

Monetary Policy and the Great Malaise

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Tokyo

March 2016

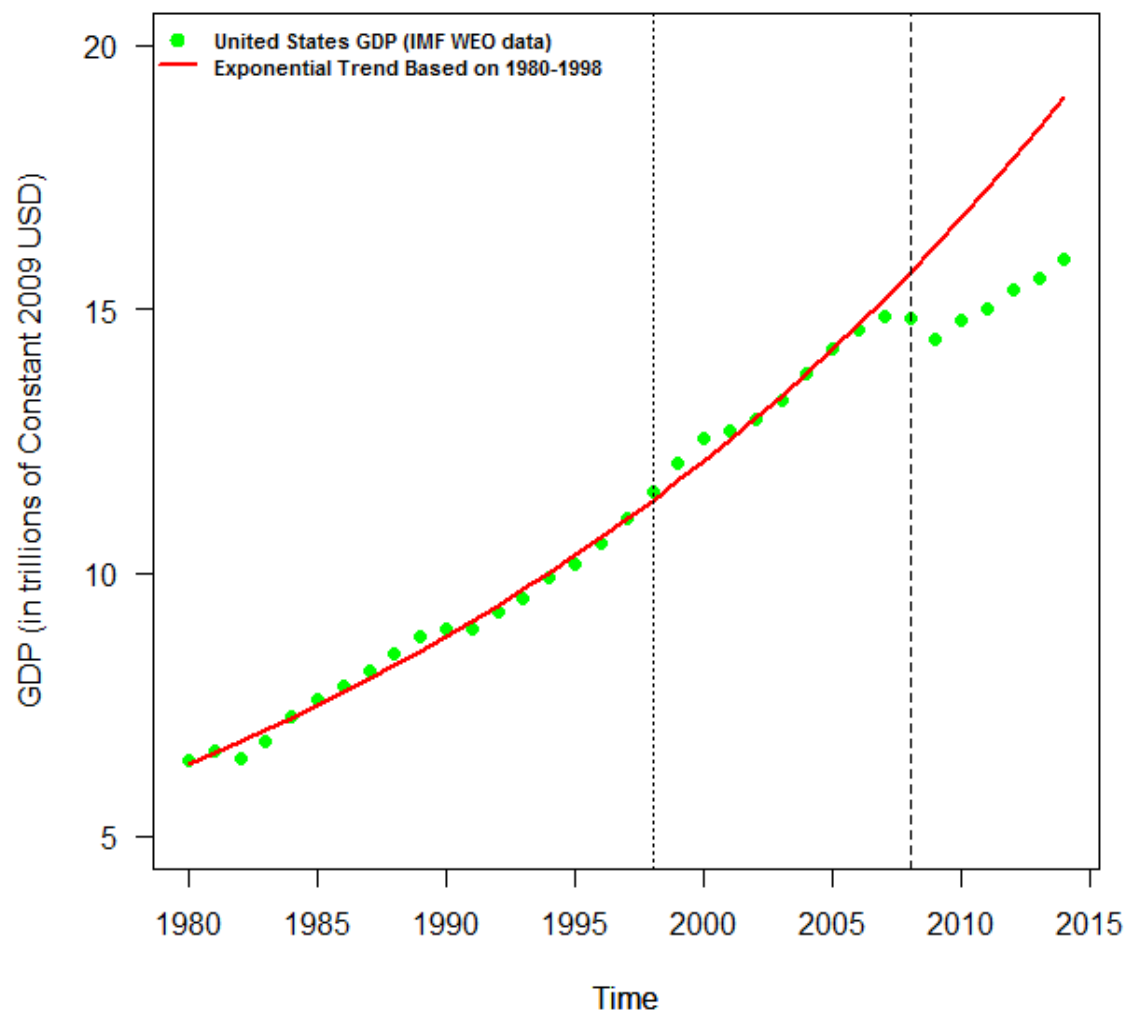
Where we are

- Slow growth—Great Malaise, New Mediocre
 - Not a crisis *yet*
 - But with persistent moderately high unemployment (in some cases disguised) in many of G-7, higher unemployment among youth and marginalized groups
 - Disproportionate share of slow growth going to a few at the top—growing inequality, wage stagnation
 - Even in countries with low “official” unemployment, raising questions of quality of job growth and disguised unemployment
 - World economy was weak in 2007, before crisis
 - Only sustained by a bubble
 - Restoring the world to 2007 simply restores us to the weak economy we had then
- Mixed prospects—small probability of returning to robust growth, large probability of recession or worse
 - Justifiable concerns about asset price bubbles that might deflate
 - Emerging markets facing massive capital outflows, with many countries and companies over-indebted

