The Real Problem was Nominal: How the Crash of 2008 was Misdiagnosed

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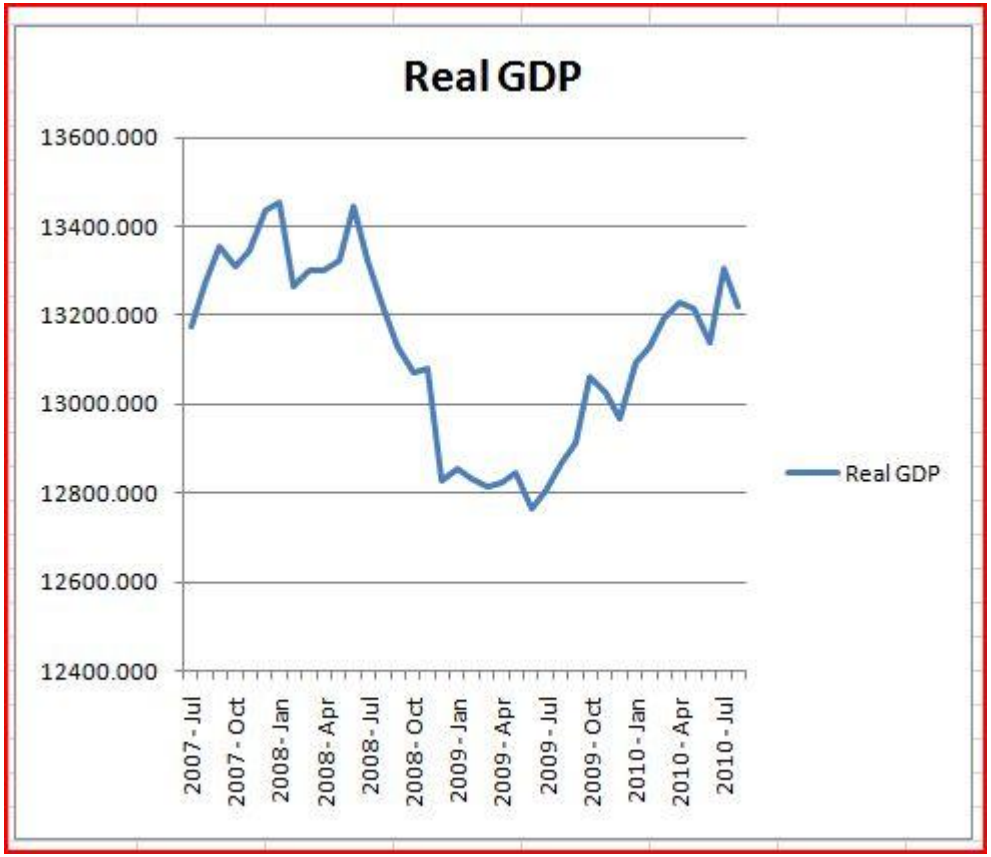
A Contrarian View

- The great crash of 2008 does not discredit the Efficient Markets Hypothesis; indeed one can make a good argument that it happened precisely because economists don't take the EMH seriously enough.
- I will argue that the standard view of the crash of 2008 is wrong. The root cause of the crash was not financial crisis, but rather contractionary monetary policy in the US and other developed countries.

