

MONETARY POLICY AND THE  
GREAT RECESSION: WHAT WENT  
WRONG & WHAT SHOULD BE  
DONE?

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# The Crisis & Monetary Policy - 1

- (1) World GDP will shrink in 2009.
- (2) Crisis not the result of a single factor.
- (3) One factor being discussed is the “conduct of monetary policy”.
  - Conservative “laissez-faire” critique = Fed failed to raise rates (John Taylor).
  - Progressive critique = flawed structure of monetary policy.

# The Question of Asset Bubbles - 1

- Last few years, debate over monetary policy focused on two issues
  - (1) **Inflation targeting** - should monetary authorities engage in explicit inflation targeting?.
  - (2) **Asset price bubbles** - should monetary authorities respond directly to asset prices bubbles?

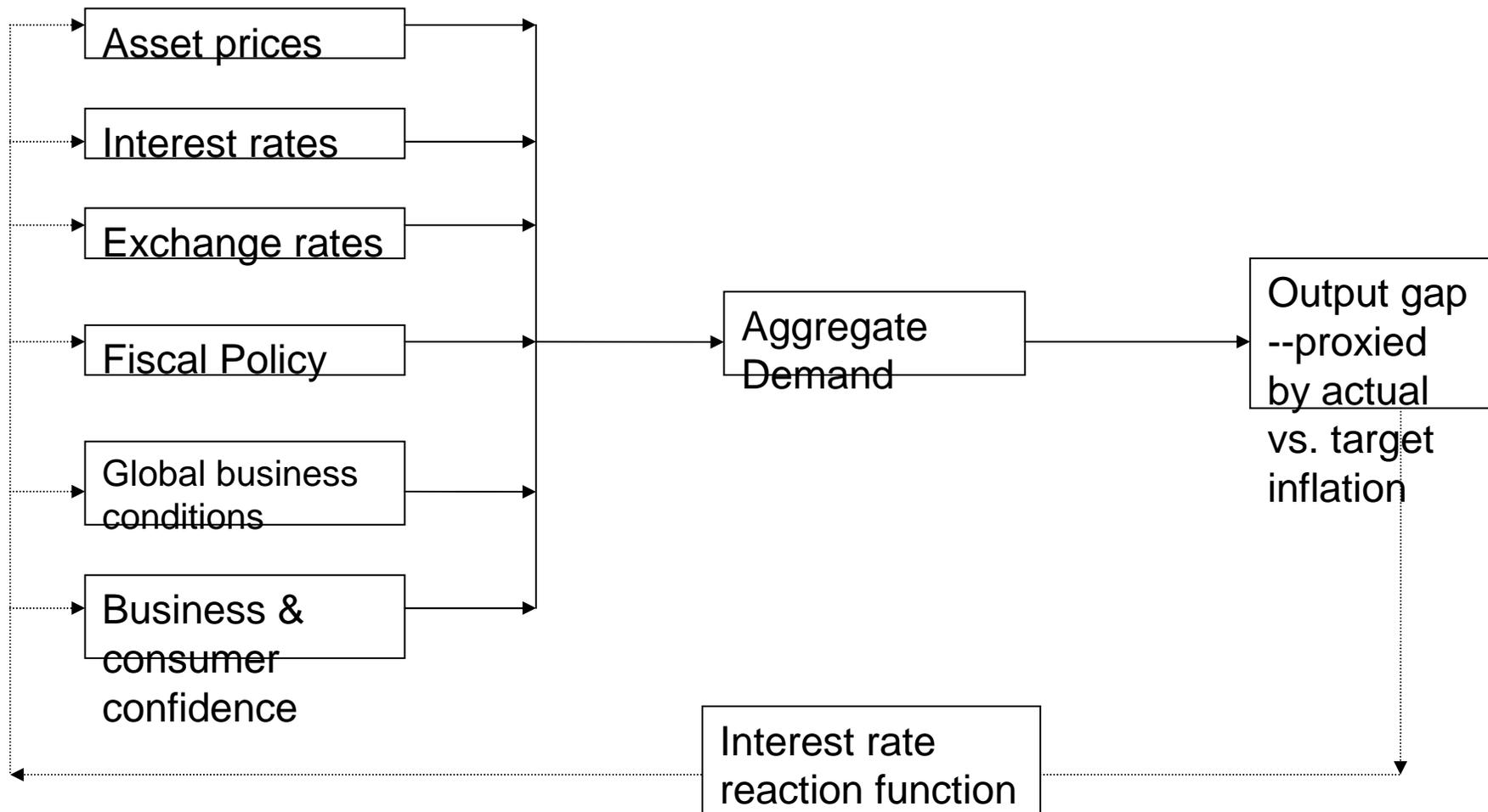
# Figure 1. Monetary Policy & The State of the Debate

