

Monetary Policy Challenges in the Decade Ahead
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Although the title of this conference is “Monetary Policy Challenges in the Decade Ahead,” the program calls this final session “Beyond Price Stability - The Challenge Ahead.” Unfortunately, I don’t think we are ready to go beyond price stability. Price stability remains a key challenge, perhaps the key challenge for the years ahead, although current conditions show the importance of other problems, including the stability of credit markets and asset prices.

I will comment on three subjects: (1) the relation of commodity prices and inflation; (2) anchoring inflation expectations; and (3) the stability of credit markets and asset prices.

1. The Challenge of Commodity Price Inflation

During the past year the prices of perishable food commodities and nonperishable oil and metals rose as much as 100 percent. Why did that happen and what should the central banks do about it?

The rise in the prices of agricultural commodities is easier to explain. The cause was not a supply shock like failed harvests. Nor was it the result of a general global rise in demand triggered by easy monetary policy. The primary reason was the increase in the demand for food in the rapidly growing countries of Asia – especially China and India – and of the middle east. Moreover, the rise in demand for agricultural commodities in those countries was not due to easy money but rather to the impact of rising real incomes on the pattern of consumption. In particular, the substitution of meat consumption for vegetarian commodities caused a very substantial rise in the demand for grains and other such commodities.

Even a relatively small increase in global demand coming from these high growth countries can cause the price of the agricultural products to rise very sharply. Because supply is virtually fixed in the short-run and the price elasticity of demand is very low, it takes a very large rise in the price to equate supply and demand. In a simple text book analysis for a single perishable commodity, the rise in the price is equal to the initial proportional rise in demand divided by the sum of the absolute demand and supply price elasticities. With completely inelastic supply in the short run and a demand elasticity of 0.1, a rise of demand in India, China and the Gulf countries equal to 10 percent of the previous global demand would cause the equilibrating price rise to be 100 percent.

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In addition, some countries responded to the global rise in particular commodity prices – particularly the price of rice – by banning the export of those commodities from their own country. This held down the domestic price of rice in those countries but caused the price of rice to rise even more sharply on the global market.

The rise in the price of oil is more complex to analyze because the increase in the spot price reflects expectations about future supply and demand and therefore about future prices. As Hotelling explained, the spot price is linked to the future price by the requirement that the price is expected to rise at the same rate as a risk adjusted rate of interest. Although risk conditions and temporary shortages may modify the precise link, the basic relation remains that a rise in expected future demand or decline in expected future supply will cause the spot price to rise. .

An important implication of this is that commodity prices should not be expected to rise as much in the coming year as they did in the past year. With time, the price elasticities of both demand and supply will rise, implying that equilibrium prices would decline if there were no further rise in the level of demand in China, India and the Gulf countries. Even if prices remain high, they are very unlikely to continue to rise by 100 percent in the coming year.

If commodity prices do rise less, headline inflation will decline if monetary authorities can avoid the second round effects of wage earners trying to maintain their real incomes.

A key requirement for the Federal Reserve and other central banks is therefore to convince participants in labor and product markets of two things:

First, that the increase in commodity import prices implies a decline in real incomes that must be accepted and that cannot be offset by a rise in nominal wages. Mervyn King has made that bad news very clear to the British public. Household surveys in the United States indicate that Americans also understand this.

Second, that the central bank will act to prevent a wage-price spiral and will thereby cause the headline inflation rate to decline.

The ability to achieve these two things will differ among the central banks. I think the Federal Reserve will succeed in preventing the wage-price spiral for four reasons:

- Labor contracts in the United States have no automatic inflation indexing of the type that contributed to the wage-price spiral in the 1970s.
- Unions are very weak. Only 7.5 percent of private sector workers are unionized.
- There is substantial slack in the labor market after payroll employment has declined for six successive months.
- Households appear to understand that the rise in gasoline and food prices implies a fall

in the level of real income that cannot be recaptured by pressing for higher wages.

