Speech

An Old School Proposal to Meet Monetary Policy Requirements in the Current Financial Environment

By Adam S. Posen
President, Peterson Institute for International Economics [1]

This is a lightly edited version of remarks given at the first annual European Central Bank (ECB) Forum on Central Banking, May 27, 2014, in Sintra, Portugal, on the panel "Monetary policy and balance sheet adjustment." See: https://www.ecbforum.eu/en/content/programme/overview/programme.html.

Let me say very sincerely that I am grateful to Peter Praet, Benoît Cœure, and all our colleagues at the European Central Bank (ECB) for including me on the program for the first ECB Forum on Central Banking. It is a great honor. In particular, it is very nice to be seated next to my friend and role model Otmar Issing, because I think he embodies what many of the people in this room (including our ECB colleagues) are trying to do, which is to build a unified Europe through economic means without sowing division between member countries. At this time and juncture, from outside the euro area, let me say that I admire the ECB for the continued pursuit in Otmar's spirit. So thank you.

Let me also begin my remarks exactly where Peter asked us to, which is how we get from some of the discussions we have had so far to practical policy. Peter placed the discussion in the context of the recurring debate between the liquidationist view and the balance sheet view. I would like to think that if the 1930s in Europe were not enough to settle the debate, then the 1990s in Japan would have killed the liquidationist view forever.[2] Unfortunately, it has not. Sometimes, as Agustín Carstens pointed out a moment ago, it is not just that bad ideas get recycled; they simply will not die. Some of us were writing back in 1998 about Japanese economic policy turning recovery into prolonged recession and having self-fulfilling monetary policy restraint because of backward-looking output gap measures, and so on. And yet, here we are in the euro area today.

The point that is worth taking away is that we already had a very strong theoretical literature by people like Caballero and Hammour or Greenwald and Stiglitz that Japan bears out: When you get these kinds of credit booms followed by a recession, the recession does not punish,

[1] The author's work in this area is supported by a major grant from the Alfred P. Sloan Foundation. The views expressed here, however, are solely his own and not necessarily shared by the ECB, the Sloan Foundation or the Peterson Institute for International Economics.
[2] See Adam S. Posen, 1998, "Recognizing a Mistake, Not Blaming a Model," in *Restoring Japan's Economic Growth*, Peterson Institute for International Economics, Washington.

let alone cleanse, the right firms. Simply having a recession is too blunt an instrument. Simply tightening monetary conditions is still too blunt an instrument. To be very pointed about this, when we look around the euro area right now, it is very difficult for anyone to argue credibly that the incidence of the current credit crunch across borders, differentiated according to the country risk within the unified monetary zone and with differentials according to the size of firms, is in any way less than arbitrary. Of course, we can rationalize why it is occurring this way, but the facts do not support a liquidationist interpretation that the right businesses are being rationed out of credit, and the better investments are the ones being pursued right now. We can debate that in religious terms, but I would hope that those who are empirically minded would let us move on.

So if we take the balance sheet view of recession as the starting point, which an increasing number of speeches by the ECB's leadership over the last year or two clearly have done—and I think, rightly—where do we go next? I found the preceding two sessions of this conference interesting but a little odd because both of them essentially ignored what I think is the main message of the financial crisis for macroeconomic analysis: Analyzing financial fluctuations and their impact in terms of representative agent models, or the impact of central bank balance sheets solely by their size, misses the point.

The point that we got fundamentally wrong in the early 2000s was that we did not include in our analyses the fact that asset classes and financial markets are highly differentiated, particularly in times of strain. This relates to an earlier discussion of the costs of the Lehman Brothers' failure—the impact of a true crisis is a switch in the overall economic environment, not just the direct impact of the shock. The euro area's macroeconomic challenge is not just that we are in a low and declining inflation state. It certainly should not be defined as just trying to calibrate monetary policy in terms of how much liquidation versus how much moral hazard we will induce. It is that we have moved from one state of blissful ignorance, moral hazard and credit boom in combination, to an already protracted state of huge risk aversion and dysfunctional financial markets. This new other state that we are in cannot be summarized by monitoring the degree of balance sheet adjustment, even though that is an important aspect. I think monetary policymakers have to take the analysis at least one step further.

Think about the way that we try to understand the Great Depression. First there was the Friedman-Schwartz argument about monetary aggregates. Then we had research by Frederic Mishkin and others who looked at household balance sheets instead of the disembodied aggregates. We found the big explanation when Ben Bernanke led the effort to deepen the analysis with the nonmonetary transmission of the shock through the destruction of information in the banking system. That remains the core cause, and in spirit it still applies today, specifically very well to southern Europe's current downturn. Now, all of you in this room know this in principle, but nonetheless our policy discussion often disengages from that reality. Yet, if any insight should have clearly emerged from the policy experience of the last five or six years, it is the fact that there is no single representative interest rate that the central bank controls that affects all assets in the economy (at least in the current state of the world). That has been our overwhelming policy constraint—the zero lower bound is reached because of that situation; it does not cause the situation.