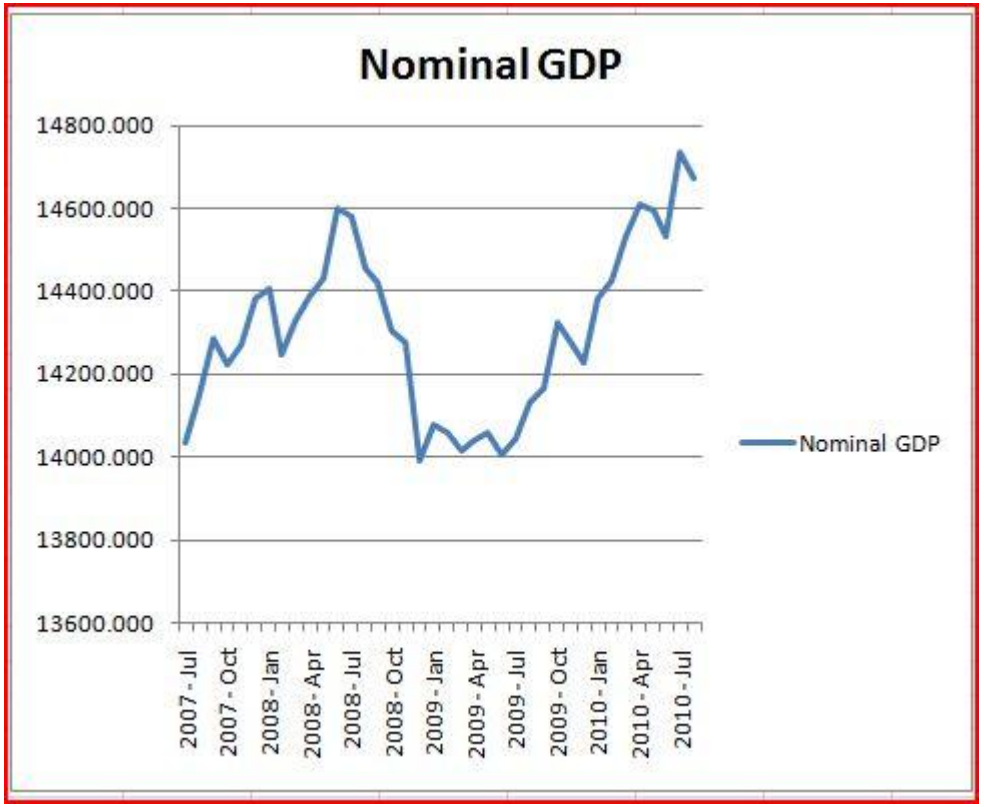
The consensus view

- “The worst financial crisis in the history of the United States and many other countries started in 1929. The Great Depression followed. The second-worst struck in the fall of 2008 and the Great Recession followed. Commentators have dwelt endlessly on the causes of these and other deep financial collapses. Less conspicuous has been the macroeconomists’ concern about why output and employment collapse after a financial crisis and remain at low levels for several or many years after the crisis.” (Robert Hall, JEP, 2010.)

Real GDP: 2007-2010, (monthly estimates from Macroeconomics Advisors)



Nominal GDP: 2007-2010



Mishkin's key lessons for monetary policy

- *1. It is dangerous always to associate the easing or the tightening of monetary policy with a fall or a rise in short-term nominal interest rates.*

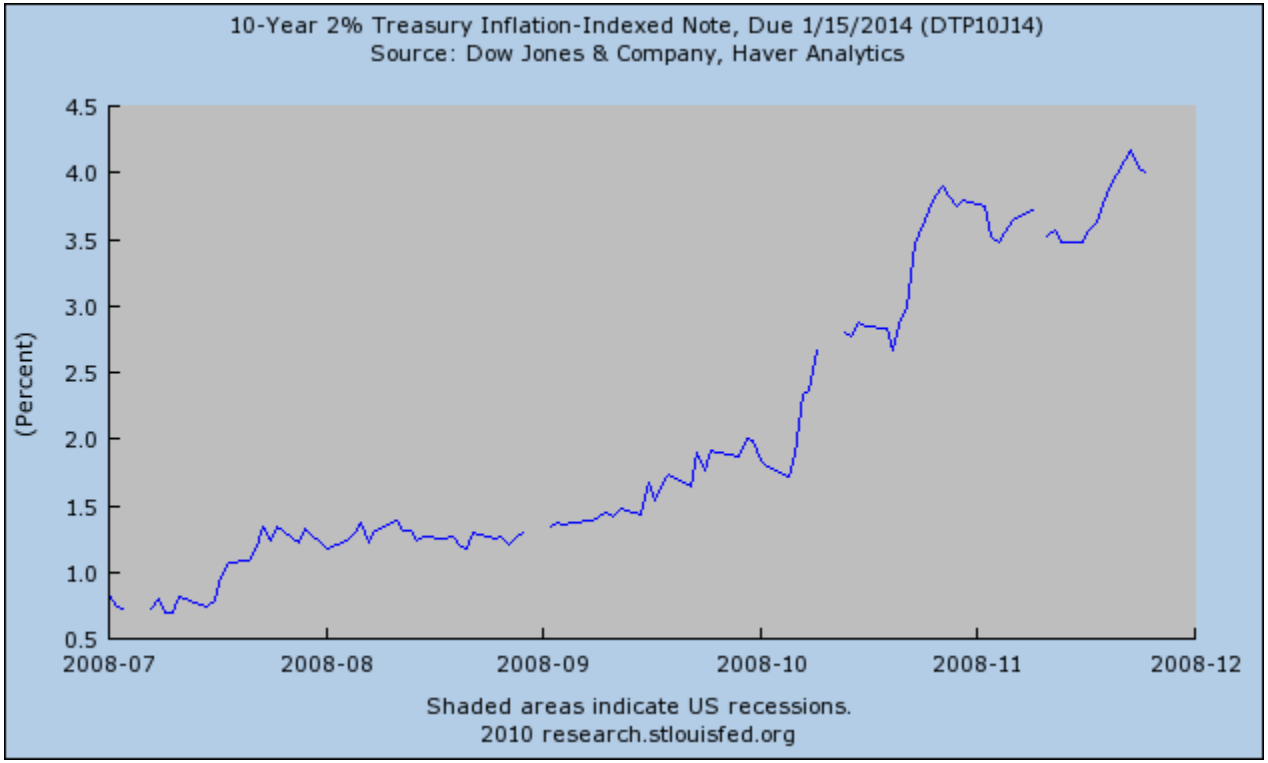
- *2. Other asset prices besides those on short-term debt instruments contain important information about the stance of monetary policy because they are important elements in various monetary policy transmission mechanisms.*

