U.S. MONETARY POLICY, 'IMBALANCES' AND THE FINANCIAL CRISIS

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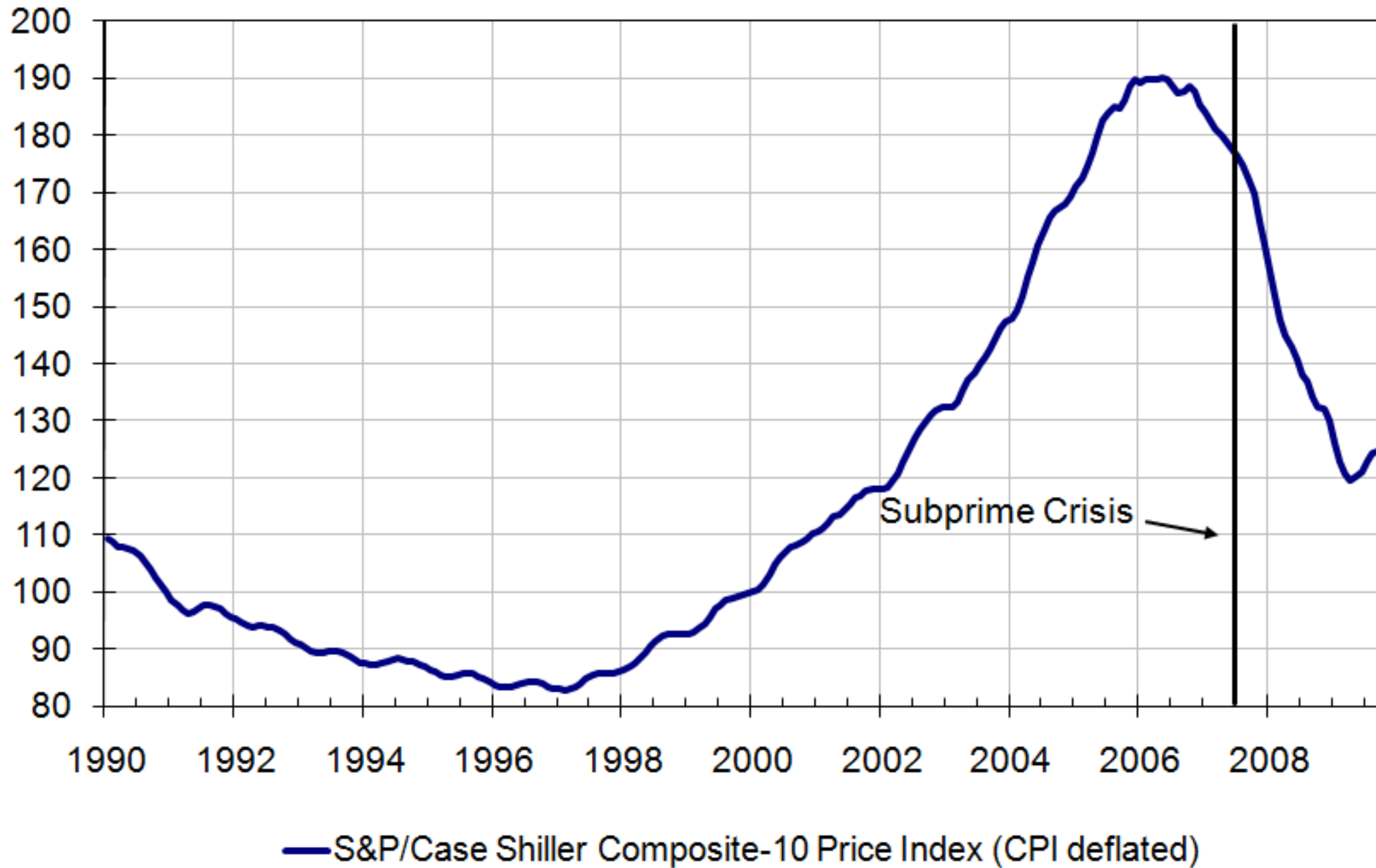
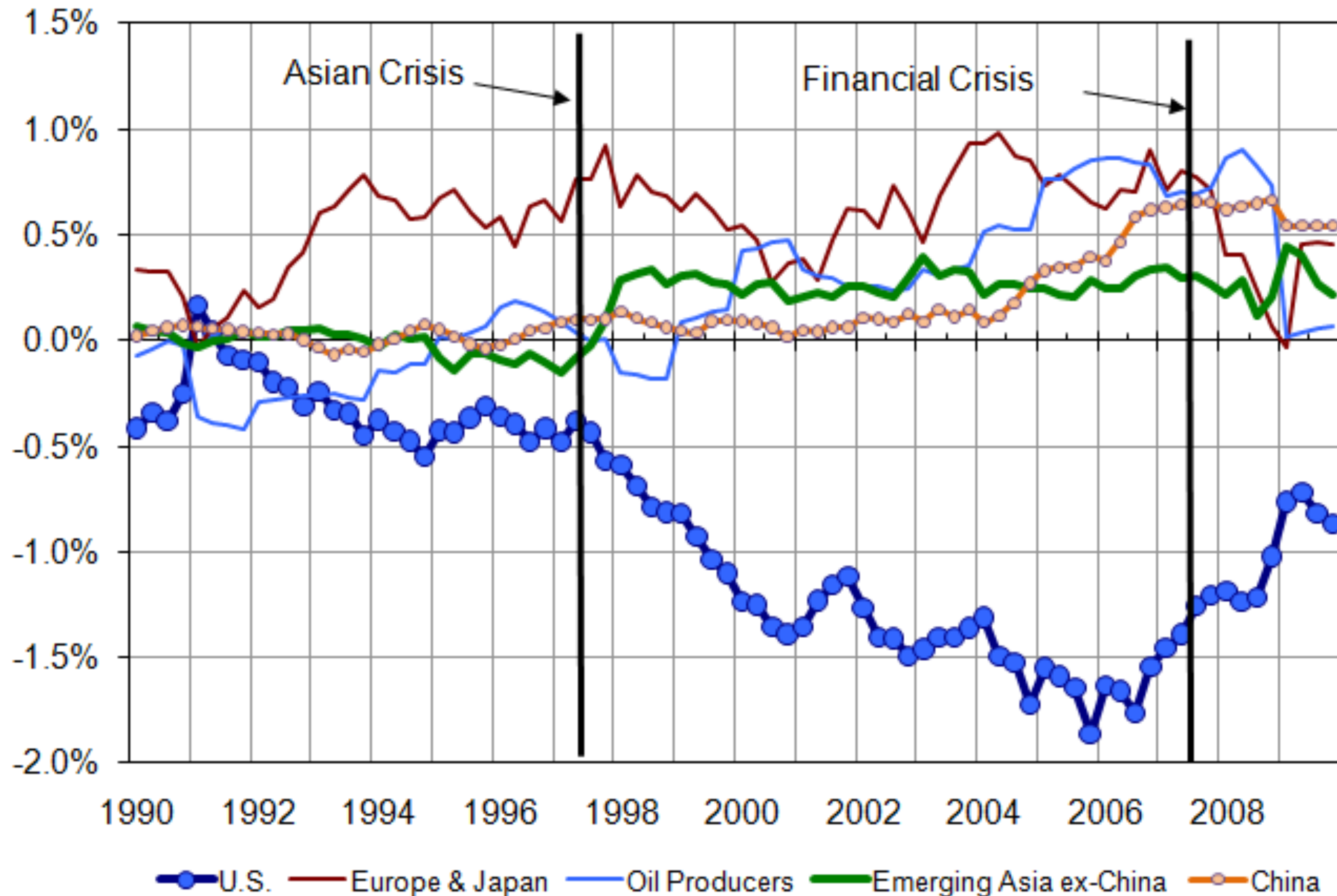
Real House Prices, 1990-2009

