

OPINION

The Fed and the Crisis: A Reply to Ben Bernanke

By John B. Taylor

Federal Reserve Board Chairman Ben Bernanke spent most of his speech to the American Economic Association on Jan. 3 responding to the critique that easy monetary policy during 2002-2005 contributed to the housing boom, to excessive risk taking, and thereby to the financial crisis.

Many have expressed the view that monetary policy was too easy during this period. They include editorial writers in this newspaper, former Fed policy makers such as Timothy Geithner (now the secretary of the Treasury), and academics such as business-cycle analyst Robert J. Gordon of Northwestern. But Mr. Bernanke focused most of his time on my research, especially on a well-known policy benchmark commonly known as the Taylor rule.

In his recent speech, the Fed chairman denied that too-low interest rates were responsible. Does this mean we're headed for a new boom-bust cycle?

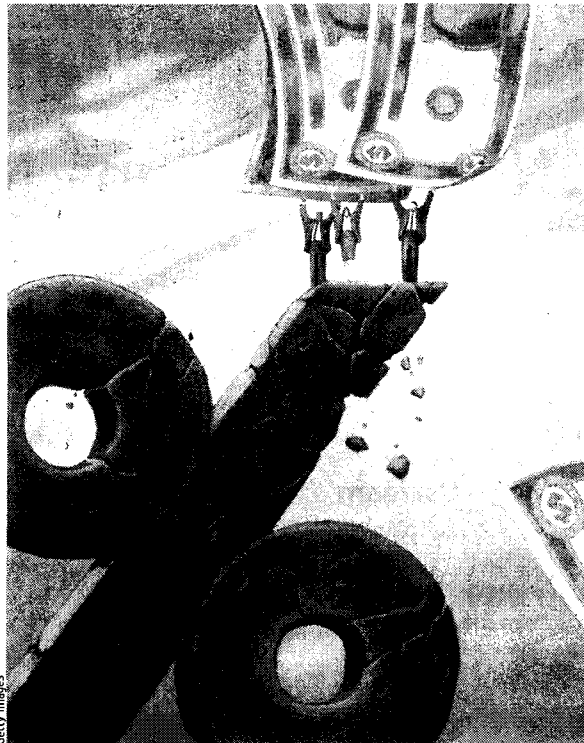
This rule calls for central banks to increase interest rates by a certain amount when price inflation rises and to decrease interest rates by a certain amount when the economy goes into a recession. My critique, which I presented at the annual Jackson Hole conference for central bankers in the summer of 2007, is based on the simple observation that the Fed's target for the federal-funds interest rate was well below what the Taylor rule would call for in 2002-2005. By this measure the interest rate was too low for too long, reducing borrowing costs and accelerating the housing boom. The deviation from the Taylor rule, which had characterized good monetary policy during the previous two decades, was the largest since the turbulent 1970s.

In his speech, Mr. Bernanke's main response to this critique was to propose alternatives to the standard Taylor rule—and then to use the alternatives to rationalize the Fed's policy in 2002-2005.

In one alternative, which addresses what he describes as his “most significant concern regarding the use of the standard Taylor rule,” he put the Fed's forecasts of future inflation into the Taylor rule rather than actual measured inflation. Because the Fed's inflation forecasts were lower than current inflation during this period, this alternative obviously gives a lower target interest rate and seems to justify the Fed's decisions at the time.

There are several problems with this procedure. First, the Fed's forecasts of inflation were too low. Inflation increased rather than decreased in 2002-2005. Second, as shown by economists Athanasios Orphanides and Volker Wieland, who previously served on the Federal Reserve Board staff, if one uses the average of private sector inflation forecasts rather than the Fed's forecasts, the interest rate would still have been judged as too low for too long.

Third, Mr. Bernanke cites no empirical evidence that his alternative to the Taylor rule improves central-bank performance. He mentions that forecasts avoid overreacting to temporary movements in inflation—but so does the simple averaging of broad price indices as in the Taylor rule. Indeed, his alternative is not well defined because one does not know whose forecasts to use. Moreover, the appropriate response to an increase in actual inflation would be different from the appropriate response to an increase



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in forecast inflation.

There are other questionable points. Mr. Bernanke's speech raises doubts about the Taylor rule by showing that another version of the rule would have called for very high interest rates in the first few months of 2008. But using the standard Taylor rule, with the GDP price index as the measure of inflation, interest rates would not be so high, as I testified at the House Financial Services Committee in February 2008.

Mr. Bernanke also said that international evidence does not show a statistically significant relationship between policy deviations from the Taylor rule and housing booms. But his speech does not mention that research at the Organization for Economic Cooperation and Development in March 2008 did find a statistically significant relationship.

Mr. Bernanke claimed that “Economists who have investigated the is-

sue have generally found that, based on historical relationships, only a small portion of the increase in house prices earlier this decade can be attributed to the stance of U.S. monetary policy.” But two of the economists he cites—Frank Smets, director of research at the European Central Bank, and his colleague Marek Jarocinski—reported in the July/August issue of the *St. Louis Fed Review* that “evidence that monetary policy has significant effects on housing investment and house prices and that easy monetary policy designed to stave off perceived risks of deflation in 2002-04 has contributed to the boom in the housing market in 2004 and 2005.”

These technical arguments are important, but one should not lose sight of the forest through the trees. You do not have to rely on the Taylor rule to see that monetary policy was too loose. The real interest rate during this period was persistently less than zero, thereby subsidizing borrowers. Thomas Hoenig, president of the Federal Reserve Bank of Kansas City, reported in a speech on Jan. 7 that during the past decade “real interest rates—the nominal interest rate adjusted for inflation—remained at negative levels for approximately 40 percent of the time. The last time this occurred was during the 1970s, preceding a time of turbulence.”

Inflation was increasing, even excluding skyrocketing housing prices. Yet even when inflation is low, the damage of boom-bust monetary policy can be severe as Milton Friedman stressed in his strong criticism of the Fed in the 1950s and 1960s. Stepping back from the fray, an objective observer of all this evidence

would have to at least admit the possibility that monetary policy was too easy and a possible contributor to the crisis.

Not admitting the possibility raises concerns. One is that if such a large deviation from standard policy is rationalized away, it might happen again. Indeed, some analysts are worried now about the Fed holding interest rates too low for too long, causing another boom-bust and a shorter expansion.

Another concern is that, rather than trying to be vigilant and avoid causing bubbles, the Fed will try to burst them with interest rates. Indeed, one of the lines from Mr. Bernanke's speech most picked up by Fed watchers is that “we must remain open to using monetary policy as a supplementary tool for addressing those risks.” We have very limited ability to fine tune monetary policy in such an interventionist way.

Finally, there is a concern that the line of analysis in Mr. Bernanke's speech puts the full burden of preventing future bubbles on new regulation. Clearly the Fed missed excessive risks on and off the balance sheets of the banks that it supervises and regulates. That policy needs to be corrected. However, it is wishful thinking that some new and untried macro-prudential systemic risk regulation will prevent bubbles.

While I disagree with Mr. Bernanke's analysis, it is good news that the Federal Reserve Board has begun to examine its policies and publish its findings. This will help inform the Financial Crisis Inquiry Commission, which will soon begin holding public hearings on the causes of the financial and economic crisis. In the meantime I hope the Federal Reserve Board will continue with this new self-examination policy and transparently evaluate all its recent crisis-related actions, from the AIG bailout to the Mortgage Backed Security purchase program.

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