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Monetary policy and the twin crises☆

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ABSTRACT

After presenting a brief overview of the recent financial crisis and the European debt crisis that followed in its wake, this paper goes on discuss monetary policy in the United States, the United Kingdom and the Euro bloc prior to and during the course of the two crises. The paper presents historical evidence for the three areas on the relationships linking the volatilities of output, inflation and monetary growth. In all three these relations are strongly positive. There is, therefore, no tradeoff between inflation and output volatility; the two move up and down together. Both, moreover, move up and down with the volatility of monetary growth. Viewed from this perspective, the increased volatilities of money supplies and the monetary base in the United States, the United Kingdom and the Euro bloc over the last half decade pose problems.

1. Introduction

As its title indicates, this paper focuses on monetary policies and the relations linking those policies to the twin crises that have plagued the advanced economies to varying degrees for over half a decade. I begin with an overview of those crises – the financial crisis that began in 2007 in the United States and

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that worsened substantially and became virulent during the course of the next year and the debt crisis that followed in the countries of the European periphery. Here I draw on the studies that have been done over the past five years, many of which have been published in special conference issues of this Journal.

I then go on to discuss the role of monetary policies in the Euro area, the United Kingdom and the United States both prior to and during the financial crisis and in the years thereafter. As measures of monetary policy I use two sets of indicators: ex post real policy interest rates – the counterparts of the nominal interest rates that the European Central Bank, the Bank of England and the Federal Reserve target – and two monetary aggregates – the monetary base and a broader definition of money that varies slightly with the country or country group.

Two inferences follow from the analysis of monetary policy prior to and during the financial crisis. The first is that in the United States and for the peripheral countries of Europe those policies were overly expansive. They, therefore, contributed to the run ups in asset prices that preceded the financial crisis in both areas. In the United Kingdom and the European core, however, this does not appear to be the case. Policies appear to have been more or less neutral. The second and related inference is that the one-size-fits-all policy that EMU brought about has simply not worked well. A monetary policy that was just about right for the European core appears to have been too expansive for the European periphery.

In reaction to the financial crisis and as the debt crisis has unfolded, policy became more expansive in the United Kingdom and the United States and to a lesser degree, Europe. Central-bank target rates fell to near zero and have remained there. More important, the monetary base in all three underwent unprecedented increases. Meanwhile the economic recoveries have varied from weak to at times non-existent. I turn to these issues later in the paper. I then go on to examine long-term evidence on the relationships between the volatilities of inflation, output growth and monetary growth for the United Kingdom, the United States and the Netherlands as a proxy for the countries of the Euro area. The evidence here is disquieting. In all three, the relations between inflation and output growth are strongly positive. There is no trade-off between inflation and output volatility; the two move up and down together. Both, moreover, move up and down with the volatility of monetary growth. Viewed from this perspective, the increased volatilities of money supplies and the monetary base in the United States, the United Kingdom and the Euro bloc over the last half decade pose potential problems that ought not be glossed over. I conclude with a series of observations on what needs to be done going forward.

2. Overview of the twin crises

In spring 2007, house prices in the United States, after a substantial run up over the course of the previous seven years, peaked and then began what eventually turned into a precipitous and rather long-lived decline.[1]

At almost the same time, the first signs of dislocations in world credit markets started to emerge both in London and New York. During the course of the next year they spread. Then in September 2008, the credit-market problems worsened even further and out and out panic ensued. Other advanced economies, many of which were experiencing problems of their own making, got sucked into the fray. The coup de grace was the Lehman failure and the announcement of The Troubled Asset Relief Program (TARP) by the United States government. The two, albeit in differing ways, were accompanied by greatly increased uncertainty in financial markets as evidenced in the soaring LIBOR-OIS spread, which at its peak in October 2008 reached over 350 basis points.

Several aspects of the financial crisis and the problems that led up to it stand out. The first is the proliferation of subprime real estate loans that were securitized and combined into collateralized debt obligations (CDOs) and that became increasingly important in the half decade leading up to the crisis. Gerald Dwyer and Paula Tkac (Dwyer and Tkac, 2009) in their paper “The Financial Crisis of 2008 in

[1] This dating is based on the Case-Shiller index. The alternative OFHEO index actually peaked three quarters earlier.

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