Underperformance of US Economy

- GDP some 15% below what it would have been had the growth rates that prevailed between 1980 and 1998 continued
- Percentage of the working-age population employed lower than it was in the early 1980s, when women were entering the workforce en masse
- Median real (household) income is less than 1% higher than it was in 1989
- Real wages at the bottom are lower than 60 years ago
- African-American youth unemployment rate is still 23.7%

United States GDP Trend Analysis

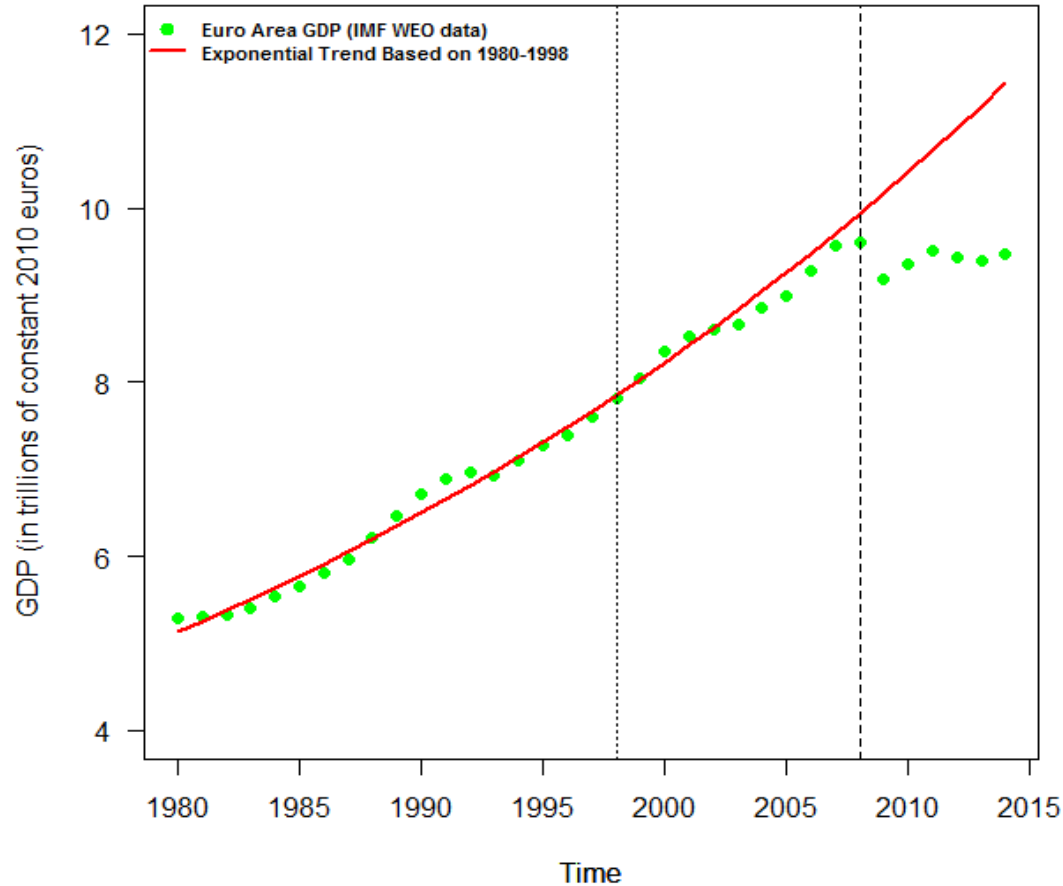


Europe is even worse

- With higher levels of unemployment
- Especially youth unemployment
- And lower levels of growth
- **Euro crisis is not over**—only under short term “remission”
 - **Haven’t created institutions that are necessary to make a single currency work, and not likely to do so at time soon**
- Gap between where they are and where they would have been growing

Dismal European performance since crisis

Euro Area GDP Trend Analysis



China

- Has been driver of global economic since GFC
 - Advanced countries affected directly and indirectly
- Likely to be significant slowdown
- Europe and US not likely to be able to make up for the slowdown of China's economy

Misdiagnosis of the Great Recession

More than a financial crisis

- Banks' balance sheets are largely restored
- Some regulatory reform (Dodd Frank)
- Yet economy is not back to health
 - Insufficient attention paid to improving credit channel
 - Helps explain why monetary easing didn't help as much as hoped

Misdiagnosis of the Great Recession

More than a balance sheet recession

- Balance sheet of large corporations largely restored
- It is not corporate balance sheets or their access to finance that are holding them back from investing
 - It is lack of demand.

