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by

Frederic S. Mishkin*

Graduate School of Business,
Columbia University
and
National Bureau of Economic Research

*The views expressed here are my own and are not necessarily those of Columbia University or the National Bureau of Economic Research.
The organizers of this panel asked us to focus on a set of four questions:

- Have the events since August 2007 changed your view of the transmission mechanism or the strategy for monetary policy?
- Does the Fed have all the tools (legal, staff, communication strategy, etc) to properly carry out its monetary policy mandate?
- Can monetary policy be meaningfully separated from financial stability responsibilities?
- Given the proximity to the zero bound, is there a preferred way to carry out any further policy easing should that become necessary?

I will focus on answering two questions that are closely related to the four above.

- Have events since August 2007 affected the monetary transmission mechanism? In particular, has the subprime financial crisis made monetary policy ineffective? I will argue that the answer is no.
- Are there some tools that the Fed should have that would help in current situation? I will argue that an explicit numerical inflation goal (often referred to as an inflation target, although this terminology is somewhat problematic) would be particularly useful now.

I. Has the subprime financial crisis made monetary policy ineffective?

The tightening of credit standards and the failure of the cost of credit to households and businesses to fall despite the sharp easing of monetary policy has led to a common view that monetary policy has not been effective during the recent financial crisis. Not only has this view been expressed by economists such as Paul Krugman (2008), but, as the minutes from the October 28-29, 2008, FOMC meeting indicate, it was also expressed by some participants in that meeting (Board of Governors of the Federal Reserve System 2008). These views hark back to early Keynesian discussions of the ineffectiveness of monetary policy during the Great Depression period. Because of the shocks to credit markets from the financial crisis, the argument is that monetary policy is unable to lower the cost of credit and is thus pushing on a string. Monetary policy is therefore ineffective.

I will argue here that this view is just plain wrong. Not only that, the view that monetary policy is ineffective during a financial crisis is highly dangerous because it leads to the following two conclusions. First, if monetary policy is ineffective, then there is no reason to use it to cope with the crisis. Second, easing monetary policy during a crisis is counterproductive because it
can weaken the credibility of the monetary authorities to keep inflation under control and thus be inflationary. I strongly disagree with both these conclusions and I will argue that, to the contrary, financial crises of the type we have been experiencing provide a strong argument for even more aggressive monetary policy easing than normal.

Financial Instability and Macroeconomic Risk

To understand my argument it is first necessary to recognize that the financial system performs the function of efficiently channeling funds to individuals or corporations with worthy investment opportunities by collecting and processing information. Although financial markets and institutions deal with large volumes of information, some of this information is by nature asymmetric; that is, one party to a financial contract (typically the lender) has less accurate information about the likely distribution of outcomes than does the other party (typically the borrower). Historically, banks and other financial intermediaries have played a major role in reducing the asymmetry of information, partly because these firms tend to have long-term relationships with their clients.

The continuity of this information flow is crucial to the process of price discovery—that is, the ability of market participants to assess the fundamental worth of each financial asset. During periods of financial distress, however, information flows are disrupted and price discovery is impaired. The high risk spreads and reluctance to purchase assets that are characteristic of such episodes are natural responses to the increased uncertainty resulting from the disruption of information.

Two types of risks are particularly important for understanding financial instability. The first is valuation risk: The market, realizing the complexity of a security or the opaqueness of its underlying creditworthiness, finds it has trouble assessing the value of the security. For example, this sort of risk has been central to the repricing of many structured-credit products during the turmoil of the past year, when investors have struggled to understand how potential losses in subprime mortgages might filter through the layers of complexity that such products entail.

The second type of risk that I consider central to the understanding of financial stability is macroeconomic risk—that is, an increase in the probability that a financial disruption will cause significant deterioration in the real economy. In particular, strains in financial markets can spill over to the broader economy and have adverse consequences on output and employment. Furthermore, an economic downturn tends to generate even greater uncertainty about asset values, which could initiate an adverse feedback loop in which the financial disruption restrains economic activity; such a situation could lead to greater uncertainty and increased financial disruption, causing a further deterioration in macroeconomic activity, and so on. This phenomenon is generally referred to as the financial accelerator (Ben Bernanke and Mark Gertler, 1989; Ben Bernanke, Mark Gertler, and Simon Gilchrist, 1996).

