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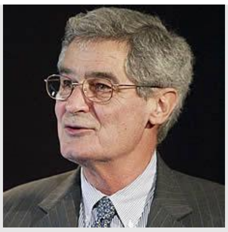
Mortgages and monetary policy

Robert E. Lucas*, *Wall Street Journal*, 19 September 2007

Je suis donc sceptique quant à l'argument selon lequel le problème des subprimes va contaminer l'ensemble du marché hypothécaire, que la construction de logements va s'arrêter, et que l'économie va entrer en récession. Chacune de ces étapes est discutable et aucune n'a été quantifiée. Si nous avons appris quelque chose des 20 dernières années, c'est qu'il y a beaucoup de stabilité intégrée dans l'économie réelle.



In the past 50 years, there have been two macroeconomic policy changes in the United States that have really mattered. One of these was the supply-side reduction in marginal tax rates, initiated after Ronald Reagan was elected president in 1980 and continued and extended during the current administration. The other was the advent of "inflation targeting," which is the term I prefer for a monetary policy focused on inflation-control to the exclusion of other objectives. As a result of these changes, steady GDP growth, low unemployment rates and low inflation rates -- once thought to be an impossible combination -- have been a reality in the U.S. for more than 20 years.

Both of these reforms work, in part, because they stabilize people's expectations about aspects of the future. The supply side tax cuts, in contrast to Keynesian on-again-off-again temporary tax cuts, are designed to be in place over the long run, and help to assure us that the returns to today's hard work and savings will not be taxed away tomorrow. Inflation targeting is a commitment that no matter what unpredictable shocks the economy is subjected to, the Fed will do what is needed to restore a fixed, target inflation rate and so maintain a "nominal anchor" to expectations.

This summer's subprime mortgage crisis puts the long-run emphasis of inflation targeting to a severe test. Something has to be done right now. What should it be?

There are two distinct aspects to this test, which deserve separate analysis.

There is an immediate risk of a payments crisis, a modern analogue to an old-fashioned bank run. Many institutions -- not just banks -- have payment obligations that are far in excess of the reserves to which they have immediate access. Against these obligations they hold short-term securities that they believed could be liquidated on short notice at little cost. If some of these securities turn out not to be liquid in this sense (and especially if no one is sure who holds them) then everyone wants to get into Treasury bonds. We have seen this very clearly recently in the widening yield spreads between Treasury bills and privately issued commercial paper.

In this process, some losses are incurred (and have been) but the more important risk is that a need to liquidate can force otherwise solid enterprises into failure. (I have to add that one of the papers that helped make Ben Bernanke's reputation as an economist was his 1983 article outlining the large, real costs of the demise of banking institutions during the 1930s.) There is no way to rule this possibility out based on market forces alone: If everyone else wants to cash out, then I want to be first in line. So we need a second commitment by the Fed, unrelated to inflation control, to stand ready to provide the liquidity if needed to serve as lender of last resort.

* "Prix Nobel" d'économie en 1995.

By reducing the discount rate and encouraging use of the discount window -- instead of reducing the funds rate until yesterday -- I think Mr. Bernanke was trying to separate the short-term problem of lender of last resort and the long-term problem of inflation targeting, and to show that we can and will deal forcefully with the liquidity crisis, if one should emerge, without weakening the commitment to price stability.

The need for a lender-of-last-resort function is one qualification to the discipline of inflation targeting, but it is a necessary one. There is a second line of argument that seems to me much less compelling. It starts with the fact that monetary policy necessarily affects future inflation rates, not the current rate: That has already been determined when the open market committee meets. We also know that whatever funds rate target is chosen, all kinds of others forces -- anything that happens to the real economy -- will affect next quarter's rate of inflation, or next year's. So we would like to forecast these other forces as well as possible and take them into account.

There is nothing wrong with this logic, but how useful it is depends on how good we are at forecasting the non-monetary determinants of prices. In fact, inflation forecasting is notoriously one of the squishiest areas of economic statistics. In this situation, it is all too easy for easy money advocates to see a recession coming and rationalize low interest rates. They could be right -- who really knows? -- and in any case we may not know enough to prove them wrong.

So I am skeptical about the argument that the subprime mortgage problem will contaminate the whole mortgage market, that housing construction will come to a halt, and that the economy will slip into a recession. Every step in this chain is questionable and none has been quantified. If we have learned anything from the past 20 years it is that there is a lot of stability built into the real economy.

To me, inflation targeting at its best is an application of Milton Friedman's maxim that "inflation is always and everywhere a monetary phenomenon," and its corollary that monetary policy should concentrate on the one thing it can do well -- control inflation. It can be hard to keep this in mind in financially chaotic times, but I think it is worth a try.

Mr. Lucas, professor of economics at the University of Chicago, received the 1995 Nobel Memorial Prize in Economic Sciences.