(deflated by Urban CPI)

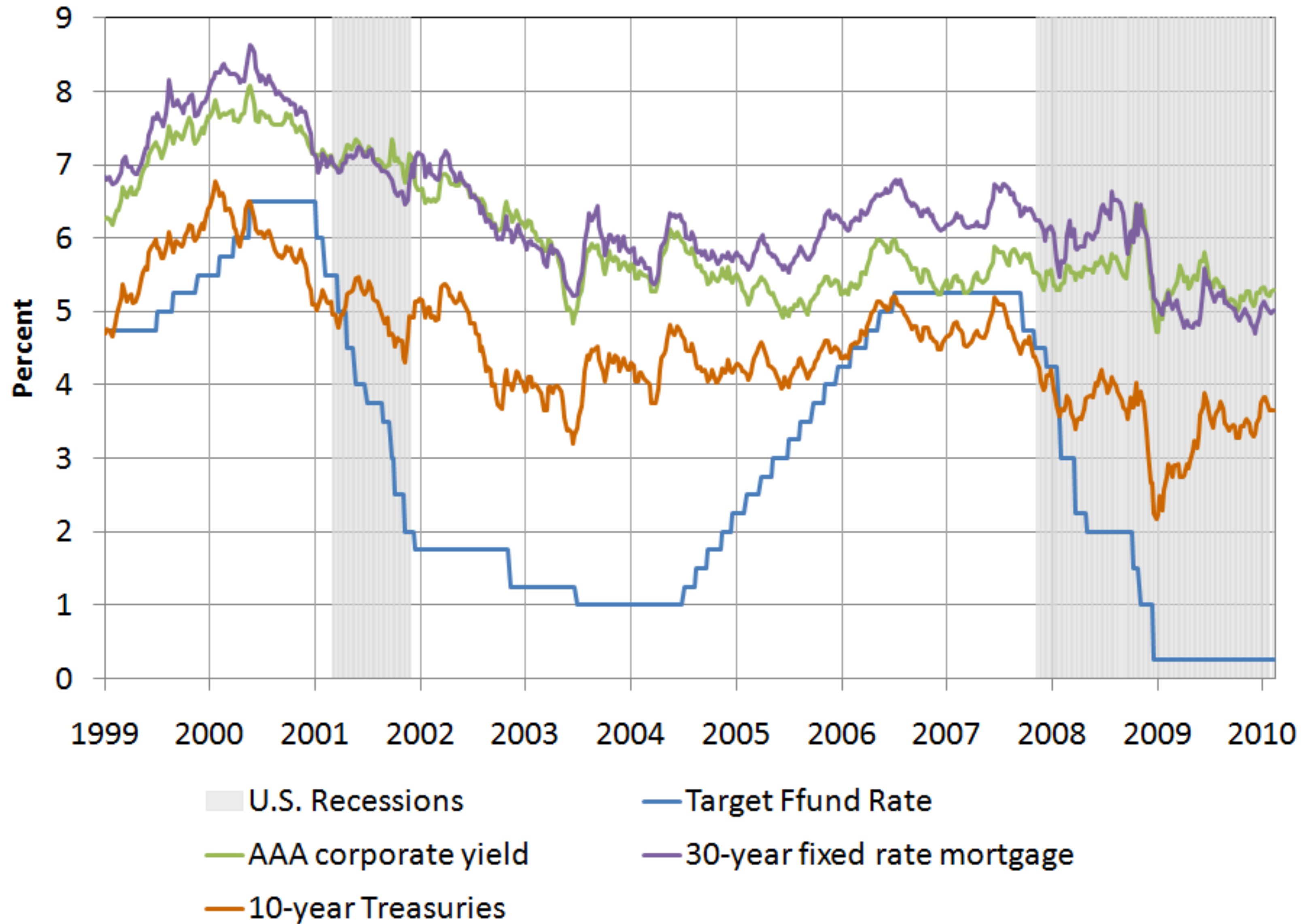


Global Imbalances: 1990-2009

