Monetary policy – lessons to be learned[1]

Colloquium in honour of Claudio Borio

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I have rarely been more pleased to receive an invitation than when I received the one to this conference. It is an opportunity to honour Claudio Borio, an outstanding researcher in the field of macroeconomics and monetary policy, and at the same time to thank a good friend for many years of stimulating exchange of views. This is a welcome opportunity to highlight a few topics that played a major role during these years. My focus will be on the dominant interpretation of the Great Financial Crisis (GFC) of 2007–08.

In March 2003, the BIS held a conference entitled "Monetary Stability, Financial Stability and the Business Cycle". My contribution was on "Monetary and financial stability: is there a trade-off?", a topic that has lost none of its relevance since then. Even then, Claudio's pioneering paradigmatic approach was evident, as he placed the analysis in the context of a changed monetary regime, then known as the "new environment". This meant the long period of low inflation in which investors, feeling a false sense of security, could make excessively risky investment decisions, a position that was also supported by then Chair of the Federal Reserve Alan Greenspan. In my article, I did not rule out the possibility that financial fragility can be significant in times of low inflation. But the statement that low inflation is not a sufficient condition for financial stability and the notion that price stability causes financial instability are worlds apart.

If the central bank employs a medium-term horizon for the maintenance of price stability, financial imbalances will implicitly obtain the attention they deserve. Yet, this does not rule out the existence of a short-term conflict. In this case it can be optimal to deviate from the desired rate of inflation in the short run to best maintain price stability over the medium run. However, if this policy leads to a longer period of deviations from the declared inflation objective, the loss of inflation-fighting reputation could outweigh the gains. It is obvious that this risk is lower for a central bank with a convincing track record of maintaining price stability.

At the end of the renewed phase of even lower inflation in the 2010s, this discussion was resumed under somewhat different circumstances. The development of the financial cycle with its longer duration and different amplitude compared with the business cycle by Claudio has contributed significantly to a better understanding of such potential conflict situations.

Claudio then described the phenomenon of regime change in inflation in his concept of the "two-regime view of inflation". Indeed, this approach makes it clear why, after the phase of very low inflation, which was essentially about relative price

[1] I am grateful for valuable comments by Mervyn King and Klaus Masuch.

changes with little impact on the general price level, the subsequent inflation process got out of hand. This is not least because the central banks were under the illusion of a temporary price increase for too long. Other factors were added, such as the incorrect assessment of the pandemic-related simultaneous decline in supply and demand as a quasi-normal economic downturn. How central banks could trust in the stability of their forecasting models under these circumstances is difficult to explain and cannot be justified. Finally, the fact that the leading central banks had long since given up taking the development of money seriously also took its toll. The previous long phase of low inflation contributed to this attitude. But how could it be that even double-digit growth rates in monetary aggregates were apparently seen as harmless?

In this context, Claudio's contribution is also worth highlighting: he convincingly demonstrates that including monetary developments would have helped to improve the inflation forecast after the outbreak of the pandemic.

His numerous publications on the topic of the real equilibrium interest rate deserve much greater attention. If monetary policy has an impact on the real rate, enforcing expansionary policy in a situation when the central bank perceives the rate as too low, the policy argument becomes circular. When one looks back at the vast number of studies on this problem, it is difficult to understand why central banks continue to give this vague, Claudio calls it "shaky", concept such importance in the design of monetary policy.

Former Fed Chair Ben Bernanke once claimed "to understand the Great Depression is the Holy Grail of Macroeconomics…the experience of the 1930s continues to influence macroeconomists` beliefs, policy recommendations, and research agendas".[2] In this tradition one might call the GFC of 2007–08 "the mother of all challenges for central bank policy". After the outbreak of the crisis, central banks made a decisive contribution to ensuring that a global economic crisis comparable to the Great Depression of the 1930s did not develop. This great success earned them the reputation of "saviour of the world", but at the same time fostered moral hazard in investors and banks. This led to an overestimation of the possibilities of monetary policy, resulting in a threat to their reputation, which the BIS clearly warned about in its 2016 Annual Report.

Without wishing to downplay the eminently important contribution of central banks, after the experiences of the last century it should not have been so difficult to avoid a repetition of the mistakes of the past.

