

# THE ROLE OF MONETARY POLICY IN THE FACE OF CRISES

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In this article I first review the Greenspan Fed's record of providing liquidity in response to its perception of shocks the economy is facing. It assumed that the shocks were likely to generate financial crises. No financial crises, however, have occurred. Yet the Fed was dilatory in draining the market of unneeded liquidity. Failure to do so meant that monetary policy remained accommodative.

I next discuss whether there is a connection between the Fed's accommodative policy and the depreciation since 2002 of the exchange value of the dollar as well as the twin deficits and growing global imbalances. In that discussion I refer to the need to raise the national saving rate, in part by eliminating the budget deficit as well as projected deficits from the unfunded liabilities of Social Security and Medicare. Monetary policy, however, must be independent of fiscal policy.

I conclude with some observations on the advisability of adoption by the Fed of inflation targeting.

## The Accommodative Fed

Note the difference in the Fed's behavior in 2000 compared with the way it performed from 2001 to 2005. Because of apprehensions that the 2000 millennium would create widespread computer problems, the Fed undertook to provide a massive infusion of reserves into the monetary system. The year ended without incident. At the start of 2000, the Fed promptly withdrew the additional reserves.

In 2001, the Fed perceived that the economy would sustain shocks that it was prudent for it to counter with low interest rates. Among the shocks it observed were the recession that began in March, then the terrorist attacks in September, corporate accounting scandals, low

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employment growth in the initial months of the recovery, hikes in the price of gasoline, and in each case, the financial crisis the Fed feared would ensue did not eventuate. Yet the Fed kept the Fed funds target rate unchanged at 1 percent from July 2003 to June 2004, unjustified in view of the economy's growth rate, and then only slowly raised the rate 25 basis points each month until it paused at 5.25 percent in August 2006.

Among the consequences of the policy of maintaining interest rates at an inappropriate low level were credit and mortgage market distortions, discouragement of personal savings, incipient inflation, and depreciation of the dollar foreign exchange rate.

## Are There Links between Fed Policy and Indicators of Global Imbalances?

In the quarter of a century between 1980 and 2006, in only three years was the U.S. current account in surplus and the capital account in deficit.<sup>1</sup> In every other year the current account was in deficit, that is, the United States imported more goods and services than it exported. The deficit in the past was small, \$1 billion or \$2 billion. Currently, the deficit is about \$800 billion. Matching the current account deficit is the capital account surplus, that is, foreign investors financed the current account deficit by purchasing U.S. assets in excess of the purchases by U.S. investors of foreign assets.

The U.S. domestic saving rate is low. Perhaps the Fed's recent low interest rate policy has contributed to this trend, but there are surely other forces. One is that increasing individual wealth raises consumption at the expense of saving. A recent discussion paper by economists at the Minneapolis Fed and New York University proposes that the fall in U.S. cyclical volatility, greater than that experienced by its partners, reduces incentives to do precautionary saving, and can account for 20 percent of the U.S. external imbalance (Figli and Perri 2006). While personal saving has been declining, corporate saving has

<sup>1</sup>The source of dollar and percentage numbers cited in this section is the *Economic Report of the President* (2006). Martin Feldstein (2006) criticizes the analysis in Chapter 6 of that report, "The Capital Account Surplus," for attributing the inflow of capital to the United States to private sector investors attracted by high earnings of U.S. businesses. That explanation was true in the 1990s but is no longer accurate. The equity share of the total capital inflow to the United States has fallen from 54 percent in 1999 to only 12 percent in 2004. Feldstein asserts that almost 90 percent of the capital inflow is now in the form of fixed income coming from governments that the data do not fully identify, and that the United States cannot assume that governments will continue to hold and acquire U.S. Treasury securities. He assumes that what has happened since 2004 is a trend change rather than a temporary deviation from past practice.

been stable, but public sector saving has also been declining. The fiscal deficit has contributed to the demand for foreign saving to finance the current account deficit.

So U.S. domestic savings are inadequate to provide funds for U.S. domestic investment opportunities. What attracts foreign capital to the U.S. is the economic growth differential here compared with the growth rate in their native countries, U.S. high productivity growth, low transaction costs owing to large and efficient financial markets, a welcoming business climate, and the willingness of foreigners to hold dollars and dollar-denominated assets.

