U.S. Monetary Policy and the Financial Crisis

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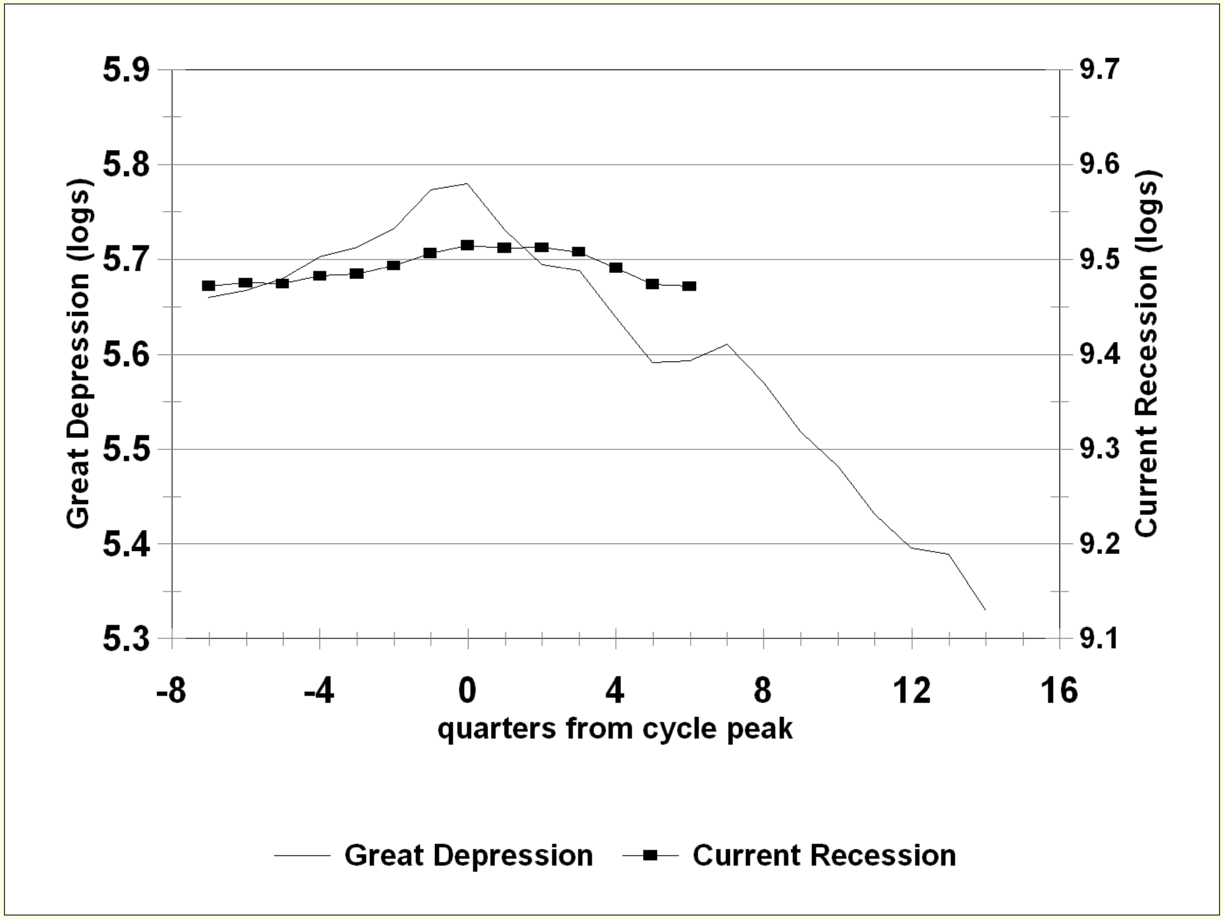
Three Key Issues

- Current US policies vs. monetary policy during the Great Depression of the 1930s
- Federal Reserve policy prior to and during the course of the recession that began in December 2007.
- What policymakers will need to do to in future to avoid a surge in inflation and the difficulties they are apt to face in implementing the necessary policy shift.

