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The Great Bubble *Debate*

BY BERNARD CONNOLLY

Can both sides be right?

The publication of this year's Annual Report of the central banks' bank, the Bank for International Settlements, ruffled some distinguished feathers among the organization's membership. The Fed chair made a direct attack on the BIS (which she referred to somewhat dismissively as "certain quarters"), and Mark Carney, chairman of the Financial Stability Board as well as governor of the Bank of England, said that the BIS recommendations were made "in a vacuum" which ignored "economic and political realities." What had the BIS done to disturb the central banking consensus? It had implied that the major central banks' approach was wrong: more emphasis should be placed on maintaining financial stability—notably by avoiding the "reach for yield" and the bubbles it engenders—and less on getting inflation back up to a somewhat arbitrary target; in consequence the major central banks, the BIS said, were underestimating the risks of not "normalizing" interest rates quickly enough.

There is now, for the first time since the 1970 struggles between "Keynesians" and "monetarists," an intellectual debate going on within the monetary policy world. As Keynes said, it takes a theory to kill a theory, and the theory which the BIS report suggests (although it does not fully articulate) would kill the theory worshipped almost religiously by central banks—or at least by the industry of theoretical macroeconomists working in central banks.

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But the political economy of the macroeconomics/central banking industry will not permit the changeover in theory that is so obviously required after the dramatic failure of the central bank model, responsible at bottom for the global financial crisis (see my article in the Fall 2008 issue of *TIE*). It is sometimes suggested that the debate is between "Keynesians" (the central banks) and "Wicksellians" (the BIS), the former school being concerned with setting interest rates to stimulate economy so as to get back to full employment, the latter group with keeping interest rates in alignment with the "natural" rate that ensures monetary equilibrium, somehow defined.

That characterization is not correct, however. Both sides are "Wicksellian" (indeed, the supreme intellectual guru of the central banks, Michael Woodford, entitled his magnum opus *Interest and Prices* in explicit homage to Wicksell, and Keynes himself was extremely "Wicksellian" in the *Treatise*). Both see the aim of monetary policy as being that of keeping market interest rates in alignment with the natural rate. However, the canonical central bank model, a Woodfordian elaboration of the so-called New Neoclassical Synthesis, sees the "natural" rate as that rate which keeps actual output in the economy in line with efficient output (something like potential output, but capable of going down as well as up) in the face of random shocks. In contrast, the BIS view seems to be that the natural rate is something like the rate which keeps the economy on an efficient growth path over time and avoids Ponzi games.

So the output and employment cost of avoiding, or minimizing, financial stability risks is higher than the BIS appears to suggest. And the financial stability cost even of merely deferring an economic downturn is higher than the Fed claims.

The Big Argument

The BIS argues that the present very low "risk-free" rates do two things. First, they encourage a bringing-forward of spending from the future (and thus create a potential future "hole" in demand which will produce a need for even lower rates, and so on). Second, they encourage savers, investors, and financial intermediaries to engage in a "reach for yield" which can put financial stability at risk. And although the BIS does not say so explicitly, its view implies that sub-"normal" rates must involve a Ponzi game and eventually lead to another financial crisis.

—B. Connolly

Why should anyone outside academia care about this spat? They should care about it for the same reasons that debates among economists in the early 1930s were so important: those debates were highly relevant to the question of how to get out of the Great Depression and thus to even bigger questions about the choice between authoritarianism, whether of the brutal Hitler/Stalin form or the milder New Deal form on the one hand, and liberal, democratic capitalism on the other.

The problem is that the two concepts of the natural rate have are have very different implications for policy. Yellen and Carney both insist that "headwinds" in their respective economies, including a supposed reluctance of banks to lend after their near-death experiences six years ago, and also the credit-restraining effect of "macroprudential regulation," mean that central banks will have to keep policy rates very low for a considerable period and will have to keep them below a "normal" level even when the respective economies are operating at full capacity again. In other words, they argue, a concept of the natural rate which had some connection with the trend rate of growth of the economy (that might be expected to mean a nominal rate of 4 percent or more in the case of the United States) would be too high even when the economy is back at full capacity and would be far too high, if implemented now, to allow the economy to get back to full capacity.

On the other side, the BIS argues that the present very low "risk-free" rates do two things. First, they

Continued on page 48

Continued from page 23

encourage a bringing-forward of spending from the future (and thus create a potential future "hole" in demand which will produce a need for even lower rates, and so on). Second, they encourage savers, investors, and financial intermediaries to engage in a "reach for yield" which can put financial stability at risk. And although the BIS does not say so explicitly, its view implies that sub-"normal" rates must involve a Ponzi game and eventually lead to another financial crisis.

The fearful problem is that both sides in the debate are right to a degree. Once monetary policy has gone wrong—as it went dramatically wrong in the second half of the 1990s, when Greenspan failed to understand the implications of an anticipated surge in productivity and when the malignant lunacy of monetary union was wilfully imposed on European countries—rates can be too high and too low at the same time: there is a failure of intertemporal coordination.

It is this wedge that apparently creates a trade-off between, in the case of the United States for instance, the Fed's dual mandate and the requirements of financial stability. One can see the very public disagreement between the Fed and the Bank of England on the one hand and the BIS on the other as being about where policy should be positioned on this trade-off: the BIS thinks that the risks of financial instability are serious enough for it to be worth taking some risks with short-term economic activity. The major central banks, in contrast, think that improvements in the position of the banking system mean that the risks of financial instability are very small and do not justify taking action that would delay or prevent the economy's return to full capacity and to the inflation target.

