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WHAT ROLE FOR CENTRAL BANKS IN VIEW OF THE CURRENT CRISIS?

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Introduction

Central banks have an aversion to bailing out speculators when asset bubbles burst, but ultimately, as custodians of the financial system, they have to do exactly that. Their actions are justified by the goal of protecting the economy from the bursting of bubbles. While their intention may be different, the result is the same: speculators, careless investors, and banks are bailed out. A far better approach is for central banks to widen their scope and target the net wealth of the personal sector. Using interest rates in both the upswing and the downswing of a (business) cycle would avoid moral hazard (Arestis and Karakitsos 2009b).

A net wealth target would not impede the free functioning of the financial system, as it deals with the economic consequences of the rise and fall of asset prices rather than asset prices (equities or houses) per se. Thus, it is not a target, say, on the S&P 500, on house prices, or on their rates of growth. Although a boost in house or equity prices will increase gross wealth, this is not a one-to-one relationship. First, the volume of houses may increase proportionately less than the increase in gross wealth, or the stock market capitalization may change. Second, if an increase in gross wealth is matched by a corresponding increase in debt or in disposable income, net wealth will not increase. In the last two years of the housing bubble, for example, gross wealth increased but net wealth decreased. A wealth target would also help to control liquidity and avoid future crises. The woes of the current crisis have their roots in excessive liquidity that financed a number of bubbles in the last 10 years. This liquidity is the outcome of "bad" financial engineering that spilled over to other banks and to

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the personal sector through securitization, and an overly accommodating monetary policy (Arestis 2007; Arestis and Karakitsos 2009a). Hence, targeting net wealth will also help control liquidity, without interfering with the financial engineering of banks.

This policy note provides the background for and details of our new policy initiative, which we suggest is of paramount importance in view of the current crisis and new economic realities.

Targeting Net Wealth

One can sympathize with those who argue that central banks should not rescue speculators, careless investors, or banks when bubbles burst because they encouraged the sale (purchase) of assets in the upswing of the economic cycle. A rescue encourages one-way bets on future bubbles, as investors expect central banks to bail them out in an economic downswing. Many commentators during the current crisis have advocated policies that avoid moral hazard. As custodians of the financial system, central bankers share this concern, but they must act when markets are dysfunctional. In the current crisis they have injected temporary liquidity and provided direct loans to banks in trouble. In the beginning (of the crisis) they refrained from lowering interest rates that would make their temporary liquidity injections permanent, thereby avoiding moral hazard issues. As the crisis deepened, however, the Federal Reserve (Fed), the Bank of England (BoE), and the European Central Bank (ECB), although very reluctantly, made temporary liquidity permanent by cutting interest rates. This action raises the issue of whether the central banks are too monolithic by merely concentrating on inflation (an argument propounded in Arestis and Karakitsos 2004 and 2009a). Edward Leamer (2007) makes the point well when he argues that the Fed's focus on issues other than housing led to an overheated housing market whose unravelling threatens to plunge the U.S. economy into recession (which has come to pass). The experience of many countries as well as the United States shows that successful control of CPI-inflation does not guarantee control of asset price inflation. The thrust of the argument is succinctly summarized by Claudio Borio (2008), who labels it a "paradox of credibility," implying that the more a central bank succeeds in keeping prices stable, the more likely that asset bubbles will be the first signal of an overheating economy.[1]

The standard argument against asset price targeting is that it interferes with not only the free functioning of financial markets but also the economy as a whole. Moreover, it is considered to be outside the realm of central banks because it results from "irrational exuberance" or else reflects market forces. According to Alan Greenspan (2005), asset price targeting would require the authorities to outperform market participants. Central bankers would rather deal with the consequences of bubbles that burst by minimizing the damage to the real economy. Greenspan's success after the dot-com bubble burst in 2001 gave some credence to this approach, which has been adopted by the four major central banks (the Fed, BoE, ECB, and Bank of Japan). But the recent housing bubble could be viewed as the result of Greenspan's "successful" policies at the turn of the 21st century that countered the threat of a 1930s-style depression after the dot-com collapse.

The way to avoid these problems is to monitor and target the implications of asset prices for consumer spending patterns. A primary candidate for this purpose is the net wealth of the private sector. Net wealth is defined as (financial and tangible) assets less personal sector liabilities, including mortgage debt and consumer credit. The ratio of net wealth to disposable income fluctuates widely in the short term but there is no trend in the long term because to imply otherwise would mean intergenerational changes in savings habits. Net wealth is an ideal variable to monitor (and control) bubbles because it is at the heart of the transmission mechanism between asset prices and debt, and consumption.

Since the end of World War II, average net wealth in the United States has been approximately five times annual disposable income. The peak of the recent equity bubble became transparent when net wealth hit a high of 6.2 times annual disposable income. The peak ratio subsided when equity prices fell, but it revived with the emergence of a new (housing) bubble. Thus, the Fed should maintain a target ratio of net wealth to disposable income in the range of, say, 4.3 to 5.3, similar to its implicit target of 1 to 2 percent for core PCE (personal consumption expenditure) inflation. The target range could be revised to account for demographics or to anchor expectations of asset price inflation. Furthermore, monetary policy should be tightened or relaxed to maintain this particular threshold. This action would not only allow asset price booms but it would also prevent bubbles, and their huge adverse economic consequences.