So, in my view, when we talk about raising inflation expectations or precommitting to a policy path or other such general approaches to easing, we are neglecting reality. I have some sympathy for the argument by Blanchard and others that, in a normal (precrisis) world we would rather be occupying, having a higher inflation target than 2 percent might offer some insurance. But I do not see talking about that as a solution to the current problem, because then all the central bank is doing is announcing that it is putting the cart before the horse. Monetary policy needs to restore enough confidence in, and stability between, key differentiated asset classes to get on a higher inflation path and to broaden the impact of traditional interest rate policies. It is not enough to announce that there will be higher inflation and, therefore, that households and business should change their entire mindset. As the Bank of Japan demonstrated with its regime shift over the last 18 months, central banks have to actually make asset purchases and push hard on intermediate targets to establish a different monetary regime, and sustain a different state of affairs, in order to achieve that higher inflation target.

The understanding of our current situation as one with persistently fragmented financial markets and heightened risk aversion brings us back to kinds of policy measures that I believe the ECB's leadership is talking about presently (at least as I gather and I hope). Policies are needed to address specific credit market problems in the euro area. This is why it is very interesting to think about some of the past emerging markets discussions of monetary policy and about the now global discussion of possible macroprudential measures. If we look at the emerging market economies' and resource-rich economies' experience of the last few years, what we find is that you need aggressive, targeted interventions to try to limit the impact of capital inflows and stem credit booms. Instrument interest rate increases alone are not enough. I would refer to what the Governor of the Central Bank of the Republic of Turkey Erdem Başçı detailed regarding the Turkish case yesterday, as well to the contemporary experiences of the People's Bank of China, the Hong Kong Monetary Authority, or the Reserve Bank of Australia. They all have found that you have to employ a whole range of measures to try to constrain credit booms. That is the difficulty of differentiated assets in the boom cycle—interest rate tightening alone does not work.

But if that is the case in the boom, it is all the more true in the bust. Under normal macroeconomic thinking, we know that in response to the circumstances of distressed balance sheets, capital-impaired banks, and investor risk aversion—as found in the euro area today—if anything the policy asymmetry goes the other way. It is *more* difficult to stimulate than it is to tighten when you have people sitting on huge piles of cash who are scared. So if anything, what the ECB faces is not a literal deflationary cycle but a dangerous sticky state of nonfinancial businesses and investors unwilling to move out a long yield curve or out of near cash except in small ways. If the ECB wants to get Europe out of that state—and it should—it does need to use multiple tools even more so than it would to fight a credit boom. You cannot pretend that moving one central interest rate or making an inflation commitment will be sufficient to reverse the cash hoarding and asset market fragmentation.

That reality creates a challenge because we know that there are arguments made from a political economy point of view, as well as from organizational convenience, to keep macroprudential policy and monetary policy separate. Is the right approach that of the Bank of England, which has overlapping financial and monetary policy committees? Or that of the United States, which has an interagency committee on financial stability, with the Federal Reserve represented but not chairing? Should the central bank draw a line so as to avoid accusations of engaging in fiscal policy?

It is easy for me to say, now that I am on the outside, but I think that we have to get the central banking community beyond this separation fixation. Most other government departments do not define their mission by their primary tool. If you are the Department of Health and Human Services or of Welfare, you might employ pensions, taxes, or social workers, but your goal is health and human welfare. If you are the military, your goal might be deterrence, peacekeeping, or war, but you do not say I am defined by being the Navy and I am only going to use traditional ships and tactics. At some point, the central bank has to clearly state that its goal is to get credit flows and risk-taking behavior back to normal because that is the basis of price stability and financial stability. That is the policy goal that we really should care about, and therefore we should set central banks' duties by that and not by the tools we used to use.

This is why I find the repeated characterization by central bankers of the policy measures of recent years as "unconventional monetary policy" to be very unfortunate, as it implies that they should be avoided if possible. This characterization is both misleading and destructive. It is misleading because historically central banks have intervened across a wide variety of private and public assets through the centuries. Go back to the monetary history analyses written by Charles Goodhart, Niall Ferguson, and others. Or look around at what the People's Bank of China and numerous emerging market central banks are doing today. It is destructive because it reinforces this notion that there is something so awful about the tools being used that we need to fixate on them rather than on our distance from our mandated goals.

What should be the next step for the ECB if you were to take my call to action in line with the reality of fragmented credit markets? Well, as it happens, I agree with where the ECB seems to be going: We need to see the ECB purchasing bundles of securitized small- and medium-sized enterprise (SME) loans. I advocated this explicitly for the euro area at the Federal Reserve Bank of Kansas City's conference in Jackson Hole two years ago.[3] I advocated such measures at the Bank of England when I was on the Monetary Policy Committee (MPC).[4] I did *not* push for such a measure for the United States because it is not relevant for the problems there given the diversity of its financial system. Bundled SME loans are not a cure-all. I advocate this policy measure here, given that in the euro area, it is the crushing of credit availability for small and medium businesses and for some consumers that is the source of great divergence and is a current barrier to growth. It is not enough to say that we must wait for balance sheets to repair. That is necessary but not sufficient.