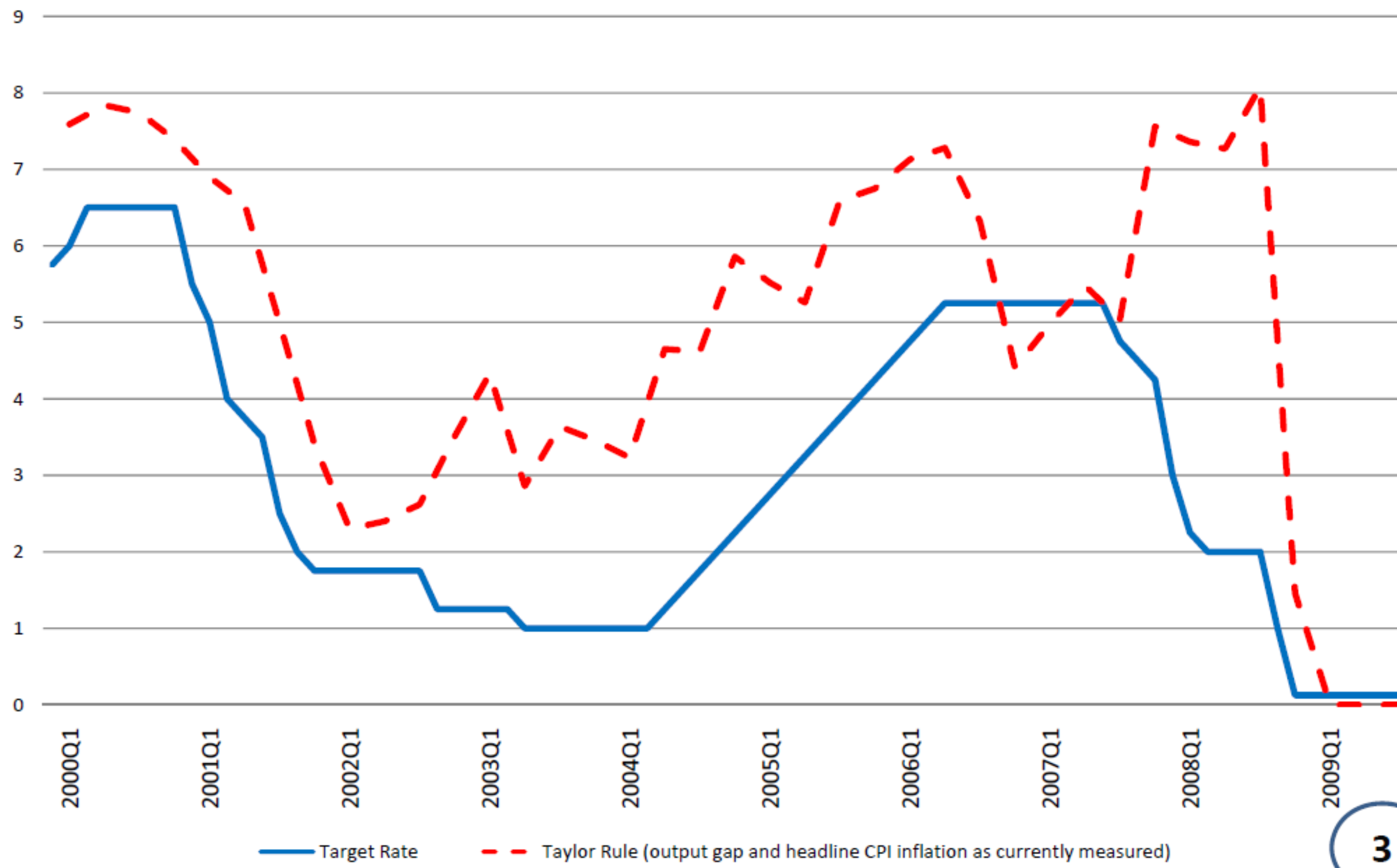
Current Account deficits as a % of World GDP