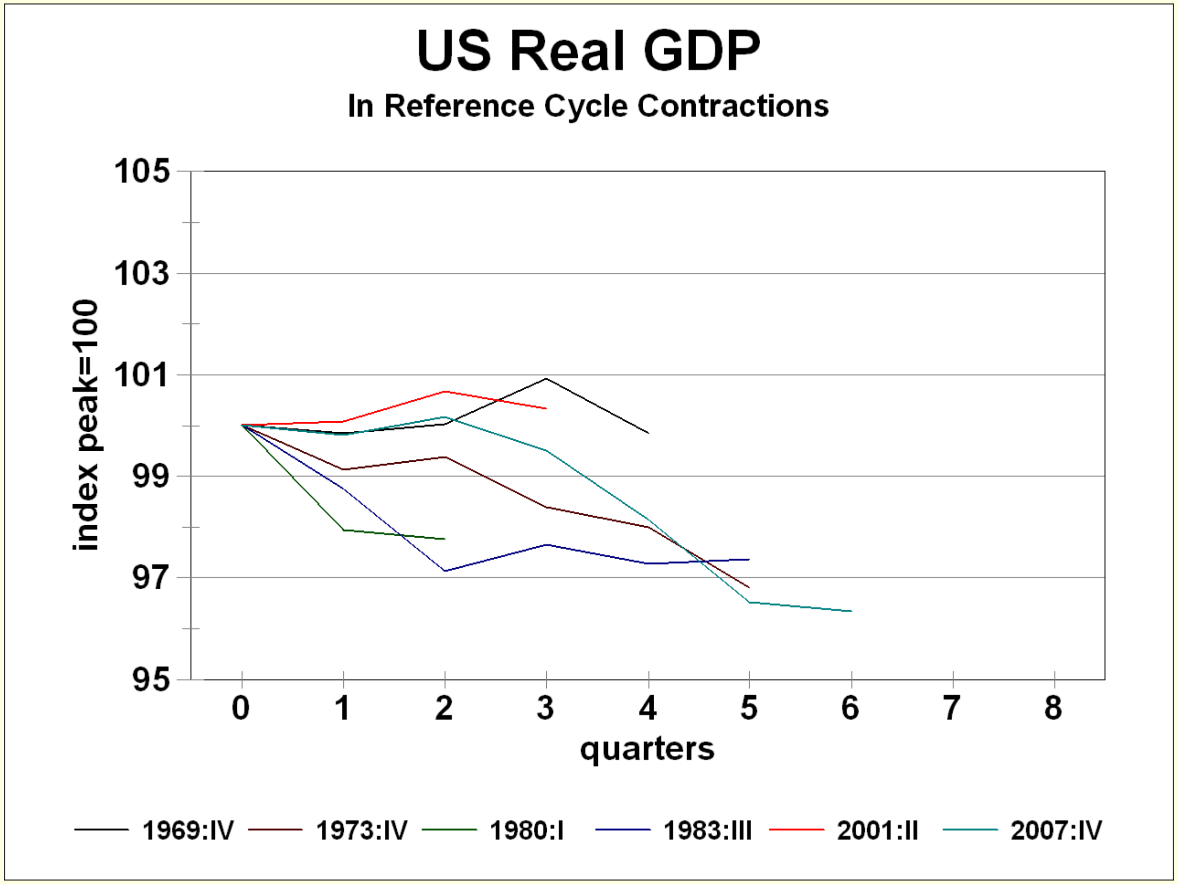
Another Great Depression?

- According to some observers (e.g., Richard Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression,* 2009) the answer is "yes"
- Nevertheless there are two key differences this time around:
  - Real economy in this episode has been much more stable
  - Monetary policy has been completely different