- *3. Monetary policy can be highly effective in reviving a weak economy even if short term rates are already near zero.*

Friedman on low interest rates

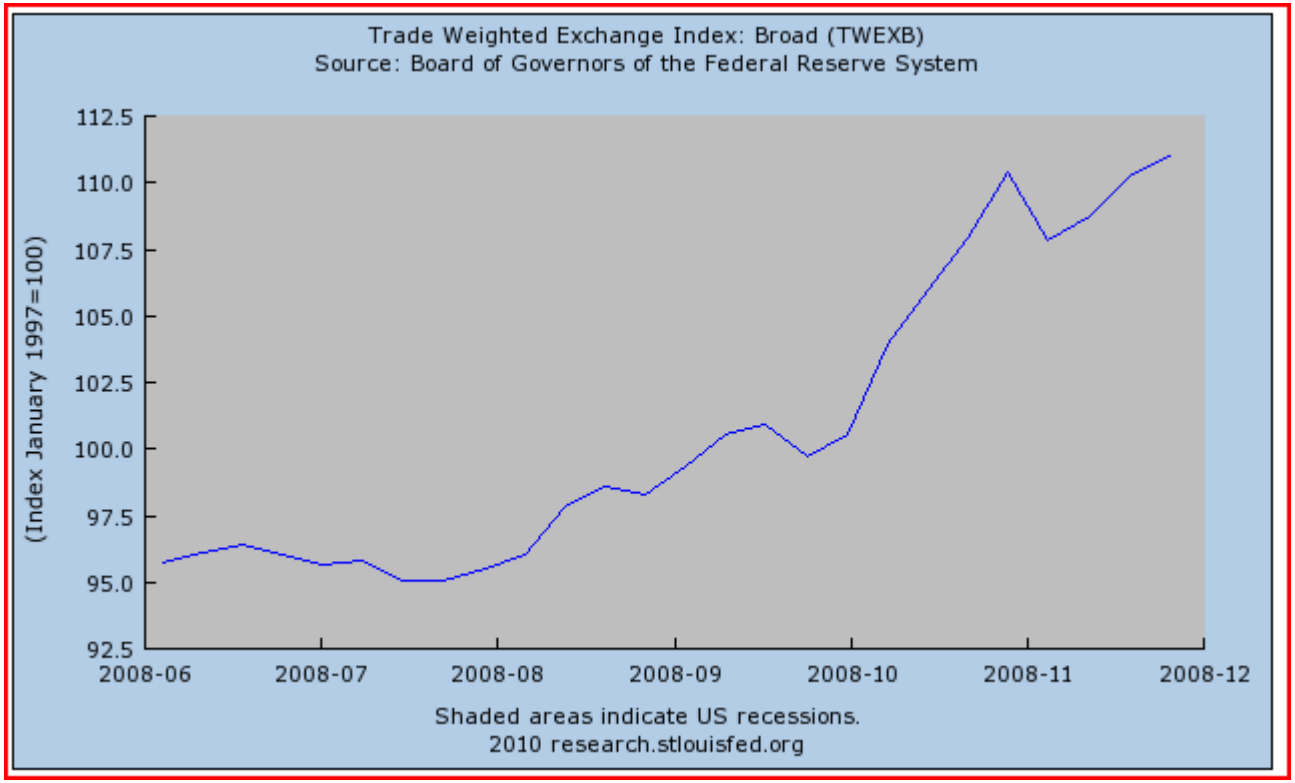
"Low interest rates are generally a sign that money has been tight, as in Japan; high interest rates, that money has been easy. . . . After the U.S. experience during the Great Depression, and after inflation and rising interest rates in the 1970s and disinflation and falling interest rates in the 1980s, I thought the fallacy of identifying tight money with high interest rates and easy money with low interest rates was dead. Apparently, old fallacies never die." (WSJ, Dec. 1997)