We are currently in exactly this kind of adverse feedback loop, and the result has been higher credit spreads despite aggressive cuts in the federal funds rate. Interest rates relevant to household and business spending decisions therefore have risen, along with a sharp tightening of
credit standards. The economy has gone into a tailspin and we are now in the midst of a serious recession.

Does this mean that monetary policy is ineffective?

Does the fact that the cost of credit has risen for households and businesses despite aggressive monetary easing mean that monetary policy has been ineffective in the current financial crisis episode? The answer is no. To see this, consider the following counterfactual: What if the Fed had not aggressively cut rates during the current crisis?

Valuation risk would certainly have stayed as high because tighter monetary policy would certainly not have made it easier to value securities by either reducing the opaqueness of securities that were hard to value or making it easier to assess credit risk.

On the other hand, tighter monetary policy would surely have led to higher macroeconomic risk. Tighter monetary policy, through its usual channels by restraining consumer spending and business investment, would have made it more likely that the economic downturn would even more severe, which would result in even greater uncertainty about asset values. Tighter monetary policy would then have made an adverse feedback loop more likely in which the greater uncertainty about asset values would raise credit spreads, causing economic activity to contract further: The contraction in economic activity then would create more uncertainty, making the financial crisis worse, causing the economic activity to contract further and so on.

If the Fed had not aggressively cut rates, the result would have been both higher interest rates on default-free bonds like Treasury securities and a substantial increase in macroeconomic risk with much higher credit spreads. Interest rates relevant to household and business spending decisions would then have been much higher than what we see currently. Aggregate spending would therefore have been lower and the current recession would be far more severe. Tighter monetary policy would have been very costly indeed.

The logic above indicates that not only has monetary policy been effective during the current financial crisis, but that it has been even more potent than during normal times because it not only lowered interest rates on default-free securities, but also helped lower credit spreads. The argument here does not, however, say that monetary policy can offset the contractionary effect of a massive financial disruption in the credit markets of the type we have been experiencing. The financial crisis has led to such a widening of credit spreads and tightening of credit standards, that aggressive monetary policy easing has not been enough to contain the crisis. This is why central banks have provided liquidity support to particular sectors of the financial system in order to contain liquidity squeezes.

The Federal Reserve, in particular, has implemented large liquidity injections into the credit markets to try to get them lending again. Starting in mid-August 2007, the Fed lowered the discount rate to just 50 basis points above the federal funds rate target from the normal 100 basis points (later to 25 basis points). Over the course of the crisis, the Fed broadened its provision of
liquidity to the financial system well outside of its traditional lending to depository institutions, leading Paul Volcker, a former Chairman of the Federal Reserve, to describe the Fed’s actions as going to the “very edge of its lawful and implied powers.” The number of new Fed lending programs over the course of the crisis spawned a whole new set of acronyms, the TAF, TSLF, PDCF, AMLF, CPFF, and MMIFF and TALF, making the Fed sound like the Pentagon with code-named initiatives and weapons. Like the Pentagon, the Fed has been fighting a war against a potentially destructive enemy, although its weapons were financial rather than guns, tanks, or aircraft.

Even though I believe that the Fed’s liquidity injections, which have expanded the Fed balance sheet by a trillion dollars, have been extremely useful in limiting the negative impacts of the financial crisis, they will not be enough. To get the financial system working again, financial institutions will need to be recapitalized sufficiently to bring them back to health, so that they have the proper incentives to go out and make loans to households and businesses with productive investment opportunities. In addition economists (and politicians) have come around to the view that large fiscal stimulus packages may be necessary to keep economies throughout the world from entering into deep recessions or even depressions. Of course it is far from clear whether these fiscal packages, like the close to $800 billion package in the United States, will be effective.

Why Monetary Policy Needs to be Aggressive During Financial Crises

The logic of the argument above which indicates that monetary policy may be even more effective during financial crises also argues for even more aggressive easing of monetary policy during financial crises.