		Inflation Targeting	
		Yes	No
Target asset bubbles	Yes		
	No	Bernanke	Greenspan

# The Greenspan – Bernanke Position on Bubbles

- **Greenspan – Bernanke position:**
  - (1) **Pragmatic objection** = targeting bubbles not feasible.
  - (2) **Theoretical objection** = direct targeting of asset markets not desirable.
- **Argument does not hold up:**
  - (1) Bubbles can be identified
  - (2) Bubbles distort economic activity & leave damaging effects
  - (3) It is possible to control bubbles through a system of asset based reserve requirements (ABRR).

# Figure 2. The Fed's Model



# The Fed's Model - 1

- **Goods Market (IS)**

(1)  $y = E(y, i_L, P_A, \dots)$      $E_y > 0, E_{i_L} < 0, E_{P_A} > 0$

- **Financial Sector (LM)**

(2)  $i_L = i_F + m$

$y$  = output,  $E(.)$  = AD function,  $i_L$  = market interest rate,  $P_A$  = asset prices,  $i_F$  = federal funds rate,  $m$  = interest rate mark-up.

- **Fed Policy** set federal funds rate to hit target output,  $y^*$ .

- $i_F^* = E^{-1}(y^*, m, P_A, \dots)$

# The Fed's Model - 2

- **Asset prices affect AD through the common funnel → if asset prices rise, increase target funds rate.**
- After bubble lower target funds rate → everything smoothly reversible → return to equilb. as before..