Real interest rates on Treasury bonds with a roughly 5 year maturity; July to November 2008



Commodity prices in 2008

The value of the dollar in late 2008



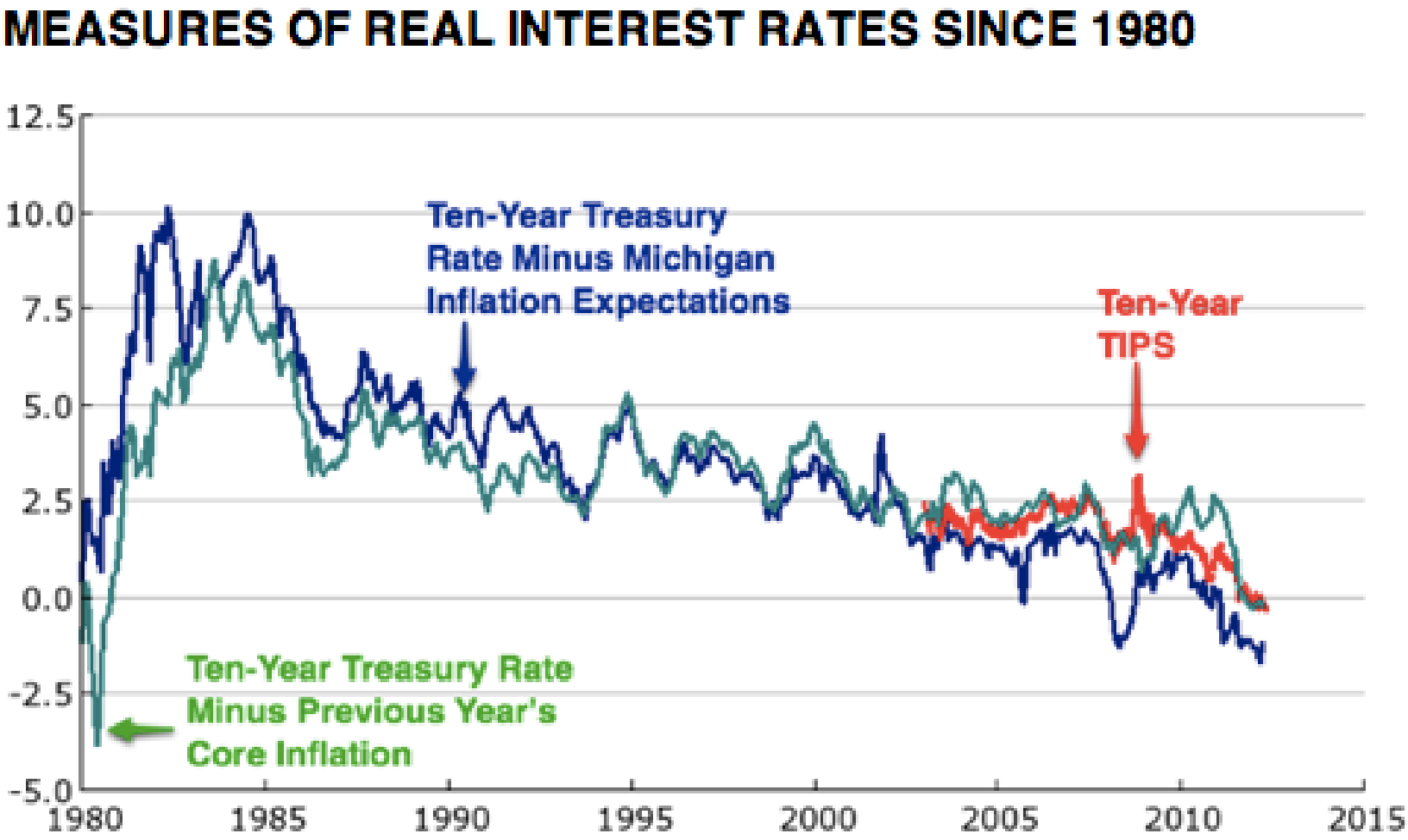
Other Asset Markets

- Stock prices crashed in late 2008
- Commercial real estate prices started falling sharply about the same time as NGDP, and long after the subprime bubble
- Residential real estate prices in the heartland (Texas, etc.) had been stable during the 2006-08 subprime crash, and started falling in late 2008 along with NGDP
- TIPS spreads (i.e. inflation expectations) fell sharply.