Further concerns

- **Persistent Global imbalances**
 - Eurozone has exacerbated problem
- Asymmetrical adjustment
 - Countries (firms, households) facing a decline in income have to reduce consumption
 - Those with increased income do not expand spending symmetrically
- **Response to changes in oil price illustrates**
 - Many had expected lower prices to increase demand, but adverse effects of “losers” more than offsetting these benefits

Diagnosis of the central problem

- **Lack of global aggregate demand**
- Combined with insufficient efforts in each country to support non-traded sectors
- Excessive reliance on debt, financialization
- More broadly, in large parts of advanced countries about a third of a century ago, there began a process of rewriting the rules of the market economy (redesigning tax structures, ill-thought out liberalization) that led to slower growth, more instability and more inequality—just the opposite of what was promised

Monetary Policy cannot/has not restored global aggregate demand

- Much of effects have been through competitive devaluations—zero sum from a global perspective
- Some of effects are through “wealth effects”—stock market booms
 - Based on trickle down economics
 - Increasing inequality
- Not surprisingly, effects have been limited
 - Especially when policies are announced to be temporary
- Key problem—credit channel not working

QE

- Much of benefits flowed *out of the country*
 - In some cases, to countries that didn't want extra stimulus
 - Money didn't go where it was needed and wanted, went to where it was not needed and wanted
- Helped create asset bubbles
 - Giving rise to risk of instability
 - And benefiting owners of land, fixed assets
- Concern about distorting price of risk
 - Reflection of market imperfections/"behavioral economics" effects
- Some of money went to finance "margin"—increasing speculation (creating "pseudo-wealth")
- Little of money went to where standard theory says it's supposed to go
 - Globally, investment has been disappointing

Fixing financial markets

- Among central banks main responsibilities is ensuring the functioning of financial markets
 - Not just preventing excessive risk taking
 - Not just ensuring transparency
 - Not just preventing abuses
 - Market manipulation
 - Monopoly power
 - Abusive practices (predatory, discriminatory lending, abusive credit card practices)
 - Recognizing that banks and bank managers have incentives that are contrary to societal interests

Basic problem

- Regulatory reform has focused on curbing banks/financial sector from behaving badly
 - Excessive risk
 - Predation, phishing for phools, market manipulation
 - Imposing harm on others
- More emphasis should be placed on ensuring that the financial sector does what it is supposed to do: allocating capital, intermediating, managing risk
 - And does it at low transactions cost
 - In fact, in US and some other countries, story of banks as “intermediating” is a fiction
 - There has been a net flow out of the corporate sector
 - Banks have moved out of lending to SMEs, their real “niche”

Failure to fix financial market one of reasons for slow recovery

Increase of liquidity through QE had limited effect inside US because credit channel is still blocked

- Increased concentration in mortgage market dampened effect of lowering long term interest rates
- Government still underwriting more than 90% of all mortgages
- Fed hasn't really understood fundamental problems with securitization, rating agencies
- Flow of money to SME's highly constricted

Zero lower bound is *Not* the problem

- Little evidence that lowering real interest rates would have significant effects
- And if that were true, there are other ways of changing intertemporal prices
- Of course, with a large enough lowering of interest rates (no repayment) there will be effect
 - Question then is to whom to give the “gift”
 - Should private banks be given the right to decide?
 - Or should the money be used for public purpose?

What central banks *might* do

- Work harder to fix credit channel
- Incentivize lending
 - US has been doing just the opposite—paying banks to park money with it
 - Make access to “window” dependent on lending
- Curtail other activities
 - CDSs, derivatives
 - Proprietary Trading
 - High interest rate consumer lending
- Reduce “tax” imposed by banks on all economic activities
 - Interchange fees
- Stimulate competition, entry

Rethinking monetary policy in the wake of GFC and its aftermath

Multiple lessons

- About central bank mandates
- Instruments
- Use of instruments
- Coordination—within a country and among countries
- Institutional structure
 - Coordination of regulation and macro-management
 - Central bank independence
- Models

A. Mandate

- Before crisis—most focused on inflation (single mandate of ECB)
 - In belief that low inflation was necessary, and almost sufficient for good economic performance
 - Even though in past, major economic problems associated with financial crises, with much larger economic costs than moderate inflation
 - Fed founded in response to Panic of 1907
- Losses from this crisis are orders of magnitude greater than any possible losses from moderate inflation
 - Around the world, losses from crises since era of deregulation began have been huge