The difficulty with the BIS view is that early and rapid "normalization" of short rates will produce a sharp downturn in output (or at least output growth) and employment unless there is a much bigger credit bubble than there already is: if rapidly rising rates popped the asset price bubble which has emerged, the credit bubble would have to take on the whole burden of maintaining the bringing-forward of spending from the future (about which the BIS is rightly worried). But a bigger credit bubble would be unlikely to emerge in circumstances in which an asset price bubble had been burst—more likely, financial constraints would tighten sharply, conceivably producing the dreaded "adverse feedback loop." So the BIS may misperceive the nature of the trade-off: the output and employment risks of early "normalization" are very substantial and certain financial stability risks would be increased.

The only way to ameliorate the frankly horrible outlook for the world is to increase the level of productivity so as to validate past levels of spending.

If "normalization" is not brought forward, it will mean, when it is eventually attempted, liquidation on as massive a scale as that in 2008 and quite possibly the nationalization of virtually the entire financial system.

Unfortunately, while early normalization is a very bad option indeed for, say, the United States, it is nonetheless the least-bad option available. For if the BIS misperceives the nature of the trade-off, so too, in a different way, does the Fed. Extraordinary monetary accommodation does not avoid a downturn in the economy but merely defers one. The economy is being held back not by exogenous "headwinds" but instead, since interest rates in the past (initially, in the second half of the 1990s) were too low and too much spending was brought forward from the future, is being held back by the endogenous working of the Euler equation for consumption, which says that consumption will be on a downward path, relative to income, if the relevant interest rate is below the rate of time preference (and, heuristically, there is reason to believe that this is the case). The Euler equation can be "turned off" if intertemporal solvency constraints are ignored—that is, if there are debt bubbles and Ponzi games. It is this feature of the economy that means that bubbles are permanently necessary, once intertemporal relations have gone badly wrong, if the aim of policy is to keep on deferring a downturn (while pretending it can be avoided). It also means that the price, in terms of financial stability risks, of deferring a downturn is extremely high: the trade-off is far more unfavorable than Yellen claims.

So the output and employment cost of avoiding, or minimizing, financial stability risks is higher than the BIS appears to suggest. And the financial stability cost even of merely deferring an economic downturn is higher than the Fed claims. Tough: that is what a capitalist system is like once it has been badly distorted by monetary policy (that is, by government intervention in the crucial area of intertemporal prices).

That said, it is the unfavorable nature of the trade-off—even the admitted trade-off—which pushes policymakers into seeking some *deus ex machina* called "macroprudential policy." Unfortunately, this is deluded. Fundamentally, the only sensible aim of "macroprudential policy" would be to make it harder for intertemporal solvency, or "No-Ponzi-Game," constraints to be ignored (unless one is talking about the European Central Bank, whose aim seems to be precisely the opposite: to encourage non-euro area investors to ignore such constraints so as to reduce the burden otherwise placed on German taxpayers by future defaults in other euro area countries).

But success for fundamentally inspired "macroprudential policy" would mean that the Euler equation was not "turned off." In turn, such success would mean that to avoid a downturn *ex ante* real interest rates would have to go ever lower. If ever-lower rates were achievable for a time, a near-term downturn would be avoided—but only at the cost of creating a bigger potential "hole" in demand in the future.

The fearful problem is that both sides in the debate are right to a degree. Once monetary policy has gone wrong, rates can be too high and too low at the same time.

The implication of that (even aside from the obviously very damaging impact on the allocation of capital and thus on productivity growth—in effect, the complete perversion of a capitalist system) would be a need for ever-higher inflation—and, if that were ultimately impossible or unacceptable, an almighty crash, all the harder for having been deferred. All savers would face ruin—either in a gradual but accelerating way via ever more negative yields or from the ultimate sudden crash in the risk assets into which they had been forced by the "reach for yield."

The BIS may misperceive the nature of the trade-off: the output and employment risks of early "normalization" are very substantial.

If the U.S. financial system is indeed relatively robust at present, as Yellen claims, that is precisely why the Fed should accept the undoubtedly considerable risks of "normalizing" rapidly—because the system might indeed be able (if the Fed's stress tests have any credibility) to withstand the downturn made inevitable by "normalization" without triggering quite the devastating adverse feedback loop so apparent in the 2007–2009 financial crisis. Yet Yellen views the claimed robustness of the U.S. financial system as a reason for not having to bring "normalization" forward for financial stability reasons. But if "normalization" is not brought forward, it will mean, when it is eventually attempted, liquidation on as massive a scale as that in 2008 and quite possibly the nationalization of virtually the entire financial system.

The only way to ameliorate the frankly horrible outlook for the world is to increase the level of productivity so as to validate *ex post,* so to speak, past levels of spending. The BIS is right to issue its warnings. The longer the central banks remain in denial, the more likely it is that productivity levels will fall short of expectations, thus making ultimate disaster even more likely and even more complete. But political and social developments suggest that the hope of the BIS that there will be an improvement in productivity sufficient to avoid the worst outcome is probably just too optimistic. ◆