2. Anchoring Inflation Expectations

There has been broad agreement at this meeting about the importance of anchoring inflation expectations. Athanasios showed that the ECB has succeeded in reducing medium term inflation expectations in the euro area. The Federal Reserve has also been relatively successful. Although the CPI rose by 4.2 percent over the past year and is expected (according to household surveys) to rise at more than five percent during the coming year, the corresponding five year expected inflation rate is only a bit above three percent.

I want to make five quick points about anchoring inflation expectations, several of them in response to issues raised at this meeting.

(1) The broader public:

I believe that the broader public and not just the financial community is concerned about inflation and monetary policy. The central bank must therefore communicate to a broader public as well as to the technical experts.

The public may not understand the mechanism of monetary policy but they do worry about inflation and the risk of recession. Financial news is not just for the Financial Times and the Wall Street Journal.

(2) Danger of Talk without Action

Alan Blinder warned about the dangers of “open mouth policy” without serious follow-through. Recently, Ben Bernanke and others have said they are “very concerned about inflation” and are “determined not to let inflation expectations rise”

If I am correct, the Fed is very unlikely to raise the federal funds rate by more than a token amount during the next six months, even though the current federal funds rate of 2 percent represents a negative real rate relative to core inflation and a rate that is less than half the CPI inflation rate.

There is a similar problem with respect to the dollar. There has recently been a coordinated effort by the Treasury and the Fed to talk up the dollar. Yet it is very unlikely that the Fed will raise interest rates to support the dollar and even less likely that the Treasury will intervene in the foreign exchange market. The dollar rallied for a few days after the Treasury and Fed statements before falling again and is now at 1.58 per euro and 107 yen per dollar.

(3) Inflation Targeting

A formal inflation target is advocated as an effective way to anchor inflation expectations. The British and euro area members know that the respective central banks are committed to achieving inflation rates of approximately two percent. Lars Svensson explained how everyone in Sweden knows the similar goal of the Swedish central bank.

Although the Fed does not have a formal inflation target, it now publishes a three year forecast of inflation that summarizes the views of the individual FOMC members. Since each member states a forecast based on what that member believes to be “appropriate policy” during the next three years, each member’s “forecast” can be interpreted as that individual’s target inflation rate. It is of course not clear how to interpret the average of these different conditional forecasts since the members clearly have different views about what is “appropriate policy.”

Perhaps more significantly, this three year forecast (most recently a range of 1.7 percent to 1.9 percent for core inflation) is not a number that the public knows so it cannot be doing anything at this point to tie down inflation expectations. It refers moreover to the core PCE which is a number that is also not known by the general population.

(4) The Cacophony of Multiple Statements

Several participants expressed the view that it can be harmful to hear different views in speeches by the FOMC members and to know that the voting about interest rate moves was not unanimous. I disagree. An outsider wants to know – and needs to know – whether a Fed decision to tighten or ease was a close vote that could easily be reversed by new evidence during the coming month. In the recent context, it is quite informative that only one or two FOMC members disagreed with the policy decision enough to vote against it.

A minority view may also be very helpful at times as a way of providing an authoritative voice to educate those who care about monetary policy. I remember reading the speeches of Henry Wallich in the 1970s when he was a strong voice of dissent about the policies that were then producing stagflation.

(5) The Short-run Phillips Curve

Most (but not all) economists believe that there is a short- run Phillips curve relating unemployment and inflation. I understand the political problem for a central bank that has to admit that it is sacrificing “growth” and employment in the short run in order to contain inflation. But a central bank that denies the existence of the short run Phillips curve loses credibility among its most sophisticated audience.

An appropriate strategy for each central bank is therefore to combine an explicit recognition that a tight money policy will slow growth in the short run with a statement that containing inflation this way will produce stronger growth and lower risks for the longer term.

3. Financial Stability

In the United States we are now seeing major financial instability. The financial markets are dysfunctional in a way and to an extent that I have not seen in more than 25 years as a careful observer and participant in those markets. Financial institutions are severely impaired and the value of financial assets – especially mortgage backed securities and credit default swaps – are depressed and often difficult to determine.