Bernanke on monetary indicators

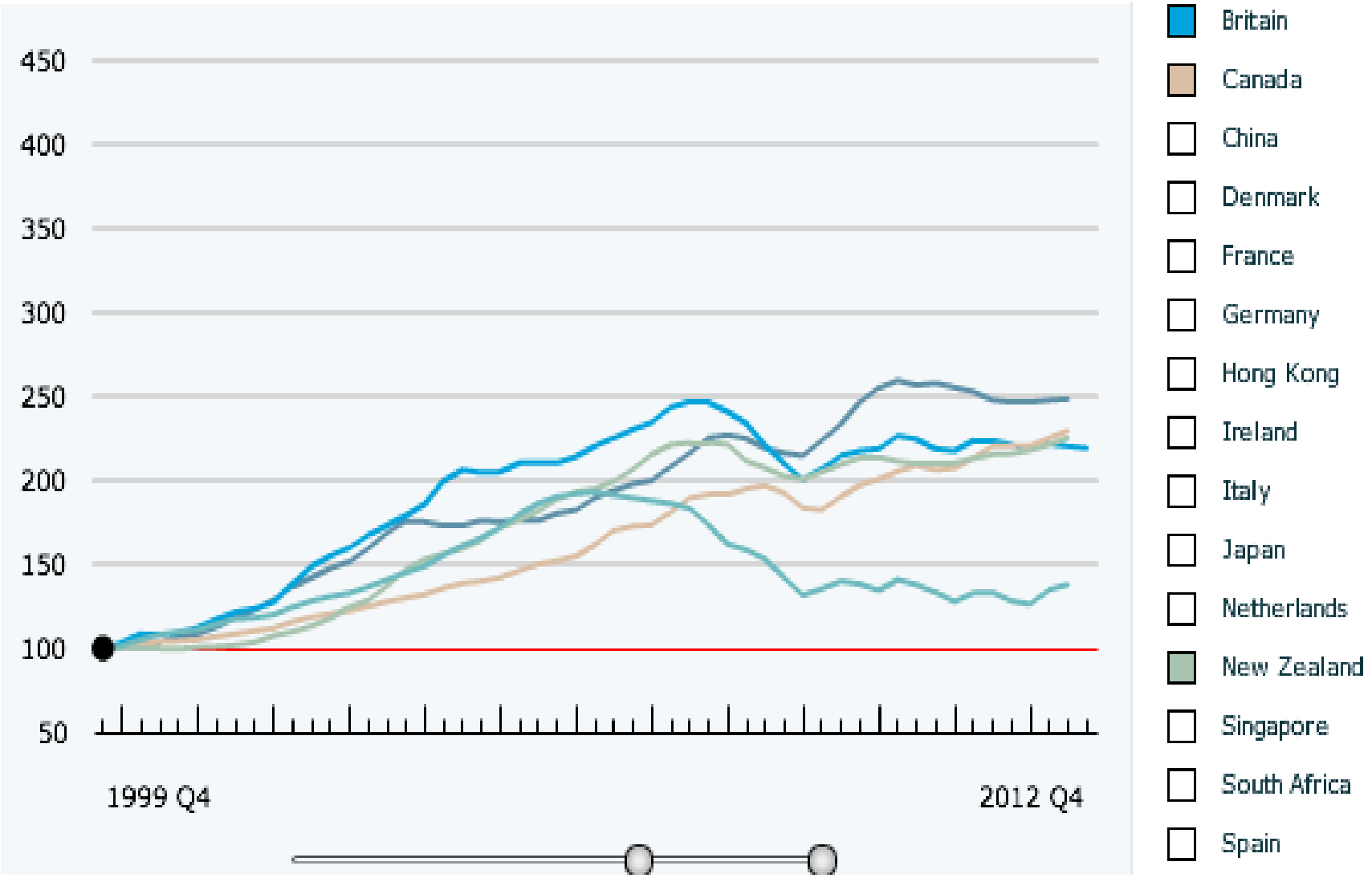
- The imperfect reliability of money growth as an indicator of monetary policy is unfortunate, because we don't really have anything satisfactory to replace it. As emphasized by Friedman . . . nominal interest rates are not good indicators of the stance of policy . . . The real short-term interest rate . . . is also imperfect . . .
- Ultimately, it appears, one can check to see if an economy has a stable monetary background only by looking at macroeconomic indicators such as **nominal GDP growth** and inflation.