Real GNP: Then and now

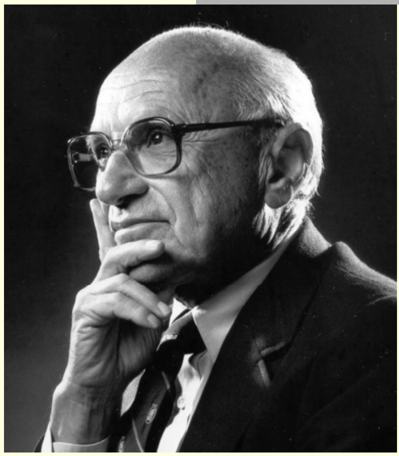


Real GDP: Recent Cycles

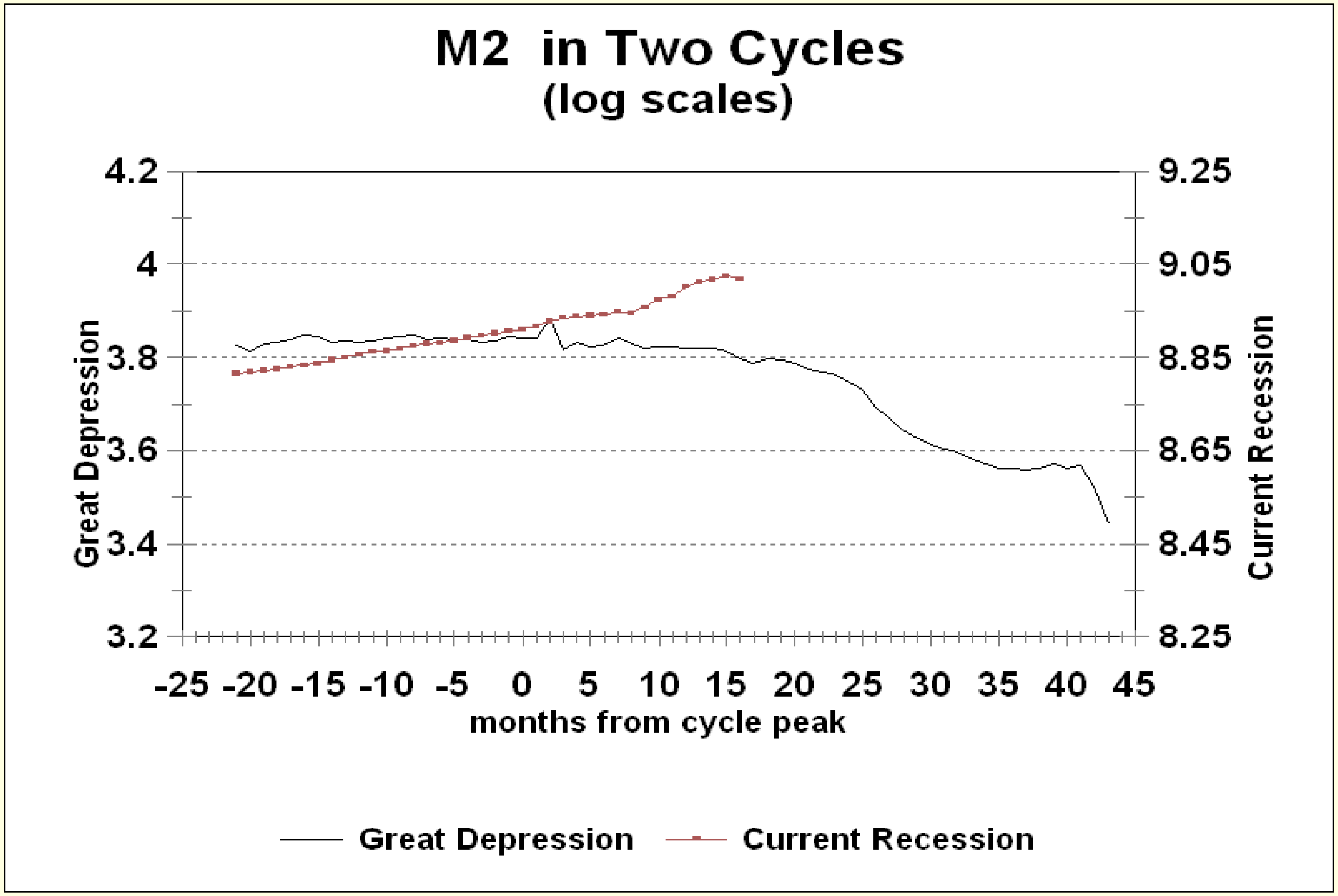


Friedman and Schwartz on the Great Contraction