These financial problems were triggered by a bursting of the house price bubble in mid-2006. Although other aspects of the financial market in which risk was severely mispriced could have triggered the current crisis, the decline in house prices was inevitable. At the peak, house values were \$20 trillion. They have fallen \$4 trillion since then. . Further declines are inevitable, with an estimated \$3 trillion to \$4 trillion further in losses to get back to a normal valuation level.

Some 20 percent of homeowners with mortgages now have negative equity in their homes. If nothing is done to change the likely path, that will rise to 40 percent a year from now.

I believe that creates a risk that house prices will continue to decline below a “normal valuation” level, spurred by defaults and foreclosures. We are already seeing record levels of defaults and foreclosures. A serious downward spiral of house prices would hurt consumer wealth and spending, stimulating a decline in GDP. The defaults would further weaken financial institutions.

The value of mortgage backed securities and therefore of the capital of financial institutions cannot be determined with any confidence as long as the risk of a downward spiral of house prices remains.

The dramatic reduction in the market value of financial institutions (Citigroup at \$18 a share is one third of its value a year ago) reflects reductions in the banks’ capital and therefore in their ability to lend and to buy assets.

Why did all of this happen? And what could the Fed (or other central banks) do about it?

By my count, there are at least 7 contributing causes to the current financial instability. I will list them quickly.

(1) The low federal funds interest rate early in the decade and the Fed’s promise to keep it low contributed to the housing boom, the availability of adjustable rate mortgages with very low teaser rates, etc.

(2) There was inadequate supervision of banks by the Fed, the Office of the Controller, and the state banking supervisors, including inadequate attention to asset quality and inadequate attention to capital adequacy, especially with respect to off balance sheet assets.

(3) The poor quality of the credit rating process used by Moody’s, S&P and others allowed

subprime and other poor quality assets to be packaged into CDOs with most tranches classified as AAA or even better (the so-called super-senior securities). This permitted the selling of those securities to US banks, foreign banks, and others who held them with inadequate capital because of their excessively favorable credit rating. The Fed and other supervisors should have been more alert to the terrible mispricing of risk.

(4) Government legislation (the Community Reinvestment Act) encouraged home ownership by low income and minority individuals who could not afford the mortgages that they assumed. The Federal Reserve enforced rules that required banks to make such loans by denying those who did not have adequate “community lending” the right to acquire other banks, to raise dividends, etc.

(5) The extensive securitization of mortgages means that individual borrowers with problems cannot renegotiate with lenders as they would if their mortgages had remained with the originating bank.

(6) The legal system of “no recourse” mortgages in many states (meaning that creditors can take the house when the borrower defaults but cannot take other assets or income) and the creditors’ practice of not pursuing debtors even when the creditors have the legal right to do so makes the housing market sensitive to falling prices and high loan to value ratios. Defaults and foreclosures are at a 30 year high and, as that further depresses prices, are likely to rise in a self-reinforcing process.

(7) The compensation systems at banks and investment banks encouraged excessive risk taking. Many of those who initiated or approved investments with strong returns but substantial risks of substantial delayed losses were nevertheless compensated for the early performance of those investments. .

What could the Fed do – what could it have done – to avoid these problems?

- avoid the very low interest rates and promise of sustained low rates
- improve supervision of asset quality and capital
- provide oversight to the credit ratings used by banks and the capital associated with supposedly highly rated securities
- push back on the mischief produced by the Community Reinvestment Act

But looking ahead it is important to bear in mind that banks have become only a small part of the complex credit markets. Attempts to reduce risk in the banking system may only shift that risk taking activity to other financial institutions or other financial markets.

I am also afraid that there is little or nothing that the Federal Reserve can do now to prevent a downward overshooting of house prices, perhaps the greatest risk now to the financial sector and to the economy. That requires action by the Treasury and the Congress, perhaps along the lines of the mortgage replacement loans (that I described in “How to Stop the Mortgage Crisis,” Wall Street Journal, March 7,2008).

In summary, the primary challenge for the central banks in the decade ahead is to achieve and maintain price stability. Anchoring inflation expectations is a key part of this process. More needs to be done to determine the best way of doing so. Going beyond price stability to financial stability, there is much to be done along the lines that I suggested to deal with the current crisis and to prevent similar problems in the future.

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