The much more difficult task, and one that I have not yet found a satisfactory answer to, is whether it would have been possible to avoid the outbreak of the crisis in 2007–08 – at least on this scale. Two questions need to be examined here. First, were there ways to recognise the emergence of a fragile, threatening situation? Second, were suitable instruments available to prevent this situation from developing or at least to mitigate it significantly?

First, the diagnosis problem. There were certainly warning voices, led by the BIS, not least by William White (former Head of the Monetary and Economic Department) and Claudio Borio. These warnings were unable to prevail over the optimistic mainstream. Alan Greenspan can probably be described as the most

[2] B Bernanke, "The macroeconomics of the Great Depression: a comparative approach", *NBER Working Papers*, no 4814, August 1994.

important representative of this position. In a 2002 lecture titled "World finance and risk management", he presented his assessment of the situation: "A major contributor to the dispersion of risk in recent decades has been the wide-ranging development of markets in securitized bank loans, credit card receivables, and commercial and residential mortgages. These markets have tailored the risk associated with holding such assets to fit the preferences of a broader spectrum of investors." And referring to derivative instruments, he added, "These increasingly complex financial instruments have been especial contributors, particularly over the past couple of stressful years, to the development of a far more flexible, efficient, and resilient financial system than existed just a quarter century ago."[3]

This view of a stable financial environment was absolutely dominant. Isn't it obvious that the fact that the worldwide eminent central banker, chairman of the Fed, delivered such an important message on the stability of the system would be seen as a signal for further leveraging? To indicate a kind of implicit commitment that the Fed would rescue banks in a future crisis? The risk of collective moral hazard and following systemic bailout was discussed in an important paper by Emmanuel Farhi and Jean Tirole.[4]

When three years later Raguram Rajan, then chief economist of the International Monetary Fund, at the Jackson Hole Conference warned that the financial system was exposed to great risk under the influence of deregulation and through the use of precisely the new financial instruments that Greenspan had identified as stabilisers, the overwhelming majority considered this warning not only exaggerated but simply erroneous.[5]

If problems do arise, they can be easily overcome by providing ample liquidity, according to Alan Blinder and Ricardo Reis at the same conference. This "mop up strategy" received a real-world stress test in 2000–02, when the biggest bubble in history imploded, vaporising some $8 trillion in wealth in the process. It is noteworthy, but insufficiently noted, that the ensuing recession was tiny and not a single sizeable bank failed. In fact, and even more amazing, not a single sizeable brokerage or investment bank failed either. Thus, the fears that the mop up after strategy might be overwhelmed by the speed and magnitude of the bursting of a giant bubble proved to be unfounded. Regarding Greenspan's legacy, then, we pose a simple rhetorical question. If the mop up strategy worked this well after the mega bubble burst in 2000, shouldn´t we assume that it will also work well after others, presumably smaller, bubbles burst in the future? Our answer is apparent.[6]

Needless to say, this extremely optimistic assessment was also widely accepted. It is therefore no surprise that monetary policy remained too expansionary for far too long and warnings of an escalation of the risk situation in the global financial system fell on deaf ears. Considering that only a few years later the real "mega

[3] A Greenspan, "World finance and risk management", remarks at Lancaster House, London, 25 September 2002.

[4] E Farhi and J Tirole, "Collective moral hazard, maturity mismatch, and systemic bailouts", *American Economic Review*, vol 102, no 1, February 2012, pp 60–93.

[5] R Rajan, "Has financial development made the world riskier?", in *The Greenspan Era: Lessons for the Future*, proceedings from the Federal Reserve of Kansas City Jackson Hole Economic Policy Symposium, 2005, pp 313–69.

[6] A Blinder and R Reis, "Understanding the Greenspan standard", in *The Greenspan Era: Lessons for the Future*, proceedings from the Federal Reserve of Kansas City Jackson Hole Economic Policy Symposium, 2005, pp 11–96.

bubble" burst, one would have expected that a wave of corrections to the previous blatant mistakes would have followed. But there was no sign of that. With the focus on overcoming the crisis, the fatal misdiagnosis faded into the background, as did the trivialisation of the mop up strategy.

Greenspan's risk management approach is based on the assumption that the risk of investment decisions can be captured using probabilistic theory. The "true" uncertainty, as Frank Knight calls it, or "radical uncertainty" by Kay and King, is not accessible to the mathematical probability calculus. "Radical uncertainty precludes optimising behaviour."[7] As Rajan's analysis suggests, monetary policy, the financial world, may have been exposed to a considerable degree of radical uncertainty before the GFC without realising it.