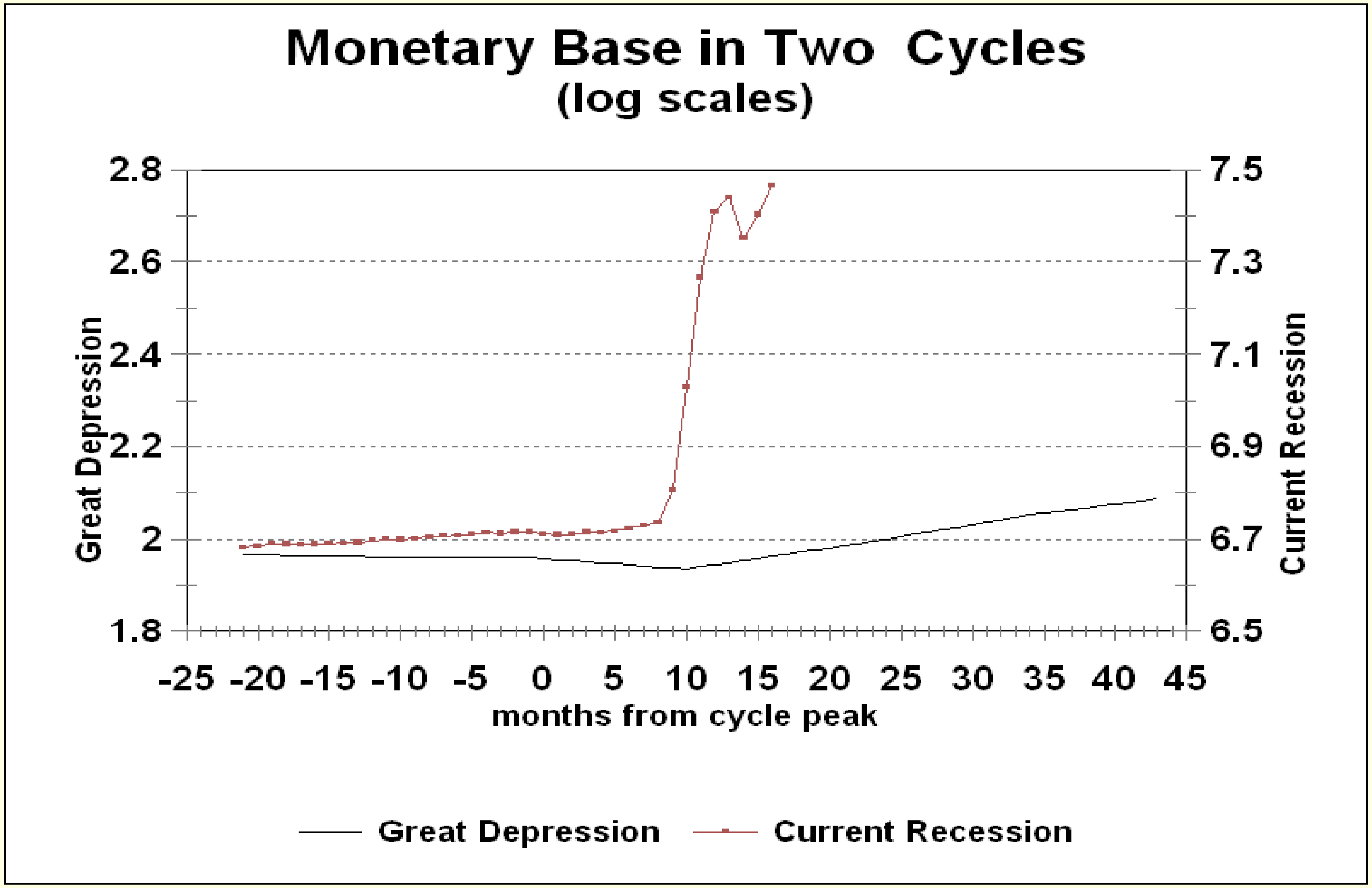
- The reason the1930's Depression was Great was that monetary policy was so inept
- Fed stood by while the nominal stock of money declined by an unprecedented 33 per cent