U.S. Monetary Policy, 1999-2009



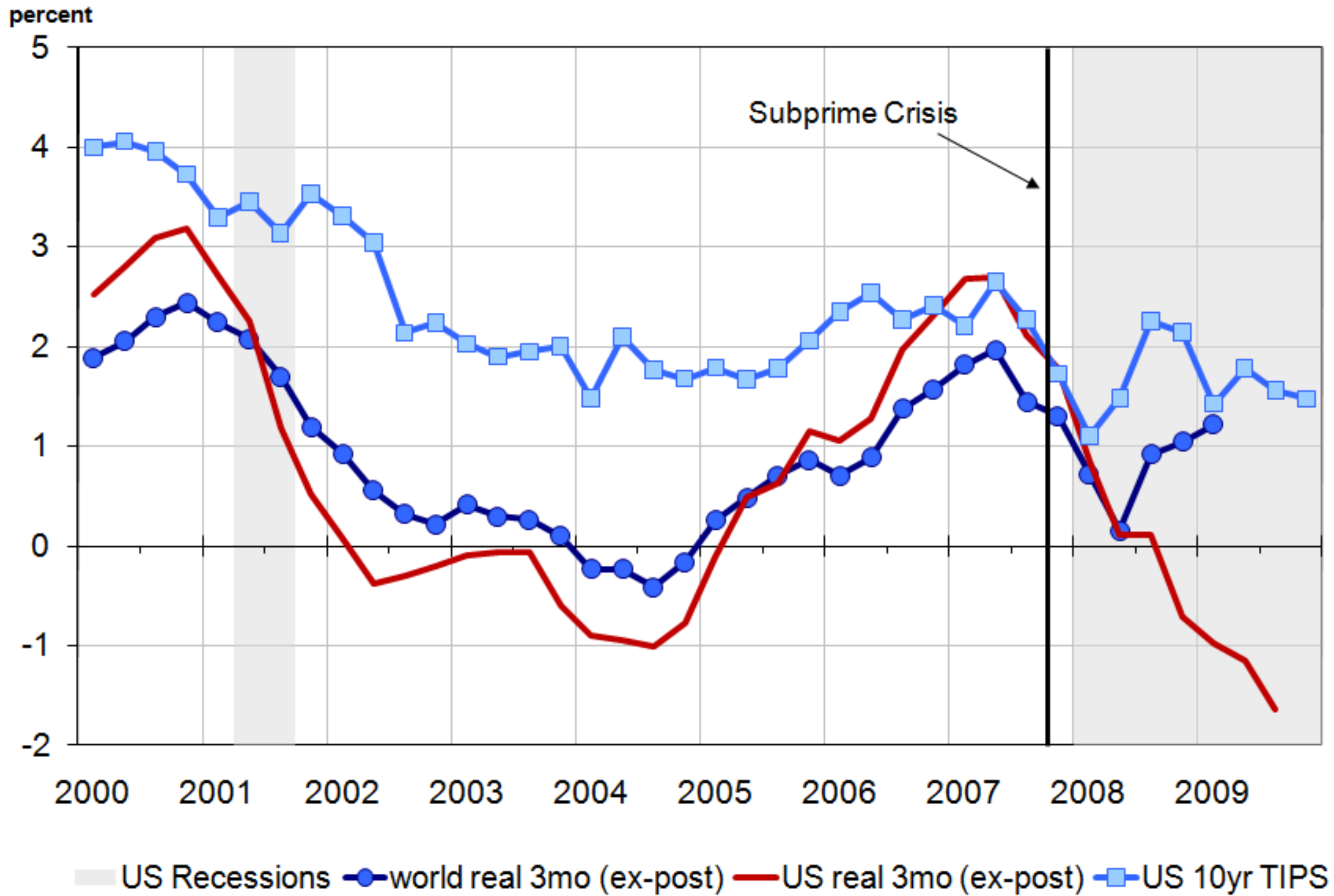
TAYLOR RULE (FROM BERNANKE, 2010)



Reasons to be Circumspect

- "Reasonable" Disagreements about:
  - Ingredients (measure of inflation, output gap)
  - Coefficients (on output gap, inflation…)
- Prescriptive content of the rule is not obvious
- Throughout the period, inflation remained stable and well-anchored, while output was also growing.