So then we get to two practical aspects of such an asset purchase program. Rrepresentatives of the Bank for International Settlements and various other speakers warned us yesterday about being prudent with central bank purchases. But purchases of securitized small loans are not as imprudent as some would have it. In terms of operations, as discussed yesterday and as I think is evident, you do need to put in some form of government guarantee for some tranche or part of these bundles. That is not the end of the world. That is effectively what Fannie Mae and Freddie Mac did through the decades in the United States. Let us remember that the problem that arose with Fannie and Freddie was not the securitization itself; the problem emerged in the mid- to late 1990s when they decided they would go into profit-making for themselves and started speculating on their own account. For decades, Fannie and Freddie were stabilizing as long as they behaved like a warehouse that just took components in (i.e. loans) at one end and sold them on in a vanilla transparent packaged form at the other.

The more serious issue raised yesterday with such asset purchases is the issue of monitoring. Of course, that relates to the core information imperfection, which drives our present difficulties of a breakdown in lending to small and medium businesses and why those borrowers can only go to banks. This is not a trivial issue by any means. It is fundamental to why these are bank-constrained borrowers. But let us think about the realities of how lending to small or medium businesses is conducted today. If you go into most banks in Europe, they have credit-scoring software that is based on large databases of past small or medium business loans. It is analogous to what we have already done with mortgages. It is slightly more complicated, definitely more risky, but only in degree; it is not worlds away. This software, with its limitations, was the basis for most lending to small- or medium-sized enterprises throughout the 2000s. It is not as though we are in a situation where we have the paradigmatic local credit officer, the *Sparkasse* manager from 1953 who is there checking in on his business buddy in a particular township. Moreover, if you want to go back to that period in history, let us look at the great example of the *Kreditanstalt für Wiederaufbau*, the

---

[3] Adam S. Posen, 2012, "Comments on Methods of Policy Accommodation at the Interest-Rate Lower Bound by Michael Woodford," *The Changing Policy Landscape—Federal Reserve Bank of Kansas City Economic Policy Symposium 30 August-1 September 2012*, Jackson Hole, Wyoming.

[4] Adam S. Posen, 2011, "How to Do More," *Bank of England speech*, available at http://www.bankofengland.co.uk.

German reconstruction bank that effectively bought bundles of small and medium enterprise loans in the immediate postwar period. It did it through the banks, but in guaranteed tranches.

Furthermore, we know from emerging markets (and there is a vast literature from the International Monetary Fund, the World Bank, and the regional development banks on this) that when central banks move into new areas of finance they create markets. So while it is true that right now in the euro area there is not that much securitized SME paper to buy, it need not remain so. We know that if a central bank creates a market, starts discounting an asset, creates standards for how this paper should be issued, creates minimum regulations for and some liquidity in the trading of it, there will be an increase of issuance and of demand for that asset class. Going back to the misguided unconventional monetary policy fixation, this actually is a beneficial intervention and one that central banks have often made until the present day. Doing so would not mean that the ECB is disrupting markets but instead is actually working to build a new integrated financial market in Europe. So to me this is the way forward.

Let me close on political economy. A number of officials and researchers are wrestling with the politics of the euro area but also the politics of central banking in general. I have conversed bilaterally with many people in this room over the years about the sincere concern that many have about monetary policy getting too involved in specific private asset markets or drifting into fiscal policy. I completely agree that central banks have to be accountable to their legal mandates and that unelected officials cannot take over the world. One might ask whether unelected officials in Europe have in some sense already done that in the recent past in terms of what they ask for from various member countries as a condition for monetary stimulus, but let us leave that aside today.

If we are going to have central banks move forward in the world—and this includes the Federal Reserve, the People's Bank of China, and the Bank of Mexico, not just the ECB—they have to meet their mandated public goals of financial and price stability. To do so, we have to recognize that in today's world financial markets are segmented. Borrowers and lenders are both differentiated. Central banks will only be able to meet their goals by engaging in intervention that is not neutral across assets or groups of asset holders. To the extent that this becomes fiscal policy, it is well within precedent and has operational trade-offs—it is not a religious matter.

Again, to draw attention to something that I have pointed out before but which is critical: In the United States it is unimaginable to some that the Federal Reserve would engage in buying private sector assets, as defined by Congress, because that would be considered fiscal policy. In the euro area, it is unimaginable to some that the ECB should buy public bonds outside the very specific conditional market program because that would be considered fiscal policy. So the issue of what can be considered an acceptable intervention does not have a universal truth. It is a matter of context and reasonableness, as is the case for any other instrument of policy. Therefore, the real issue is what if the central banks were to lose some money in dealing in nongovernmental assets. And the answer to that is you set in place a rule for recapitalizing your central bank ahead of time so that does not arise as a problem.

I hope that I have correctly interpreted some of what the ECB is working towards. I was very glad to see the joint announcement in June of the ECB and Bank of England talking about the SME market. I hope this advances that discussion, and I am very grateful for the opportunity to address this distinguished audience.