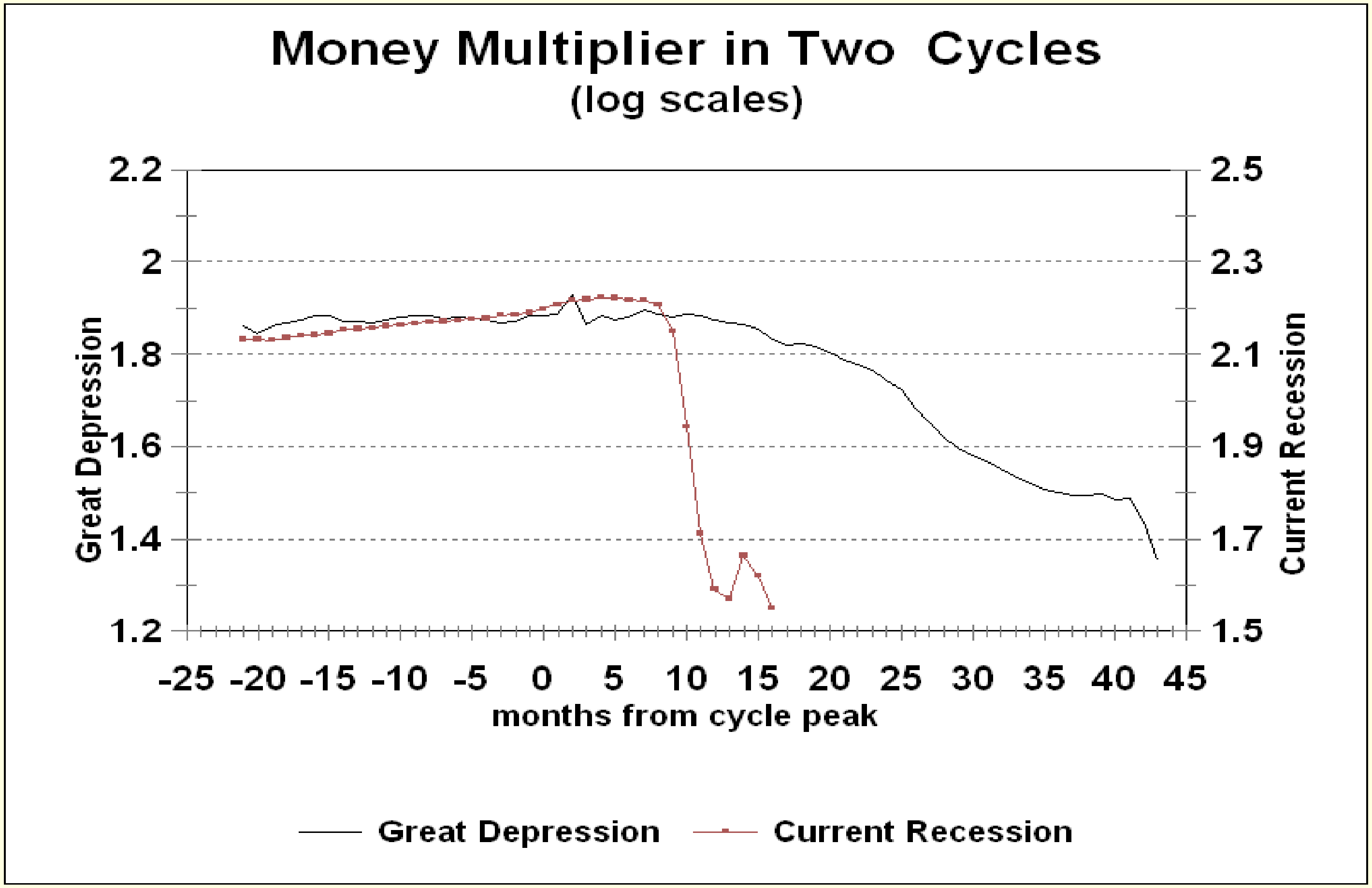
Money Supply Behavior: Then and Now



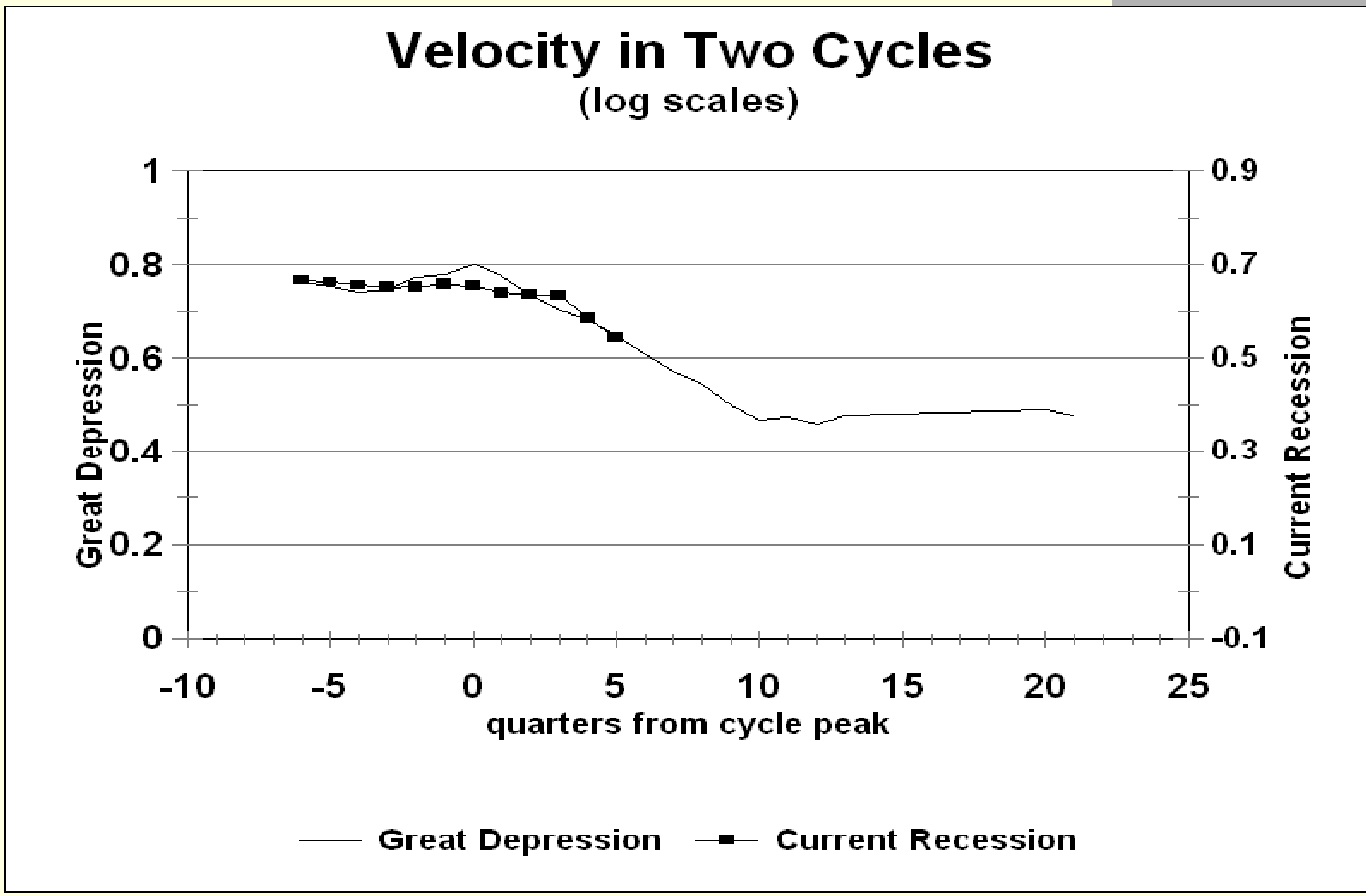
The Monetary Base: Then and Now



The Money Multiplier Then and Now



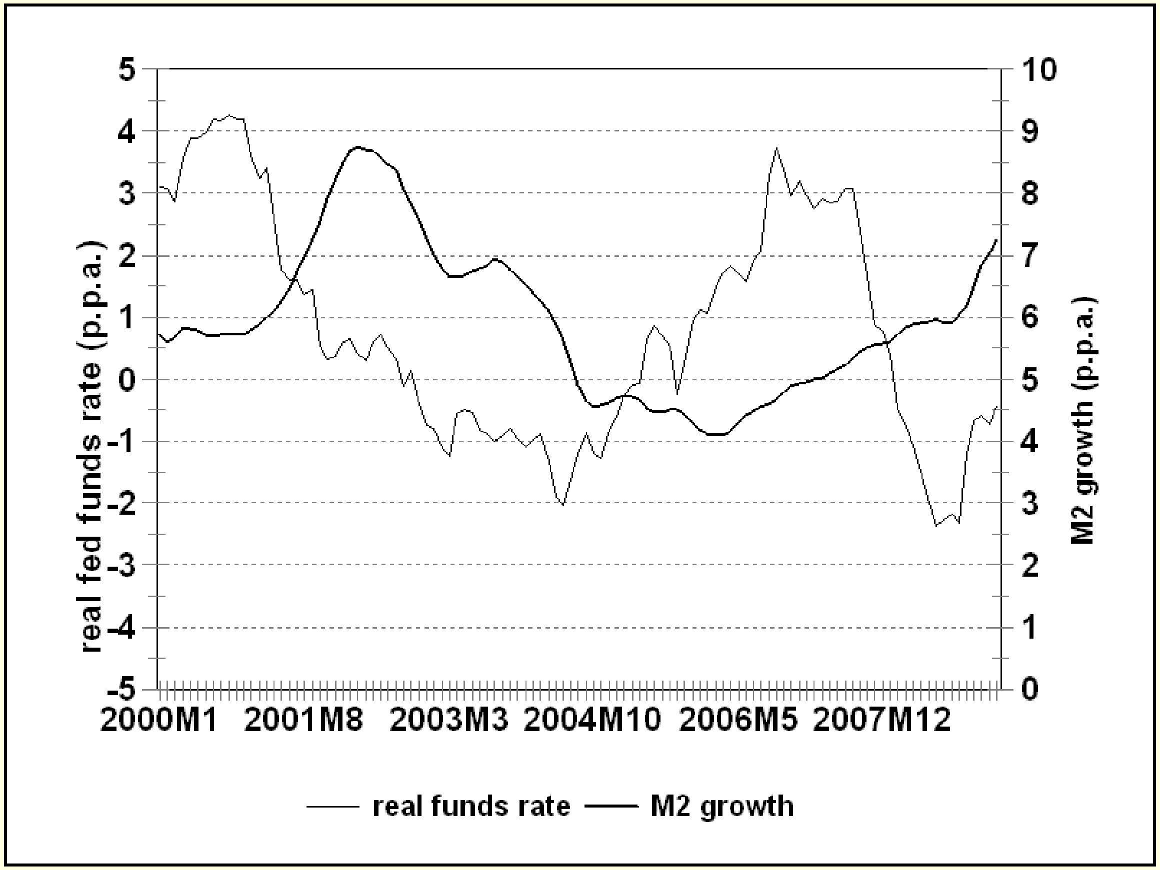
Velocity:
Then and Now



Liquidity Traps

- Basic notion:
  - Money demand is metastable
  - Monetary policy impotent as a result
- Problem No. 1: Wasn't true then
  - See time-series studies of Meltzer (1963); Gandolfi and Lothian (1977) and cross-state studies of Gandolfi (1974); Gandolfi and Lothian,(1976)
- Problem No. 2: Based on overly narrow view of transmission mechanism

The Real Federal Funds Rate and M2 Growth



Fed Policy: Before and in the Crisis

Period averages of real fed funds rate and growth in M2

Period	Real funds rate	M2 growth
2000	3.78	5.86
2001-2003	-0.14	6.99
2004-2005	-0.47	4.76
2006-2007	2.34	5.38
2008-2009	-1.21	8.13

Fed Policy: Before the Crisis and the Taylor Rule

