ECONOMICS U$A
21ST CENTURY EDITION

PROGRAM #25
MONETARY POLICY

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(MUSIC PLAYS)

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FRANK STASIO: Economics USA, a 21st Century Edition audio supplement designed to explore 21st century challenges to micro and macroeconomic principles. The subject of this edition is Monetary Policy. I am Frank Stasio; my guest is Kevin D Hoover. Dr. Hoover is a professor of Economics, and Philosophy, at Duke University. Professor Hoover, welcome.

(MUSIC ENDS)

KEVIN HOOVER: "Thank you, it's good to be here."

FRANK STASIO: I'd like to talk about Monetary Policy with respect to the downturn in 2008. Ordinarily by controlling monetary policy—the money supply right?—the Fed can stimulate business activity, or check inflation. That's the traditional role of monetary policy. Fair to say? So that role for monetary policy was the case for most of the 20th Century. Then we see in the crisis of 2008, lower interest rates, even pumping more cash into the banking system didn't seem to bring back economic activity—not very quickly, and certainly not where jobs were concerned. What happened?

KEVIN HOOVER: "Well, the way that the Fed tries to control the economy is through– you refer to it as controlling the money supply— but typically what they're doing is targeting interest rates. They target a short term interest rate in order to affect a long term interest rate, and you could think about this as something on the analogy of driving a car, where the Fed is in the driver seat, and the Fed can push the accelerator down a little bit when it wants the economy to go faster, or to let off a little when it wants the economy to go slower. Imagine that you're in such a car, and the fuel pump breaks. Well, then it's a big problem, and it's not one you solve by pushing the accelerator down even further. Essentially what the Fed did when the recession hit was to push the peddle to the floor, move interest rates—at least short term interest rates—down as far as they could possibly go, probably pushing long-term interest rates down about as far as they'll naturally go, and it still didn't have that much of an effect, and this is because something is broken in the system. What's broken? Well the two biggest things, and they're related, are the expectations of businesses, the environment in which they're working, their prospects that they have for making more money, for making more profits by developing and expanding their lines of business; and one of the reasons why those prospects don't look particularly good is because we had come out of an economy in which consumers were very much indebted, and when their incomes fell, maintaining those debts was difficult. Now they're not in a mood to expand their expenditure, no matter what the Fed does. They want to take care of their debt position. They want to get back into a situation where they feel more financially secure before they increase their expenditure, and of course that's when businesses, when they start seeing that happen, that they'll wish to make further investments, and expand the size of their economic activity."

FRANK STASIO: So is there a formula that economists use in a case like that with regard to monetary policy, and say, 'Oh, this is a fundamentally different situation. Here is the trick. Here is the formula in our policy that we should follow?'"

KEVIN HOOVER: "No, there's really no such simple formula.   In their ordinary operations of monetary policy, the formula is pretty simple. If the inflation gets high, or if the demand of the economy is expanding in what's regarded as too fast, then you raise the interest rate a little bit, and you try to bring things down. If it's going to slow then you lower the interest rate, and try to stimulate it—and of course the Fed has tried to do as much of that as they can—but each major crisis is a little or maybe a lot different from previous crises, and they have to muddle their way through, and find out what you know.

It’s just like the mechanic trying to fix the car. Lots of things can go wrong with a car. Is it the fuel pump, is it the transmission? They have to figure that out and fix it, before they can do anything more. So in this case, it’s partly fixing the regulatory environment, partly getting the whole side of the consumer side of the economy just to work through its problems and get into a more reasonable debt position, so they can go about the kind of ordinary business of spending that they were used to in the past.”

FRANK STASIO: Aren’t we able to apply the lessons of the depression, the Great Depression in the 1930s, to this?

KEVIN HOOVER: “Well we can apply some of the lessons in the 1930’s. One of the problems that they had was that the price level was falling, and a falling price level meant that people who, for example, had mortgages on farms, had found it was harder and harder to repay the debts, so there was a similar kind of debt problem. It wasn’t generated in the same way. We’re not facing falling prices, but we did manage through the expansion of mortgage loans and especially borrowing against mortgage loans for consumer expenditure to get people into a position where they have a similar kind of problem in repaying their debt. Another thing that happened in the 1930’s was that many banks were failing, and that there was a cascade of bank failures. So one of the major reactions that the government and the Federal Reserve had in this particular crisis was, in fact, to do whatever they could—exercising what the Fed refers to as the lender of last resort function—to make sure that we didn’t have a cascade of financial collapse. So that was a very positive thing, and it really did come out of reading the lessons of the 1930’s. On the other hand the financial system today is very different, it is much more complex. It’s much more interconnected with the rest of the world, and so you can’t just simply read off the lessons, but you do have to take the big picture and learn from the past in that kind of broad-brush kind of way.”

FRANK STASIO: Let’s talk about those interconnections for a moment. Has the globalized economy changed the role of central banks like the Fed?

KEVIN HOOVER: “Well, yes and no. The yes part is that the economies, especially financially, now are deeply interrelated. So for example, mortgage backed securities that were a problem in the United States show up on the balance sheets of foreign banks, European banks, and cause banking problems in other countries than our own. So we tend to be in a situation where problems can be transmitted from one country to another, and as a result, the central banks are engaged in kind of more coordinated activity than they have been before on bank regulation, and on trying to solve immediate kinds of crises. On the other hand, the central banks are still mainly directed towards making their individual economies better, and it’s not much prospect that they are going to change that. They are very much looking towards what it will do for us, not what it will do for the world.”

FRANK STASIO: But, as we look ahead, can you maintain that kind of outlook? Do banks have to act in coordination, in concert, in order to be effective given the fact that once the dollar leaves it can go anywhere it wants?