Now to the question of whether central banks, if they had made the correct diagnosis, could have prevented or at least mitigated a development that was the starting point for the subsequent collapse of the financial system. Almost all studies I know of come to a clear conclusion: a more restrictive monetary policy would not have been able to prevent this development and would also have been associated with too high losses of growth and employment. Two aspects are crucial here.

As far as I can see, this result is based not least on the fact that an alternative monetary policy would have been based exclusively on a sharp increase in central bank interest rates. This is usually accompanied by the observation that, according to the Tinbergen Rule, interest rates cannot also serve a second purpose, namely controlling asset prices.[8]

A number of studies have provided arguments for the central bank to slow down in a timely manner:[9]

- Even small changes in the spread between long- and short-term interest rates might have a substantial effect on the profitability of financial actors with high leverage and maturity mismatch problems. For such actions to have effectiveness, it is important that they are taken at an early stage before "irrational exuberance" and the "this time is different syndrome" can take hold. Since the central bank can influence the yield curve, it would contribute to curtailing maturity mismatch and leverage.[10]

7 J Kay and M King, *Radical uncertainty*, London, 2021.

8 Interestingly, Taylor presented a counterfactual comparison according to which house prices could have been significantly dampened with a timely moderate increase in interest rates by the Fed. J B Taylor, "Housing and monetary policy", in *Housing, Housing Finance, and Monetary Policy*, proceedings from the Federal Reserve Bank of Kansas City Jackson Hole Economic Policy Symposium, 2007. See also A Orphanides and V Wieland, "Economic projections and rules of thumb for monetary policy", Federal Reserve Bank of St Louis *Review*, July /August 2008, vol 90, no 4, pp 307–24.

9 European Central Bank, "Asset price bubbles and monetary policy", *Monthly Bulletin*, April 2005, pp 47–60; L Papademos, "The 'Great Crisis' and monetary policy: lessons and challenges", in *Economics Conference 2009*, proceedings from the Central Bank of the Republic of Austria conference, September 2009, pp 29–40.

10 T Adrian and H S Shin, "Prices and quantities in the monetary policy transmission mechanism", *International Journal of Central Banking*, December 2009, vol 5, no 4, pp 131–42.

- Communication about evolving imbalances combined with relatively small changes in the key policy rate could serve as a signalling device and support the credibility of the risk assessment of the central bank.[11]
- Finally, even a moderate increase in the central bank interest rate at an early stage of an asset price boom – in combination with the first two factors – could work against herding behaviour.

This leaves us to compare the welfare costs of "leaning" versus "cleaning" or mopping up. As is well known, just letting things go resulted in a collapse of the global financial system and brought the world to the brink of a depression with all the economic and political costs comparable to those of the 1930s. This extreme risk must be prominently included in the negative balance of not taking action in a timely manner. Even if these costs are difficult to quantify, they probably far exceed the welfare losses if central banks had acted early. Added to this have to be the huge sums that had to be spent on rescuing banks. The negative balance should also include the fact that the next decade of monetary policy was shaped, or more precisely distorted, by a policy of the central banks that wanted to avoid even the slightest danger of a relapse into a new financial crisis. Finally, the bank rescue damaged the reputation of the market economy in a way that can hardly be overestimated in terms of its social impact.

Where can we find an appropriate assessment of the GFC and the lessons for future monetary policy? The prevailing view, however, is that the central banks acted correctly at the time, with the implicit message that they will not do anything different in the future.[12]

The BIS and in particular Claudio Borio have always provided timely warnings of undesirable developments. My fear is that as long as the assessment of the GFC remains at its current, in my view completely unsatisfactory, level, the risk of a repeat of past mistakes remains alarmingly high.

For me, the final verdict on the GFC of 2007–08, its origins, the policy response and the subsequent effects on the monetary policy of the major central banks is still pending. Claudio is still young enough to see his position in this debate vindicated.

[11] M Hoerova, C Monnet and T Temzelides, "Money talks", *ECB Working Papers*, no 1091, September 2009.

[12] References to the new instrument of macroprudential supervision, for example, have little reassuring effect.