The calculations in the chart are based on the following equation:

$$R^*_t = 2.5 + \pi_{t-1} + .5\,(\pi_{t-1} - \pi^*) + .5\,[100 \times (y_{t-1} - y^*_{t-1})], \qquad (1)$$

where R^*_t is the implied fed funds rate, π_{t-1} is the a year-over-year inflation rate in the previous period as measured by the pce deflator, π^* is the target inflation rate, y_{t-1} is the log of the real gross domestic product in the rate in the previous period, and y^*_{t-1} is the log of the estimated level of potential output in the previous period.

Policy Going Foward

- Will need a massive drain of reserves
- Technically doable – Y2K but with several additional problems
- Politically not so easy
  - Can expect lots of flak from the pols
  - Huge deficits and their effects

Alan Meltzer on the task ahead

"Paul Volcker is now the head of President Obama's Economic Recovery Advisory Board. Mr. Volcker and the administration's many economic advisers are all fully aware of the inflationary dangers ahead. So is the current Fed chairman, Ben Bernanke. … I do not doubt their knowledge or technical ability. What I doubt is the commitment of the administration and the autonomy of the Federal Reserve. Mr. Volcker was a very independent chairman. But under Mr. Bernanke, the Fed has sacrificed its independence and become the monetary arm of the Treasury: bailing out A.I.G., taking on illiquid securities from Bear Stearns and promising to provide as much as $700 billion of reserves to buy mortgages."

Bernanke and Geithner:
A New Accord?

Paul Krugman sees things differently

- In a column in the New York Times entitled "Falling Wage Syndrome," he wrote:

  "Credit where credit is due: President Obama and his economic advisers seem to have steered the economy away from the abyss. But the risk that America will turn into Japan — that we'll face years of deflation and stagnation — seems, if anything, to be rising."

What about Deflation?