Figure 3. The Fed's Model

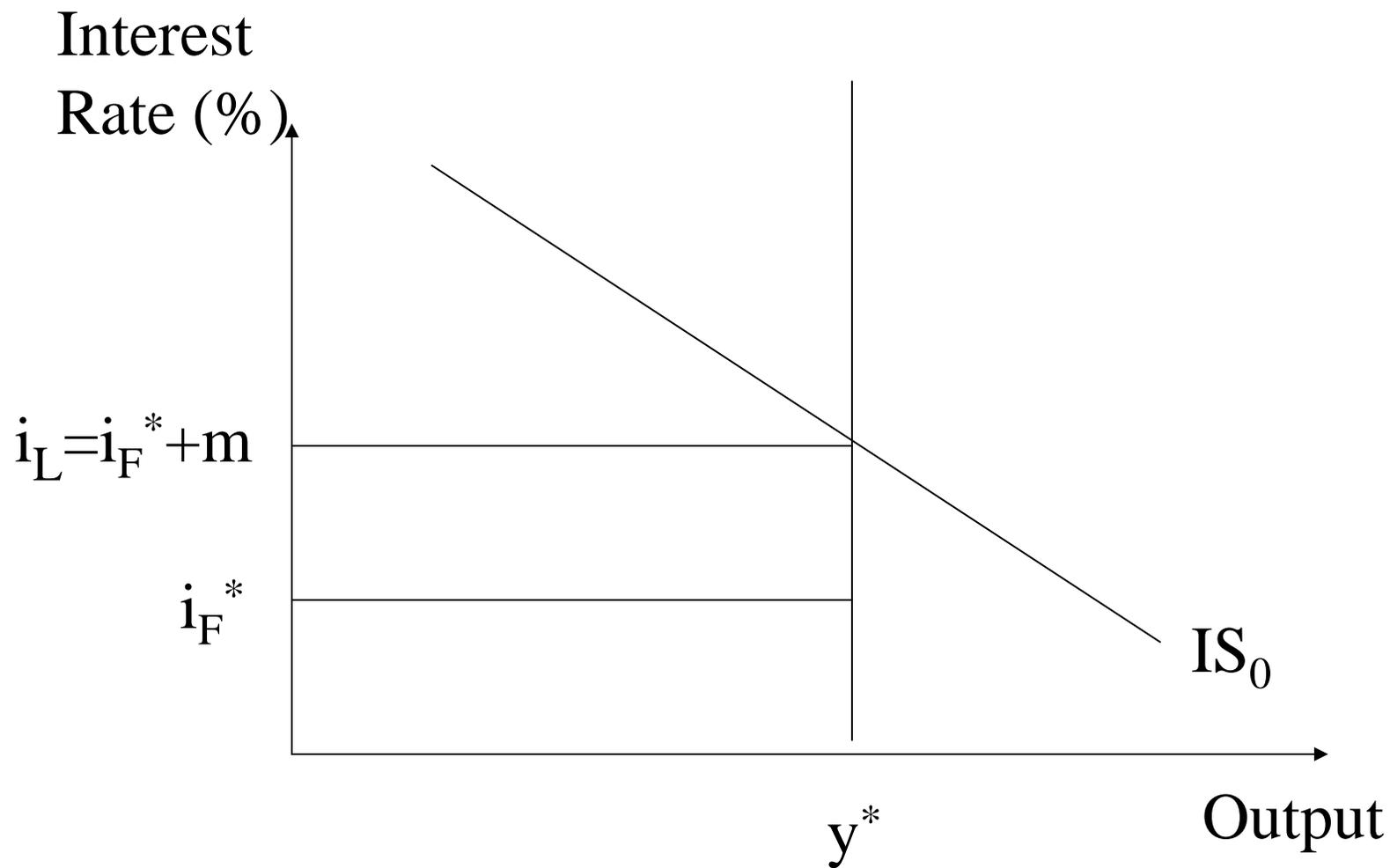
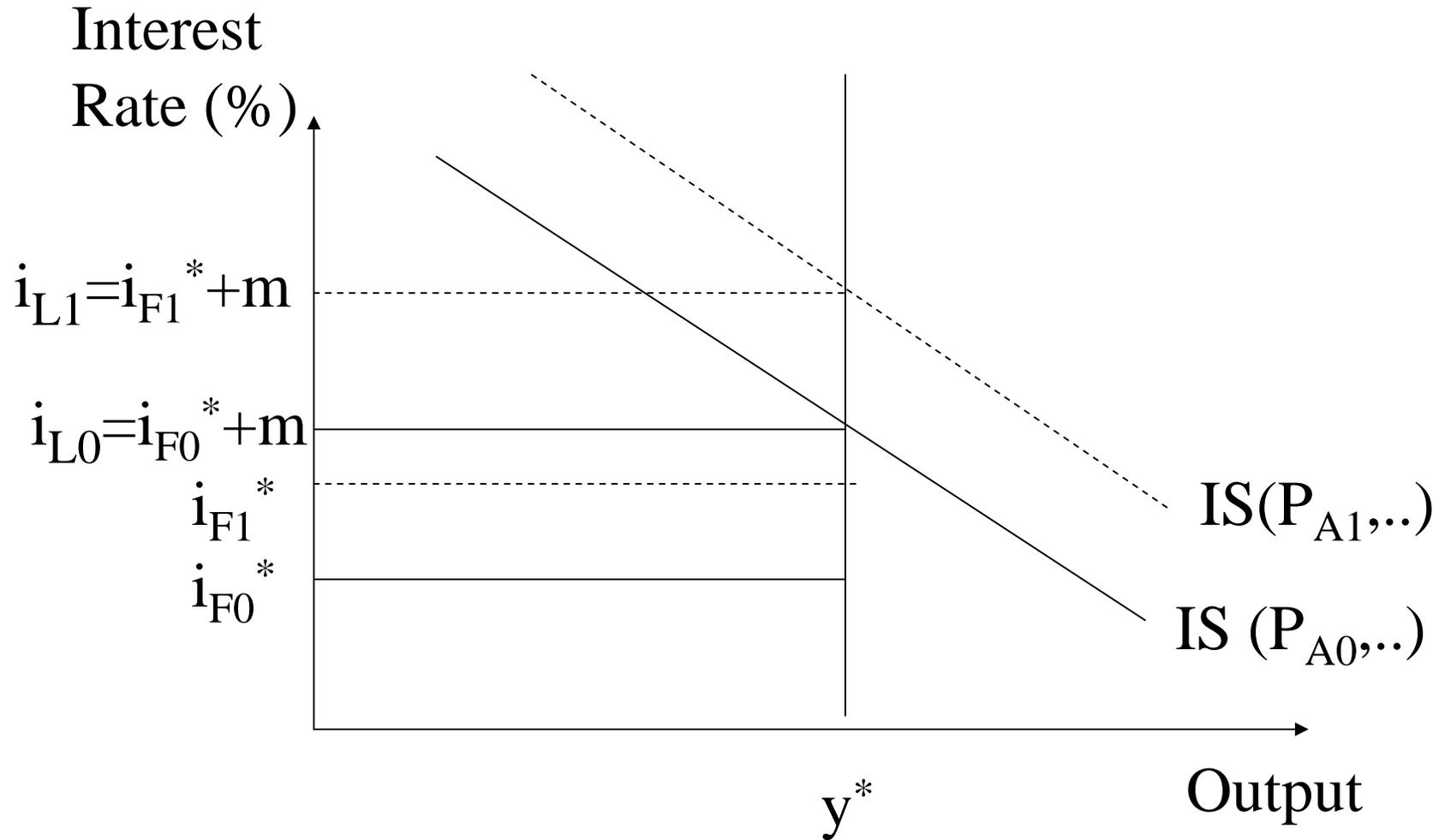