This approach would also help to regulate financial engineering. Securitization implies a transfer of risk from banks to the personal sector, making banks more willing to promote both lending and the sale of asset-backed securities to the personal sector. Financial engineering enabled the U.S. housing market bubble, and its complexity means that central banks would find it difficult to measure, monitor, and control total liquidity in the economy. A wealth target, however, would mitigate the consequences of liquidity and not impede the financial engineering of banks.

The Merits and Perils of Wealth Targeting

If monetary policy is guided solely by inflation, then a central bank is unlikely to deal adequately with a credit crisis because the volatility of the output gap is greater than the volatility of inflation in an asset-led business cycle. When credit expands and asset prices soar in a cycle upswing, inflation remains subdued for two reasons. First, potential output increases, thus dampening the positive output gap and containing inflationary pressures. Second, cyclical productivity improvements (which appeared to be structural in the United States in the late 1990s) reduce unit labor costs and also put a lid on inflation. But the expansion of credit and soaring asset prices increase output disproportionately compared to the default demand-led business cycle. Therefore, a central bank is well advised to have two targets in an asset-led business cycle—inflation and the output gap—in order to successfully deal with a credit crisis and the consequences of a bursting asset bubble (and despite the fact that its only instrument is interest rates).

In a highly leveraged economy like the United States, however, even these two targets would be inadequate to deal with an economic crisis; increasing leverage means that monetary policy would likely lead to a prolonged crisis and possibly to instability, because the economy responds to changes in interest rates and profitability at different rates. The rationale is as follows. Net wealth depends on interest rates, which affect house prices and equities, and on profitability, which influences aggregate demand and equities. Both of these items of net wealth are related to the degree of leverage, and the higher the leverage, the higher the items' sensitivity to interest rate changes. As an example, consider the implications of structured investment vehicles (SIVs). SIVs created a shadow banking system outside the control and regulation of authorities, who significantly expanded liquidity (Arestis and Karakitsos 2009b). SIV activities were financed through the London money market, and their profitability depended on the yield curve (the relationship between short- and long-term interest rates). They were very sensitive to interest rates, and collapsed when the yield curve became slightly inverted by a small rise in money market rates above mortgage rates. Since the asset-backed securities issued by SIVs were held by the personal sector, household net wealth also became very sensitive to changes in interest rates.

Thus, central banks face a much more difficult problem in stabilizing a leveraged economy. The credit crisis is prolonged by the heightened response of net wealth to interest rates and profitability, as central banks are forced to move interest rates up and down within target ranges. This response makes the system unstable, and an economy never converges to its initial steady state following a (temporary) credit crisis. Oscillating interest rates from the central bank ultimately cause instability because the economy responds to profitability faster than to interest rates, which are a stylized fact of the real world. Given that the real profit rate plays an important and more immediate role than interest rates in stabilizing an economy, and given that the interest rate influences the real profit rate (which is responding to economic developments), it is not unreasonable that the actions of the central bank may destabilize a highly leveraged economy. Therefore, the response of monetary policy to inflation and the output gap in a highly leveraged economy will likely be inadequate in dealing with a credit crisis. Mild wealth targeting would prove beneficial in this environment.

A wealth target would reduce the impact of widening credit spreads on net wealth, so there would be a milder recession in light of smaller declines in profits and in interest rate cuts by central banks, leading to lower costs in terms of lost output and enabling the economy to weather the bursting of a bubble. A mild wealth targeting agenda at central banks is therefore beneficial in stabilizing an economy around potential output during an asset-led business cycle.

We caution that overly zealous enthusiasm for wealth targeting might cause instability and lead to a deeper recession than that associated with mild wealth targeting, despite initially arresting the fall in net wealth. Large swings in interest rates, combined with lags in the effects of monetary policy and the quick response of demand and wealth to profitability, would create volatility, destabilizing the economy and leading to a prolonged recession. Mild wealth targeting, therefore, is preferable to either no or excessive wealth targeting. In the real world, profitability adjusts faster than interest rates, and economies respond faster to changes in profitability than to changes in interest rates.

Conclusion

The sole reliance of monetary policy on inflation is highly unlikely to deal with the current global credit crisis in an asset-led business cycle because the volatility of the output gap is greater than the volatility of inflation. Adding the output gap to a central bank's target list would enhance its ability to stabilize an economy around potential output. In a highly leveraged economy, however, these two targets would do little to free up credit, because the economy responds faster to profitability than to interest rates. Mild, but not excessive, wealth targeting would reduce the lost output in a credit crisis as well as the amplitude of the business cycle.

Note

1. "Paradoxically, these endogenous responses to credible monetary policy increase the probability that latent inflation pressures manifest themselves in the development of imbalances in the financial system, rather than immediate upward pressure on higher goods and services price inflation" (Borio and Lowe 2002, p. 22).

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