Low Real Interest Rates, 2000-2009



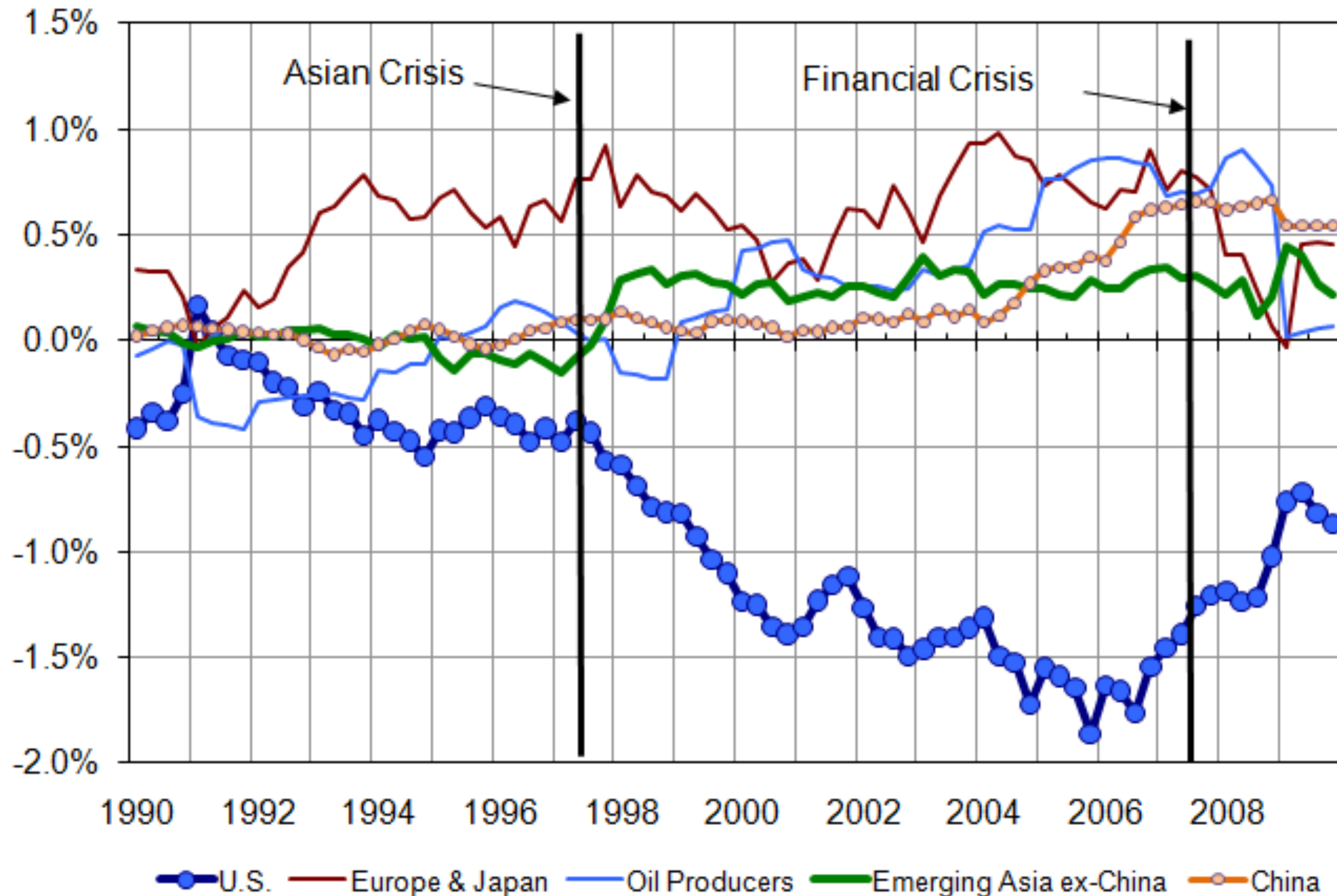
Dealing with Asset Bubbles: Should the Fed Lean?

- The Fed's view:
  1. Markets take care of themselves
  2. Undesirable for price stability
  3. Difficult to identify bubbles
  4. Effectiveness of raising rates on bubble is unclear
  5. Interest rate policy can "mop-up"

- (1) and (5) casualties of the crisis
- But (2)-(4) remain. Interest rate policy may not be the instrument of choice.
- Bigger failure : Fed failed to remain vigilant.