Long term trends in real interest rates

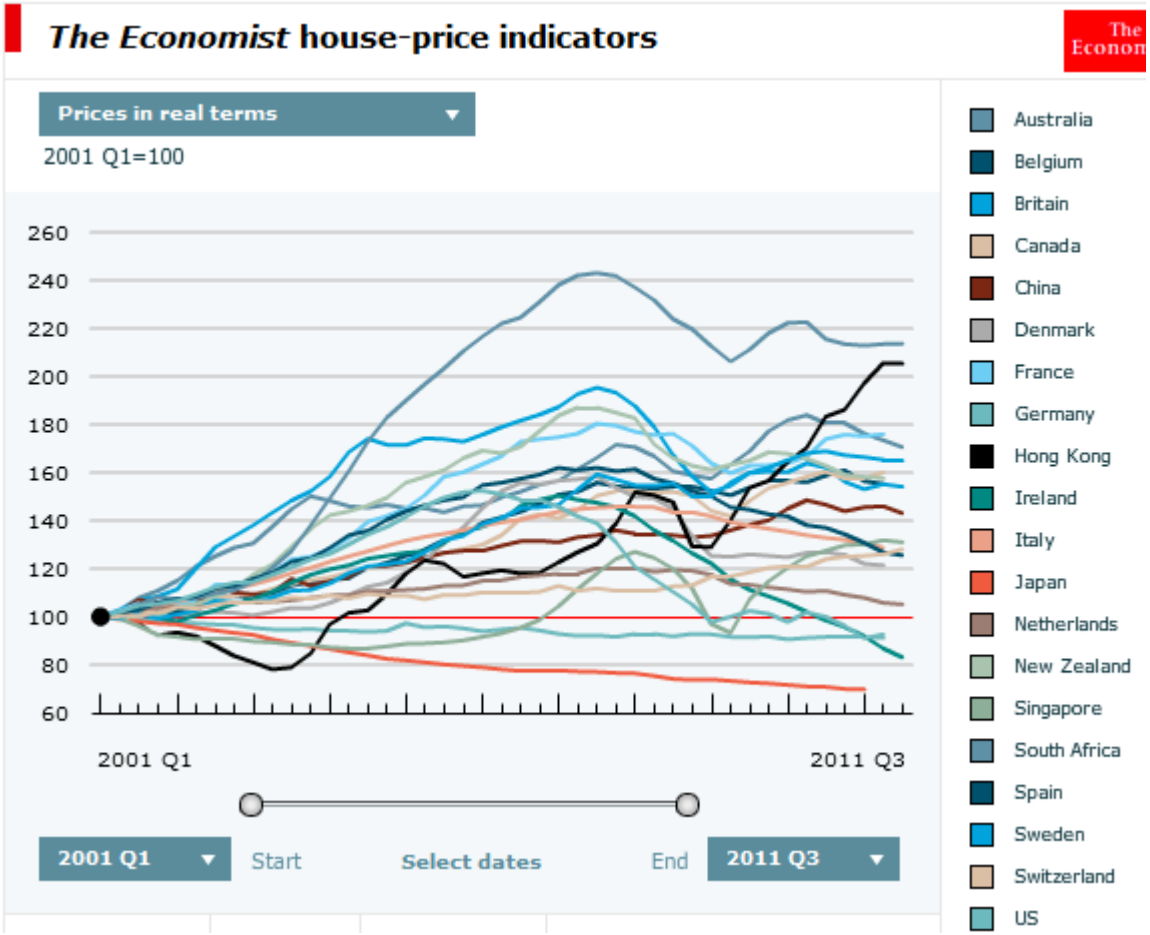


Share of Treasury debt held by the Fed

Bubbles are surprisingly hard to spot



Real housing prices