- No good economic theory behind belief—based on ideological presumptions concerning functioning of markets
 - In spite of large body of theory emphasizing market failures associated with financial markets arising from imperfect and asymmetric information and incomplete risk markets, macro-economic externalities, agency problems
 - Including credit market interlinkages that could lead to bankruptcy cascades
 - Almost as if Fed studiously avoided issues

New Mandates

- In US, financial stability has been added to inflation, growth, and employment
- Failure of Europe to have broader mandate has contributed to its problems
 - Allowed US to engage in competitive devaluation through QE

B. Broader instruments

Before crisis, many argued that CB should limit itself to managing short term interest rate

- No good economic theory behind this belief
- Macro-economic behavior affected by credit availability and lending rate
- Endogenous variables affected by a host of instruments— including **micro- and macro- prudential instruments**

- Housing bubble and tech bubble could have been dampened had Fed used these instruments
- Congress had given Fed instruments, Greenspan and Bernanke refused to use instruments until too late, even though one member of the Board consistently warned of housing bubble
- Explanation: (a) Belief that markets are efficient, and therefore there could not be a bubble, in spite of long history of bubbles

(b) Can't tell (for sure) that there was a bubble until after it broke

- All policy is done in context of uncertainty
- Evidence of bubble was very strong

(c) Cost of cleaning up after crisis less than risks of interfering with market

- Judgment badly flawed
- Again, based on presumption that markets were efficient

C. Use of instruments

- Before crisis: widespread use of Taylor rule, adjusting interest rates in response to inflation
 - Regardless of the source of the perturbation to the economy
- Now: focus on employment
- And growing recognition that policy needs to respond to source of perturbation

D. Coordination

Tinbergen rule only valid under highly restrictive conditions

- In general, need as many instruments as one can get
- And full coordination between monetary and fiscal authorities
- (Even if one assigned one instrument to one agency, pre-crisis assignment not necessarily best; could lead to instability)

E. Global Coordination

- Large countries can exert large externalities on others, which they fail to take into account
 - Not true for small countries
 - QE provided limited benefits to US, imposed high costs on other countries, on global economic system
- Ideally, should be global coordination in policy and regulation
 - But difficulties in getting coordination part of strategy for blocking regulation
 - More important to have regulation
 - Implications for design of each countries regulatory system (subsidiaries rather than branches)

F. Changed views on global financial market integration

- Capital controls are an important instrument for ensuring stability
 - Consistent with new views on need for regulation
 - Cross border capital flows are different

G. Institutional structure

- Coordination of macro- and regulatory policy
 - Before—in separate agencies
 - Now: recognize need for coordination
 - Had been emphasized before crisis in theories focusing on credit availability

Institutional structure: Central Bank independence

- Many of the less independent central banks performed far better
- Independent central banks had been captured (cognitively) by special interests
- Led to undermining credibility of central bank and government
- Especially problematic when CB were engaged in quasi-fiscal operations
 - Giving out hundreds of billions of dollars in non-transparent ways
 - Trying to hide behind independence as a basis of non-accountability

Rethinking Models

- Models many central banks used were badly flawed
 - Not only didn't predict crisis
 - Said it couldn't happen
- Left out banking sector, good modeling of financial sector
- In standard models, no room for “liquidity and liquidity crises (access to credit)”
 - Even though we have had models of credit rationing for more than a third of a century
- Single minded focus on interest rates
 - Evidenced even now in discussion of ZLB

Failures in what was left out, what was left in, and in intellectual coherence

- Ignored inequality
 - IMF now recognizes critical role of inequality for growth and stability
- Many aspects of intellectual incoherence
 - Argued for diversification before crisis
 - Recognized dangers of contagion after crisis
- Ignored macro-economic externalities
 - Failing to model financial sector as a network meant couldn't capture scope of externalities within financial sector, bankruptcy cascades
- Failing to model agency problems led to belief that banks had incentives to manage risks
- Failing to model incentives of too big to fail, too correlated to fail, too interlinked to fail banks meant failure to model incentive for excessive risk taking

- Good news: many of the elements required to construct better macro-models were already available before the crisis
 - Almost studiously ignored
- Challenge of central banks is to construct better models, incorporating broader mandates with more instruments, and developing better institutional arrangements for coordinating policy both within and among countries

Central Banks and the Great Malaise

- Central banks have been very creative in response to the global financial crisis
 - Even if some central banks played a central role in creating the global financial crisis
 - May have prevented another depression
- But in spite of unprecedented actions, the global economy remains weak
 - Showing the limits of monetary policy
- Too much was asked of monetary policy—more should have been asked of fiscal policy
 - It was largely absent; in many countries, governments undertook contractionary policies
 - Even true in US
- But the global financial crisis and its aftermath has taught us much about monetary policy and theory