As argued above financial disruptions can have particularly nonlinear effects on the economy because they can lead to an adverse feedback loop. As I outlined in Mishkin (2008a), the resulting nonlinearity argues against the result from a linear-quadratic (LQ) framework that optimal monetary policy should display considerable inertia. An alternative approach is for monetary policy to engage in risk management by using monetary policy to take out insurance against tail risks.

As I mentioned above, periods of financial instability are characterized by valuation risk and macroeconomic risk. Monetary policy cannot aim at minimizing valuation risk, but can reduce macroeconomic risk. By easing monetary policy aggressively to offset the negative effects of financial turmoil on aggregate economic activity – this includes cutting interest rates preemptively, as well as using nonconventional monetary policy tools if interest rates fall to close to the zero lower bound – monetary policy can reduce the likelihood that a financial disruption might set off an adverse feedback loop. The resulting reduction in uncertainty can then make it easier for the markets to collect the information that facilitates price discovery, thus hastening the return of normal market functioning.

1The now-classic textbook on this topic is Michael Woodford (2003).
One danger from aggressive easing monetary policy easing is that it might unanchor inflation expectations. This unanchoring of inflation expectations could then lead to significant inflation in the future because the behavior of inflation is significantly influenced by the public’s expectations about where inflation is likely to head in the long run (Mishkin, 2007). Therefore, aggressive preemptive easing of monetary policy would be counterproductive if these actions caused an increase in inflation expectations and the underlying rate of inflation; in other words, the flexibility to act preemptively against a financial disruption presumes that inflation expectations are well anchored and unlikely to rise during a period of temporary monetary easing.

How can a central bank keep inflation expectations solidly anchored so it can respond preemptively to financial disruptions? The central bank has to have earned credibility with financial markets and the public through a record of previous actions to maintain low and stable inflation. Furthermore, by clearly communicating the rationale for its policy actions, the central bank can make it clear that it will not let inflation spin out of control. In addition, inflation expectations are more likely to remain anchored if the central banks communicate that it will be flexible in the opposite direction by raising interest rates quickly if there is a rapid recovery in financial markets or if there is an upward shift in projections for future inflation. In this way the central bank can show that it is prepared to take back some of the insurance it has provided by its earlier monetary policy easing.

Now let me turn to the second question: Are there some tools that the Fed should have that would help in current situation? The answer is yes: the Fed needs to adopt an explicit numerical inflation objective.

II.
Why the Fed needs an Explicit Numerical Inflation Objective Now

Many central banks throughout the world have adopted an explicit, numerical objective for inflation, commonly referred to as an inflation target, although this terminology is somewhat misleading because having a numerical objective does not mean that you should try to hit it over short periods of time as the word “target” seems to imply. The Federal Reserve is currently not one of them, but it is discussing this possibility. In the current circumstances with the economy in free fall, is it crazy for the Fed to move in this direction? Is an increased commitment to stabilizing inflation the right thing to do when we are in the throes of a financial crisis and the economy is doing so poorly?

My answer is absolutely yes. Adopting an explicit, numerical inflation objective is exactly what is needed right now to help the U.S. economy to recover.

As many of you know, I have been a strong advocate of the Fed having an explicit numerical inflation objective. The usual argument for establishing a transparent and credible commitment to a specific numerical inflation objective is that it provides a firm anchor for long-
run inflation expectations, thereby directly contributing to the objective of low and stable inflation. Adoption of an explicit, numerical inflation objective has been successful in other countries in keeping inflation from going too high. However, particularly important now is that an inflation target can help prevent inflation from falling too low. At this critical juncture, this benefit can have enormous value.

Up until recently, inflation risks were on the upside. But the contractionary shock from the severe disruptions in the financial markets that we have been experiencing lately has shifted the economic landscape completely. Not only has the economy entered a deep recession, but inflation has plummeted. CPI inflation on a year-over-year basis has fallen below 2%, which is below what would be a sensible inflation objective consistent with price stability. On a three-month basis inflation has been falling at a negative 10% rate. Core measures of inflation, which strip out food and energy prices and are thus potentially more accurate guides to underlying inflation, also indicate that the risks to inflation are on the downside. Core CPI inflation on a year-over-year basis is below 2%, but over the last three months has been below 0.5%.