Figure 4. Asset Bubbles & The Fed's Model

$$P_{A1} > P_{A0}$$



# Critique of the Fed's Model - 1

- Ignores two types of problem:
  - (1) **“Debt footprint”** effects of bubbles = after-effects of debt on AD & interest rate spreads.
  - (2) **“Blunderbuss”** effect of interest rate adjustment = collateral damage effects of higher interest rates.



# A Model with Footprint and Blunderbuss Effects - 2

- **Financial Sector (LM)**

$$(3) \quad i_L = i_F + m(D_{-1}, \dots) \quad m_D > 0$$

$$(4) \quad D = D_{-1} + B(dP_A, \dots) \quad B_{dP_A} > 0$$

$$(5) \quad P_A = P_{A-1} + dP_A$$

$$(6) \quad i_F = i_F^*$$

$$(7) \quad i_F^* = E^{-1}(y^*, i_L, P_A, B, D_{-1}, \dots) \geq 0$$

- where  $dP_A$  = change in asset prices.

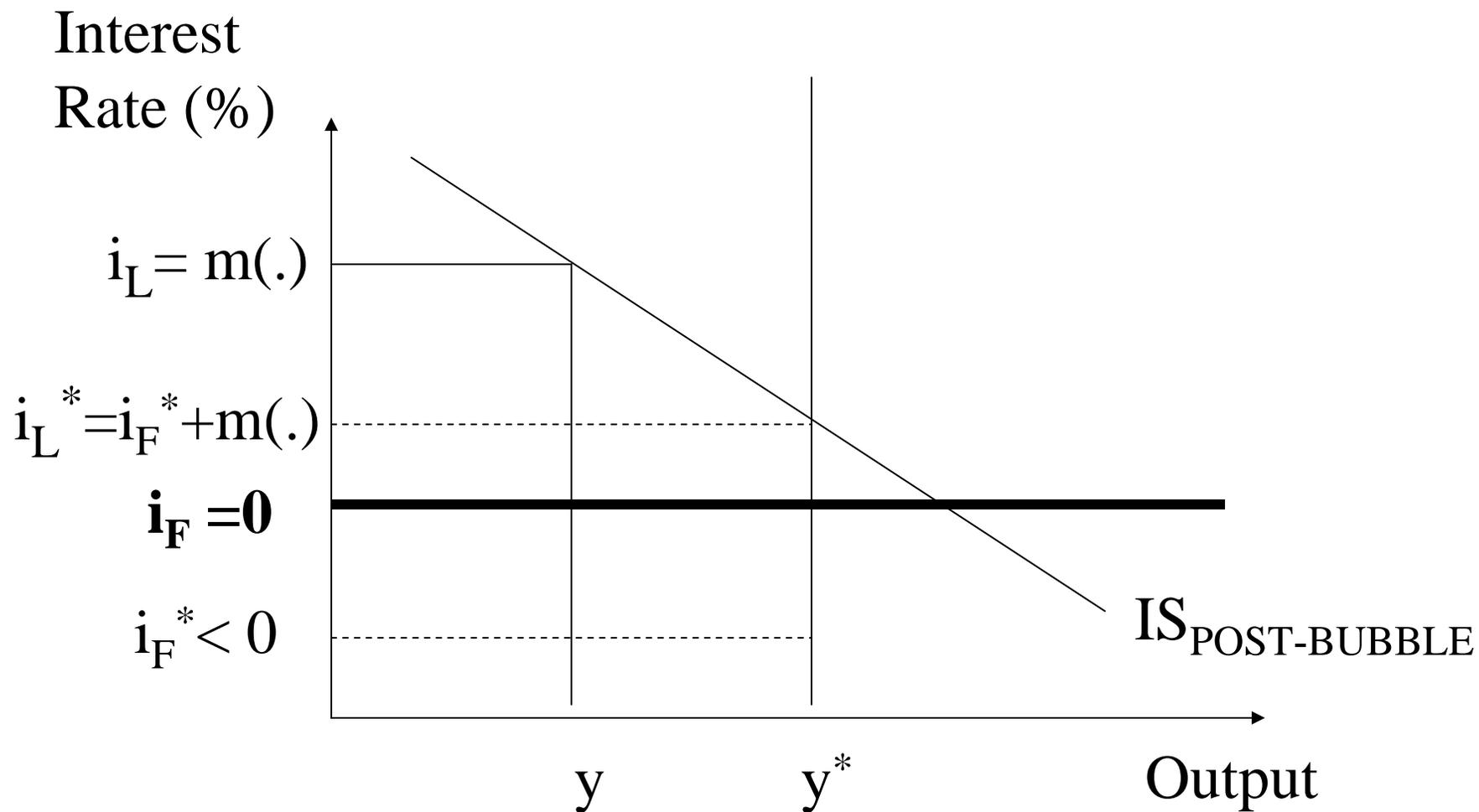
# A Model with Footprint and Blunderbuss Effects - 3

