion. Discretion provides great latitude for bargaining and for members of Congress to harvest campaign contributions from financial firms. Financial firms want to shape the outcome and within limits will do so. They will be at least partially successful in getting obscure special provisions in the law that will soften regulation and perhaps even provide competitive advantage. That is the way democracy works when it emphasizes administrative discretion.

Another regulatory approach is to restrict bank activities. Most of the argument today is over proprietary trading operations. This approach is not satisfactory. Trying to enforce a list of permissible activities is a recipe for endless regulatory avoidance as lawyers, accountants and consultants create structures that fall within, or are arguably within, the boundaries of permissible activities. Regulatory flexibility is part of the problem that created the financial crisis. Tougher standards in the law and less regulatory discretion are what is needed.

With regard to recent regulatory discretion, note that the SEC lowered minimum capital requirements on investment banks in 2005 (date correct?). Note also that regulators in many countries joined together to set new standards in the Basel II accord. That negotiation lasted many years, and worked in the direction of reducing capital standards. It certainly made the standards much more complex. The negotiators had almost unlimited discretion; they had the authority, if they wanted to use it, to completely gut capital standards.

The way to think about regulation is the way we think about a sound portfolio management policy. There should be a policy concerning asset allocation, for example, that is determined to be appropriate across a wide range of market situations. Then, the manager sticks with the policy whatever may be the current state of the markets, unless a new policy is substituted that will be followed across all market conditions. That is how we ought to think about regulatory policy—the rules should provide discipline and consistency; they should not change based on regulators' gut feelings or hunches about the current business environment.

Another serious problem is that certain regulatory practices, such as a list of permissible activities, may require international coordination to be effective. Tight international coordination will prove unattainable in the long run. Countries have different views and different market situations. Governments will naturally want to gain competitive advantage for firms based in their countries; if country X thinks it can gain an advantage over New York and London, then X will certainly try to bend its regulations to the advantage of its firms. Competition tends to undercut regulation, especially in financial services businesses.

This argument holds with equal force for capital regulation, such as a subordinated debt requirement. However, the competitive disadvantage of sub debt should not be large. Indeed, to the extent that sub debt is a substitute, as it should be, for the heavy hand of discretionary

regulation, the costs to banks of dealing with the regulatory environment should be lower rather than higher. In any event, whatever other countries do, the United States must end the moral hazard created by the bailouts. If other countries want to prop up weak banks, so be it. That is not something the U.S. government should do.

Pricking Asset Price Bubbles

Many believe that a central bank ought to be prepared to change monetary policy to affect asset prices. Although the difficulties of such a monetary policy have been widely discussed, advocates argue that the costs of the housing price bubble have been so large that an imperfect policy is to be preferred to no policy.

That is a dangerous view. It has been standard practice in macroeconomics research for several decades to embed a policy rule in a macro model. For example, there is no way to evaluate Taylor-type rules with different coefficients without embedding the rule in a macro model. Equations describing private sector behavior depend on the policy rule, and the rule cannot be evaluated without specifying how private behavior is affected by different rules.

To evaluate the likely effects of an asset-price intervention policy (“APIP”), there is no substitute for an approach that embeds the policy in a macro model. There are many possible variants of an APIP. One possibility would be to add a term to the typical Taylor rule. An approach like this seems to be what some advocates have in mind. The central bank might set the interbank interest rate higher than would otherwise be the case if some asset price were deemed “too” high.

The APIP term in a Taylor-type monetary policy rule might be the gap between an actual asset price, like an index of equity prices, and an assumed equilibrium asset price. The gap

would be multiplied by a coefficient, as with the GDP gap term in a Taylor rule. To be operational, the model would have to specify the equilibrium equity price index and the macro model would have to integrate asset prices in, for example, business fixed investment decisions.

To my knowledge, no one has even attempted to specify an asset price term in a monetary policy reaction function and then embed that function in a macro model. The fact is that we just do not know what the effects of an APIP would be, even in a simple illustrative “toy” macro model. To me, it is simply foolish to argue that monetary policy should nevertheless be adjusted to “take account of” asset prices.

There is indeed extensive experience with interventions in one asset market—the market for foreign exchange. The intent of this APIP is to move the exchange rate to an “appropriate” level, or to lean against prevailing speculative winds. Foreign exchange intervention among major high-income countries has fortunately fallen into disuse. The record is a sorry one, with intervention creating additional uncertainty and, sometimes, massive losses for the governments involved.

In a democracy, every important policy has a political component. Did the U.S. architects of the Troubled Asset Relief Program (TARP) to recapitalize banks anticipate that the program would morph into a program to control executive compensation in banks? I fear that those who want the central bank to intervene to influence asset prices do not understand the forces they are unleashing and the unintended consequences, political and economic, that would flow from the effort. When a policy cannot be defended on the basis of careful economic reasoning and modeling, then it is especially ripe for political capture. Policymakers should not respond to “do something” pressures. That is how the United States got wage-price controls in 1971; there are many other examples.

As with regulatory flexibility, monetary policy flexibility, which I interpret as an absence of standards for conducting monetary policy, will be a recipe for increased economic instability and increased risk of financial crisis.

Limiting Leverage

The financial crisis broke open in August 2007, after house prices had declined by a relatively modest amount. True, expectations of further house price declines were widespread, but even there the extent of the actual and anticipated house price declines was small relative to the stock market declines earlier in the decade. Why did the house price decline create a crisis whereas the stock price decline did not?

The difference was leverage. Mortgages were widely held in highly leveraged accounts. Moreover, many of these portfolios had a large duration imbalance between assets and liabilities. The mortgage assets were long term; in many portfolios, a major share of the liabilities was due within one year and the portfolios had relatively little equity capital. In contrast, common stock was held largely in unleveraged portfolios, such as mutual funds and household investment portfolios.

Without question, leverage makes the economy more vulnerable to financial crisis. Why, then, does the U.S. tax code subsidize leverage? The reasons are in part historical and in part a function of the political strength of financial and real estate interests that traditionally finance their activities heavily through debt. Instead of simply exhorting households and firms to rely less on debt, Congress should phase out the deductibility of interest on all personal and business tax returns. A quick calculation on U.S. corporate returns indicates that a revenue-neutral reform would be to reduce the statutory corporate tax rate from 35 to 15 percent while phasing out the

deductibility of interest. That reform would certainly reduce the incentive for high leverage. I see no good argument against that reform.

Concluding Comment

The financial crisis offers an immense word of caution with regard to the potential for discretionary policy to control the economy. There are two issues. One is that unless we find a way to put smarter and more effective policymakers in office than we have in the past, we can expect that policymakers will miss some important developments as they, and I, did with the growing risk of financial crisis during the 2002-2007 period. It is often said that this was a period of regulatory failure; in fact, the problem was much more serious. The failure was a consequence of economists not understanding the risks in housing markets and housing finance.

The second key issue is that even if policymakers identify a risk, getting the political system to respond appropriately is a huge problem. The problem is not a new one; for example, we have known since the late 1970s that changing demographics would require major revisions to the U.S. Social Security and Medicare systems. The Social Security actuaries' reports every year, year after year, have confirmed the bleak outlook. Yet, nothing has been done.

I conclude that we need to search for structural reforms, such as to the tax code, that increase economic and financial stability. We should not be dependent on the expertise of policymakers and the timeliness of congressional action to stabilize the economy. A useful analogy is that U.S. political stability is dependent primarily on the Constitution and a body of law, custom and experience that condition what individual Presidents and Congresses can do. We need to look to ways to embed that sort of institutional strength in our financial system to create deep and lasting financial stability.