“Re-allocation” was almost complete before the severe phase of the recession (i.e. secondary deflation) had even begun

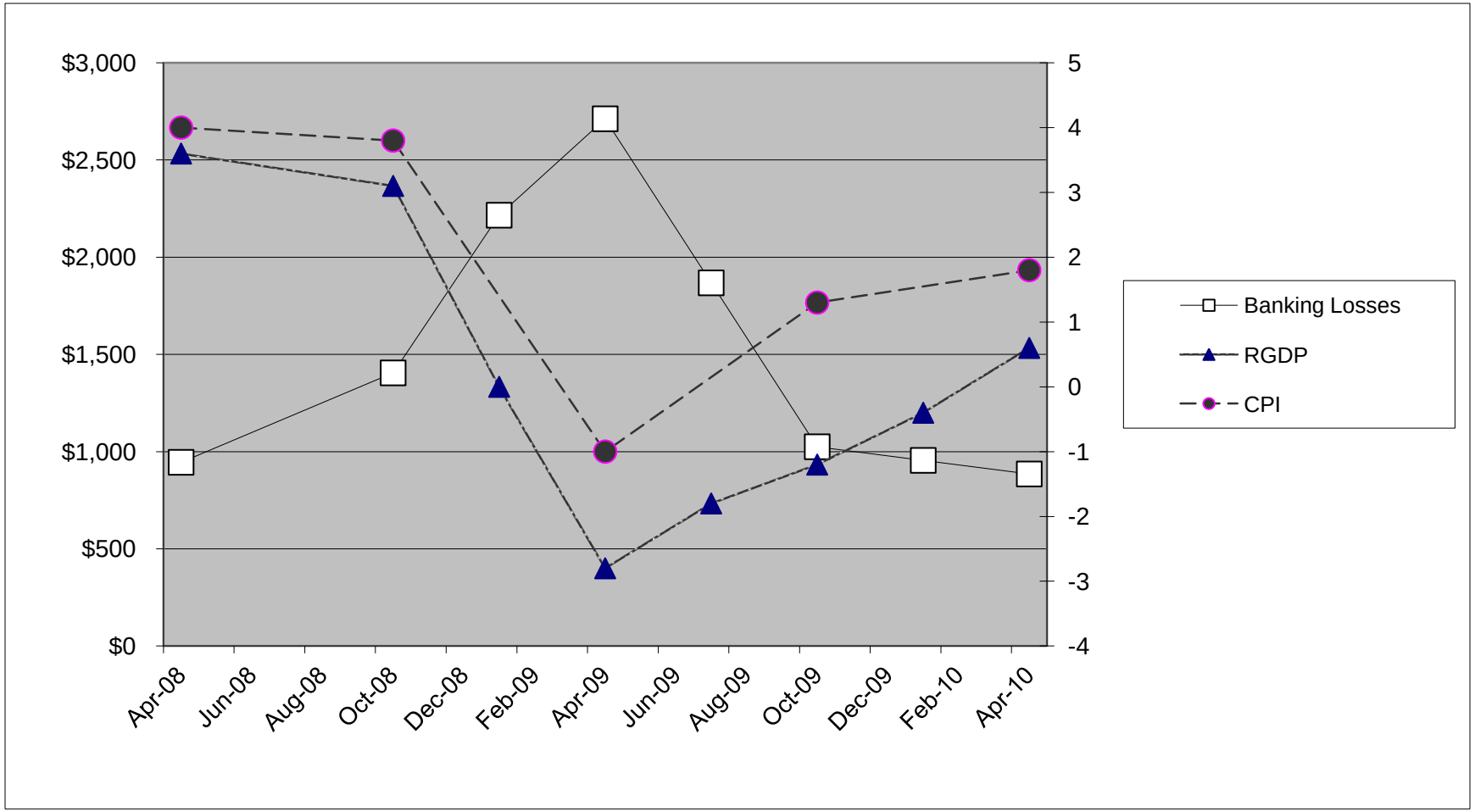
The housing crash was mostly over before the unemployment rate began rising sharply.