The evidence does not support the notion of a reliable relation between the fiscal deficit and the current account deficit—the so-called twin deficits. The relationship has sometimes been observed, and at other times has not. This is true for the United States as well as other countries. Thus in the United States from 1983 to 1989, domestic private saving and domestic investment were about equal, as were the trade deficit and the federal budget deficit, fostering the notion of a relation between the twin deficits. In the 1990s, however, the budget deficit declined and became a surplus, while the current account deficit surged. In recent years, as the federal budget deficit has grown along with the trade deficit, the twin deficits notion has been revived. The unreliability of the twin deficits framework is illustrated by the experience of Japan and Germany, where current account surpluses and capital outflows have been accompanied by large fiscal deficits that were more than offset by private saving balances.

The idea was that the federal budget deficit and private sector investment were sources of demand for capital. Domestic private savings and the trade deficit were sources of supply of capital. It is true that since 2001, expansionary fiscal policy has created budget deficits that increased domestic spending for capital and imports. Expansionary monetary policy then lowered interest rates, which should have discouraged foreign investment but did not, and depreciated the dollar exchange rate. The weak dollar should have made American goods cheap for foreigners and imports expensive for Americans, which has not occurred. The validity of this framework is obviously questionable as an explanation of external developments, even though in recent years both the budget deficit along with the trade deficit rose.

Some observers conclude that the persistent current account deficit is a U.S. problem that only the United States can solve (Steil and Chinn 2006). They are wrong. The current account deficit is a global problem that other countries and the United States must cooperate to

manage. The reason the United States is the world's largest recipient of net capital inflows from industrialized countries (Japan, Germany, China) and from oil-producers and exporters (Russia, Saudi Arabia, et al.) has much to do with the conditions in those countries that yield lower returns on investment there than can be earned in the United States. In addition, central banks of some capital exporters as a policy choose to hold foreign reserves in dollar assets.

What then is the path to reduce global imbalances not only of the U.S. current account deficit but also the imbalances of capital exporters to the United States?

What the United States can contribute is a program to raise national savings, in order to narrow the gap between domestic saving and investment, and thus to lessen the need for other countries' savings. That step will require political will to eliminate the existing fiscal deficit as well as the projected unfunded liabilities of entitlements. The United States must also undertake a sustained campaign to induce the public to increase its personal saving rate.

The Fed must be a bystander with respect to action or inaction in the matter of the unfunded liabilities of Social Security and Medicare entitlements. These are fiscal problems that should not affect monetary policy. In the past, the Fed was snookered into coordinating monetary policy with fiscal policy. The 1968 income surtax the Johnson administration persuaded Congress to enact is an infamous example of the erroneous response by the Fed to fiscal action. The misguided Fed decided that it was its responsibility to provide monetary ease to offset fiscal tightening, unwittingly accelerating ongoing inflation. Coordinating monetary with fiscal policy is not the Fed's mandate. Sooner or later the polity must confront the problem of the government's unfunded liabilities. The Fed should stand clear of any involvement.

I now discuss the adjustments by the leading capital exporters with current account surpluses that are required to reduce their own and the U.S. imbalances. In all four countries—Japan, Germany, China, and Russia—domestic savings exceeded domestic investment. Each country exported its surplus savings, with Japan sending the lion's share, not because the Japanese savings rate has increased, but because its domestic investment rate has declined. That decline occurred as a result of slow economic growth for many years until 2005 following the bust in the late 1980s of boom conditions. If Japanese economic growth strengthens and persists, its savings will be needed for home investments rather than sent abroad.

Germany was a capital importer in the decade ending 2000, but by 2004 became second to Japan as the largest capital exporter, also

because of a declining rate of home investment rather than a rising rate of saving. Germany's economic growth has been impeded by legal and policy regulations that stifle business formation and employment. Labor market reforms have been introduced, but it remains to be seen whether the effort to improve flexibility in labor and product markets succeeds. If it does, and economic growth revives, German savings will be needed to finance home investment rather than exported.

Although China is the recipient of large capital inflows, it is a net capital exporter, third in order of magnitude, after Japan and Germany. China's capital outflows are occasioned by its central bank's hoarding of foreign reserves. Increases in its foreign reserves are matched by increases in its current account surpluses. China's saving rate, the highest in the world, has outstripped even its colossal domestic investment rate. The high saving rate can be attributed to China's aging population, the absence of a social safety net, and a lack of financial market provision of consumer loans. China's exchange rate policy to deter currency appreciation also limits consumption. A stronger yuan would increase China's global purchasing power.