GLOBAL IMBALANCES: 1990-2009

CURRENT ACCOUNT DEFICITS AS A % OF WORLD GDP

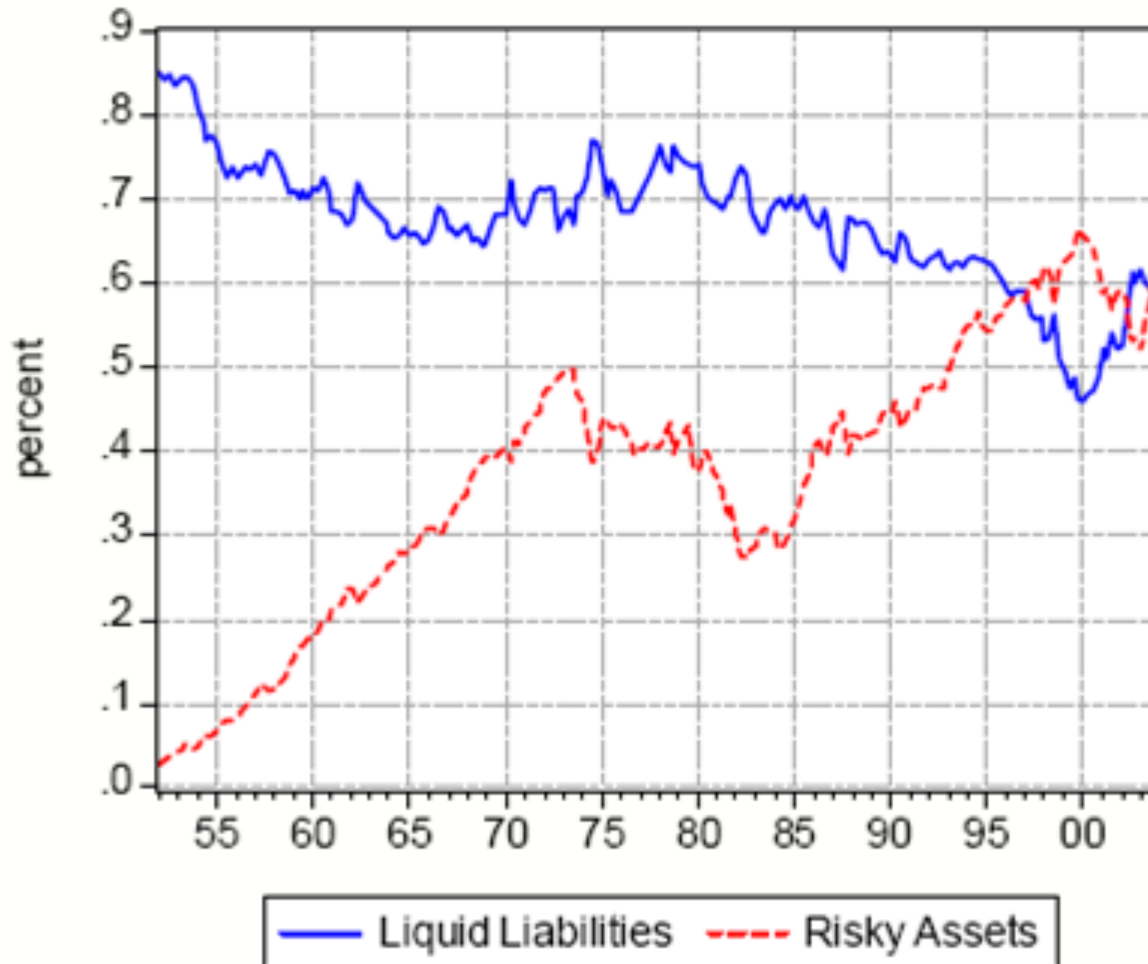


What Global Factors?

- Global Imbalances? Unlikely
  - What matters is global savings and global investment.
  - Could have “rebalanced” without changing the cost of funds
- Instead, post 2001 and 2004: massive surge in demand for U.S. “triple-A” debt instruments
  - Asymmetry between economic and financial development in emerging economies
  - Post 2001, rebalancing of portfolios
  - Surge in reserve accumulation from EM to insure against sudden stop
  - Sterilization policies from surplus countries to peg their currency in dollar terms.
- Why U.S.? Historical liquidity provider.

U.S. as Global Liquidity Provider

Debt as % of gross liabilities; Equities and FDI as % of gross assets



Safe-Asset Imbalance

- Global surge in demand for safe U.S. assets
  - Profit opportunity for U.S. financial sector: manufacture *quasi* triple-A debt assets from riskier assets (securitization)
  - Transfer demand for safe assets to other classes and fuels housing bubble. Wealth increases allows more borrowing. Feedback loop.
  - Synthetic assets much more vulnerable to systemic risk
  - When financial crisis occurs, run on structured credit instrument. Only bona-fide safe assets are U.S. Treasuries.

CONCLUSION

- Monetary policy in 2001-2007 no immediate threat to the economy
- Interest rate policy is a second or third best instrument.
- But low real interest rates, strong growth and housing bubble should have pushed policymakers to be more vigilant and more creative

- Global imbalances played limited direct role
- More important was the demand for safe U.S. debt instrument.