KEVIN HOOVER: “Well, they might do better through some more coordination, but there seems to be very little prospect for a kind of—let’s say, super national Federal Reserve, or central bank. The arguments or the reasons why that’s unlikely to occur is first of all, we don’t live in a world in which we for example have a common currency, or a world in which we have a well-defined international currency system as we did after WWII with the Bretton-Woods System, where exchange rates were fixed and there were rules of the game. We live in a world in which there are always attempts to get greater coordination, but they’re never comprehensive, and could they be comprehensive? Well it’s not even clear that we have the expertise to do that, and given that we don’t have the expertise— who would do it, and would they know the right things to do it— is a serious question, and the political will is probably lacking. We can see the problems for instance, that the European central bank, and the European Union are now having with the Euro zone, the problems with Greece and Spain and Portugal, lined up against the interest of other countries in the Euro zone, like Germany.”

FRANK STASIO: But in the absence of that coordination, and I think you've outlined well the obstacles, is monetary policy, or can it be as effective in the future in a globalized economy?

KEVIN HOOVER: "Well, it has a different set of challenges, and how like many things in the history of monetary policy, it has been a muddling through to meet various challenges, and I expect that that will continue, and I would expect to see any sort of comprehensive solution; but we will have to continue to muddle through because those connections now exist, and we can't make them go away. We can't act like we don't live in a world where other countries are economically important to the world as a whole, but to us as well."

FRANK STASIO: What impact do federal deficits have on monetary policy?

KEVIN HOOVER: "Well there is one simple connection which is that when the government runs a deficit, the deficit has to be financed somehow, and the choices for financing are selling more debt or increasing money supply. When you finance the deficit through creation of monetary base, it's called monetizing the debt, and typically we have not monetized very much of the debt in the United States. Some countries, say Argentina, have done a lot of that in the past, but we haven't done too much of it; but recently there has been a substantial amount of monetization of our deficits as a result of the programs that the Federal Reserve refers to as quantitative easing. So it's QE1, and QE2."

FRANK STASIO: And how does that work?

KEVIN HOOVER: "Well, how it works is the Federal Reserve, the government, issues bonds, and the Federal Reserve, which is a kind of hybrid organization—it's part private, part government—but it buys those bonds, and the way it pays for the bonds is to create, is through money it creates. It pumps money back into the system. Now it hasn't been a terribly successful program in the sense that the long term interest rates haven't come down very much, and the lending of commercial banks to either consumers or to corporations has not risen by a lot. So this has been a very big, and unprecedented action, but not an overwhelmingly successful action."

FRANK STASIO: Well we know what the goal is. Now what's the down side to monetizing the debt?

KEVIN HOOVER: "Well the downside depends, it depends on what you think is going to happen in the future, and what people worry about is that now banks are sitting on an enormous amount of monetary base. So they have a lot of reserves that they could and are not now lending out. If all of a sudden they started lending out those reserves in the kind of levels that were typical of their past behavior, and what we have grown to expect, then there could be a massive expansion of bank lending, of deposits at banks, of the ability of the people they are lending to spend, and that additional spending might turn in to inflation in the future, so that's a big concern."

FRANK STASIO: Part of the reason for the meltdown in 2008, was a proliferation of new financial instruments, novel instruments that created a sort of black box for monetary planners. They just didn't know what these things did. Do wild cards upset these plans? Is it something that monetary planners want to get a handle on?

KEVIN HOOVER: "Well of course they want to get a handle on it, but we've been, for at least the last 250 years, we've been faced with financial innovation, and there was a time when bank notes, paper money was a financial innovation, when checking accounts were a financial innovation. Credit cards, futures, options, bare bonds, all these things were financial innovations and all of them upset the monetary control regimes of their day. The Fed, like any central bank, is always playing catch up with the way that the financial system is developing. Now, the downside is that they often don't know how to manage the situation as they find it, and they have to learn through one crisis or one difficulty or another how to deal with it. The upside is that all this financial innovation as of yet has been a positive thing, which operates at a level, and a level of sophistication that could not have been imagined even fifty years ago, much less 200 years ago, and it requires the kind of financial instruments that are out there; but as long as this kind of process continues, the Fed is probably always going to be one step behind it, and so that's what you see now with legislation trying to say, 'Well how should we regulate in this new environment?' Now you don't want things to run amuck. On the other hand you don't want to get rid of all innovation when it's been productive in the past."

FRANK STASIO: Are there any lessons that economists agree on? I can stop right there, the answer must be no, but let's assume there are really some lessons in terms of monetary policy that have been learned out of the debacle of 2008.

KEVIN HOOVER: "I don't know that you could find the lessons that economists entirely agree on, but I think the one thing that I would say that economists think on the whole that the Fed did right, and that many people in the public don't necessarily agree that they did right was the kind of rapid interventions that happened in 2008 when we started seeing the collapse of Lehman Brothers and other institutions. I mean some people thought that the Fed's mishandling of that initially caused some of the problems; but their willingness to make sure that we didn't have a cascade of collapses in the financial system, whether it was handled efficiently or not was, I think, endorsed by almost all economists, because we know from history how bad things could really get if we allowed that to continue unchecked. We've had not a very nice time with the economy recently, but it is not the Great Depression, and one of the reasons it's not the Great Depression is that the Fed and monetary policy makers and the treasury, did prevent us from having cascading financial collapse."

FRANK STASIO: Professor Hoover, thank you very much.

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STASIO: I've been talking with Kevin D. Hoover, a Professor of Economics, and philosophy at Duke University. I'm Frank Stasio.

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