The danger right now is not that inflation expectations will be too high, but rather that they become unanchored in the negative direction. Indeed, inflation expectations, whether measured by consumer surveys, surveys of professional forecasters or the difference between interest rates on non-indexed Treasury securities and Treasury indexed bonds, all point to a sharp decline. Longer run inflation expectations have just recently come down to levels consistent with price stability, but if they fall further they could lead to two dangerous consequences. First, there would be an increased likelihood that inflation would become persistently negative, that is, a deflation. The experiences with deflation in the Great Depression and the “lost decade” in Japan suggest that a deflation causes great hardship in the economy. Second, with the federal funds rate near zero and therefore unable to go lower, persistent deflation would raise the effective cost of borrowing to households and business because it would mean that the interest rate adjusted for changes in the prices of real goods and services would rise. Despite an interest rate of zero, monetary policy would then become highly contractionary.

How would adopting an explicit numerical inflation objective help in the current economic environment? First, a commitment by the Federal Reserve to keep the inflation rate near an explicit objective, say 2%, over a longer term horizon would provide more incentives by the Fed, both because it would want to stick to its word and because it would subject it to more public scrutiny, to take future steps to have monetary policy be sufficiently expansionary in the future. Economic research has shown that a lack of such commitment was one reason why nonconventional monetary policy actions such as quantitative easing by the Bank of Japan was ineffective in promoting economic recovery.

Second, when the financial system starts to recover, to keep future inflation under control the Federal Reserve will need to drain the massive amounts of liquidity that it has pushed into the financial system over the past year and a half. A commitment to an explicit numerical inflation objective will encourage the Fed explain to the public how this liquidity will be removed and subject the Fed to public pressure if it was not taking the necessary steps to make this happen. In other words, a commitment to an explicit numerical inflation objective will help
the Fed in developing an exit strategy from the enormous expansion in its balance sheet that it has been using to engage in expansionary, nonconventional monetary policy.

How difficult would it be for the Fed to commit to ban explicit numerical inflation objective at this juncture? The answer is not very, as I outlined in my last speech as a Federal Reserve governor in July of 2008 (Mishkin, 2008b). I pointed out that doing so would involve three steps.

- First, the horizon for the projections on output growth, unemployment, and inflation should be lengthened. This change might involve simply an announcement of FOMC participants’ assessment of where inflation, output growth, and unemployment would converge under appropriate monetary policy in the long run. Alternatively, the horizon for the projections could be extended out further, say to five or more years.

- Second, FOMC participants should work toward reaching a consensus on the specific numerical value of the mandate-consistent inflation rate, and this consensus value should be reflected in their longer-run projections for inflation.²

- Third, the FOMC should emphasize its intention that this consensus value of the mandate-consistent inflation rate would only be modified for sound economic reasons, such as substantial improvements in the measurement of inflation or marked changes in the structure of the economy.

The Fed has just recently adopted the first step after the last FOMC meeting. The second step would also not be very difficult to do since the minutes of the last FOMC meeting indicated that most FOMC participants had a long-run projection of 2% for inflation under appropriate policy, with the lowest value being 1.5%. Thus the difference between FOMC participants on what they think the long-run inflation objective should be is not that large. The last step would be very natural because Federal Reserve officials always emphasize that their decisions on monetary policy are driven by sound economic reasoning. Indicating that the inflation goal should be decided on the same basis is therefore consistent with the way the Federal Reserve has been operating.

The time for hesitation by the Federal Reserve in adopting an explicit, numerical inflation objective is past. The Fed needs to do this now.

² FOMC participants would work toward reaching this consensus about mandate-consistent inflation using the overall inflation rate, as measured by PCE inflation, to be consistent with the Federal Reserve’s dual mandate. Overall and core (excluding changes in the prices of food and energy) inflation rates are likely to be at similar rates at a horizon of five or more years.
References