- “Blunderbuss effect” on AD & composition of spending [equation (2)]
- Negative impact on investment & net exports.
- Similarities with recent economic expansion  
→ boom in construction sector, weak investment spending, & record trade deficits.

# A Model with Footprint and Blunderbuss Effects - 4

- “Debt Footprint” effects work through both goods market & financial sector (equations (2) & (3)).
- a) When bubble dies down → debt footprint imposes direct drag on spending.
- b) Debt increases mark-up/credit spreads in the financial sector due to increased default risk.
- After bubble → AD contracts & market interest rate rises → Fed may be unable to push Fed funds rate low enough to hit full employment due to zero floor.

Figure 5. The Post Bubble Trap.



# Further Considerations

- Additionally can have “Financial Capacity” effects → emphasized by Bernanke (1983).
- Destruction of financial sector capital disrupts provision of credit → AS & AD contract → leaving economy below “normal” potential output.

# The Policy Instrument Problem

- Fed needs to be able to respond to asset price bubbles – especially in real estate.
- Need additional instruments to target bubble & avoid blunderbuss and footprint effects
- Can be provided via system Asset based reserve requirements (Palley, 2000, 2003, 2004)

# What are ABRR?

- FIs Hold reserves against assets... Asset categories can be zero-rated
- Applied to all FIs... Level playing field
- Reserve requirement ratios can be adjusted at discretion of monetary authority
- Creates  $n - 1$  additional instruments, where  $n =$  number of asset categories

# Advantages of ABRR

- (1) Can change relative costs of asset categories while holding federal funds rate constant.. Precision monetary instrument
- (2) Can direct funds to socially deserving areas if desired.
- (3) Good counter-cyclical properties... Higher asset prices, higher reserves needed
- (4) Seignorage benefits
- (5) Re-build demand for liabilities of central bank and strengthen monetary policy transmission mechanism

# ABRR vs. Risk Based Capital

- ABRR counter-cyclical v. RBC pro-cyclical
- Financial crises: ABRR asset default frees up reserves v RBC forced to get more equity
- ABRR a tool of discretionary monetary policy v. RBC not.
- ABRR seignorage benefits v. RBC none
- ABRR strengthen monetary policy channel v. RBC not

# Conclusion: The Challenge of Central Bank Reform - 1

- Greenspan – Bernanke argument does not hold up.
- Bubbles are dangerous.
- Bubbles can be identified.
- Dealing with bubbles requires additional policy instrument → system of ABRR.

# Conclusion: The Challenge of Central Bank Reform - 2

- **Failure of monetary policy just one part of a broader failure of central banking & economic policy.**
- **Microeconomic failure:** central banks embraced paradigm of de-regulation & non-regulation.
- **Macroeconomic failure** = central banks bought into new neo-liberal paradigm that created a new business cycle (Palley, 2005)

# Conclusion: The Challenge of Central Bank Reform - 3

- Invites a broader & deeper conversation about what went wrong.
- Crisis challenges economic paradigm that has dominated thinking since 1980.
- Central banks captured by this thinking.
- Challenge of how to break this intellectual monopoly.

# Conclusion: The Challenge of Central Bank Reform - 4

- Dangerous to have an investment portfolio that undiversified
- Dangerous to have a central bank that is intellectually undiversified & closed-minded.
- Need specific policy reforms.
- Also need to shake up central banks intellectually.
- Overcome capture of central banks by neo-classical economic ideology that excludes alternative points of view & supports interests of Wall Street.