The prescription for China to reduce its current account surplus is to shift to domestic production instead of overemphasizing exports, to promote financial development that will finance consumer purchases, and to liberalize its exchange rate to a greater extent than it has hitherto. The U.S. Treasury has pressured China to accelerate the appreciation of the yuan as a way of constraining its exports to the United States. I suggest a different form of pressure on China that may be more effective than the exchange rate gambit. China requires its exporters to deliver to a government agency the dollar proceeds of their exports, for which they obtain yuan. The Treasury should pressure China to allow exporters to keep their dollar revenues. Some dollars would probably be spent on U.S. goods and services, reducing the U.S. current account deficit, and raising the standard of living for China's consumers.

Russia became the fourth largest capital exporter in 2004. It has enjoyed larger export proceeds from rising oil and natural gas prices and its current account surpluses have risen in tandem. Fiscal surpluses have also risen. Although national saving has increased, the share of saving by the private sector has fallen. Other oil and gas producers have also increased their capital outflows and current account surpluses. Russia and the other oil and gas producers need to increase investment in domestic projects to reduce their national saving rates. Some investment spending, however, could be directed to improve oil sector production.

The foregoing assessment of global imbalances has not mentioned the Federal Reserve. Historically, the Fed has not regarded the balance of payments as its responsibility. The role of the Fed is limited to its core responsibility: deliver price stability. By performing this role, it will assure the soundness of the dollar, maintain the attraction of the United States as a desirable place for investment, and facilitate the global adjustment of imbalances.

Let me conclude with remarks about scenarios proposed by some alarmists. They envision that holders of dollar reserves will dump them because the dollar magnitude of U.S. indebtedness to the capital exporters has magnified the risk of dollar repayment. The U.S. will be compelled to raise interest rates yielded by dollar assets, resulting in a depression that will imperil the whole world. The dollar, alarmists believe, will be replaced by the euro as the reserve currency.

The U.S. net foreign debt in 2004 was \$2.5 trillion, or 22 percent of GDP. Despite the level of foreign debt, the U.S. earned \$30 billion in net foreign income. It earned over \$200 billion in net foreign income from 1995 to 2004, although its net foreign debt grew by \$3 trillion during that period. When debt earns a positive return, it does not appear to be a burden. Moreover, net capital inflows are likely to decline in the future as the adjustment process proceeds.

The scenario that envisages foreign holders dumping dollar assets is not credible. If China and other hoarders of dollars were willing to accumulate them from 2001 on, when the interest return on short-term government securities was minimal, why would they dump them in 2006, when the size of the return is more normal? A switch from dollars to the euro is also questionable. Is the stagnant economy of the European Union a credible competitor to the vibrant U.S. economy? The dollar's role as a reserve currency is not threatened by the euro. In 1995, 59 percent of global foreign reserves were in dollar assets. In 1999, the percent rose to 71 percent. In 2004, the percent declined to 66 percent. A flight from the dollar by holders of dollar-denominated assets is not under way.

## Should the Fed Adopt Inflation Targeting?

The Fed has already informally adopted one element of inflation targeting. It has announced that its target for the core consumer price index is 1 to 2 percent inflation. The element that it has so far not adopted is communicating with the public by means of a periodic report that summarizes the Fed's concerns and how it proposes to deal with them. Whether or not the Fed formally operates as an inflation targeter, it should certainly improve its communication with

the public. Too often the statement it issues about the Fed funds rate after each Federal Open Market Committee meeting uses language that can be interpreted in a variety of ways. A flood of commentaries appears after each statement and after the release of the transcript of an FOMC meeting. This is not the experience of the Bank of England, the European Central Bank, and other central banks that target inflation. They issue reports that are unambiguous. The Fed should study these reports and try to improve the content of its communications.

On the central issue of whether the Fed should formally declare that it will target inflation, Alan Greenspan's opposition to such a course should give advocates pause. He cautioned that an inflation target would imperil the Fed's independence, that Congress would feel free to advise the Fed that the target was too low, that a recession labeled "a jobless recession" would motivate legislators to draft legislation instructing the Fed to raise the target enough to generate jobs, and that, if the Fed has a target for inflation, it can also have a target for real GDP growth. I believe these are serious reasons for the Fed to hesitate about adopting an inflation target.

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