Jan. 2006: starts = 2,303,000, completions = 2,058,000, average = 2,180,000, **U-rate = 4.7%**

April 2008: starts = 1,008,000, completions = 1,014,000, average = 1,011,000, **U-rate = 4.9%**

October 2009: starts = 527,000, completions = 745,000, average = 636,000. **U-rate = 10.0%**

IMF estimates of US banking losses (in billions), as well as inflation and RGDP growth rates for 2009 and 2010 (combined.)



Policy implications

- Stabilize NGDP growth through a policy of targeting the forecast
- Lars Svensson—Use internal Fed forecasts
- Alternative approach, NGDP futures targeting

Central Planning vs. market-based policy

- A key Fed meeting occurred two days after Lehman failed, on September 16, 2008. The Fed left interest rates unchanged at 2.0%
- The minutes of the meeting indicated the Fed saw an equal risk of recession and inflation.
- But not *low* inflation, *high* inflation.
- On the day the Fed met, TIPS markets showed 5 year inflation expectations at 1.23%, well below target. (Which will prove to be roughly accurate.)

What should have been done

- The Fed should have followed Bernanke's advice to the Japanese: show "Rooseveltian resolve."
- The Fed should have lowered rates enough to boost inflation expectations to around 2% (or better yet 5% NGDP growth targeting.)
- The Fed should have promised to do *level targeting* once rates hit zero, as Bernanke had told the Japanese to do in 2003.

What should have been done, continued

- The Fed ***should not*** have adopted an interest on reserve program on October 6, 2008, which had effects similar to the Fed's doubling of reserve requirements in 1936-37—higher demand for bank reserves.
- If necessary, they should have charged a negative rate on ERs (a penalty rate) as the Riksbank did under Lars Svensson's leadership.

What should have been done, continued

- The Fed should have done the November 2010 QE in 2008, as soon as rates hit zero (which should have been October, not December.)
- All the effects of QE2 on assets markets were exactly as predicted in Mishkin's textbook. Fed speeches hinting at QE2 raised equity prices, forex prices, inflation spreads, etc. (Mishkin's own analysis of 2008 is not consistent with his model.)

A 21st century macro

- No more “wait and see” how policy will work. The markets told us immediately in early 2009 that fiscal stimulus was woefully inadequate.
- Since September 2008 markets have been repeatedly telling us that monetary stimulus has been inadequate, and they’ve been right.
- It’s a scandal that the federal government has not created and subsidized trading in a NGDP futures market, which could provide essential real time data on *expected demand growth* at low cost.

Lessons for the left and right

- “The Great Recession has revealed lack of capacity for engaging with monetary issues to be a major institutional weakness of the progressive movement.” Matt Yglesias.
- The right is supposed to believe in efficient markets, but despite ultra-low TIPS spreads they kept repeating the mistakes of conservatives in the 1930s; denying more AD was needed, warning of high inflation, “crying fire, fire in Noah’s flood.”

Who's to blame? We are.

- The Fed rarely deviates very far from the conventional wisdom of mainstream macroeconomists.
- Some economists have argued policy is too easy, some have argued it's too tight, but most seem to view Fed policy as roughly correct.
- The profession made a tragic mistake in late 2008, forgetting everything we teach our students about monetary policy.