

An Underreported Counterinterview on Fed Policy

Arpit Gupta | August 11, 2010

The latest transcript from the FOMC reveals a Fed more concerned than before about the downside risk of deflation. The body has affirmed that interest rates will remain low for an extended period of time, and has decided to reinvest the proceeds of agency-backed mortgage backed securities into long-dated Treasury debt. Many of the more extraordinary interventions at the time of the financial crisis are over, but the Fed continues to pay banks a sizable interest rate for holding their reserves.

While looser policy during times of crisis is frequently thought to be well warranted, it does raise potential concerns about moral hazard. One skeptic raising these views is Raghuram Rajan, who is widely known for his prescient warnings on the financial crisis, but has continued with a wave of comments on current policy.

One of his recent arguments is that a prolonged experience of low interest rates may be damaging to the economy, and so the Federal Reserve may wish to tighten monetary policy sooner than it may otherwise prefer.

This call, coming as it does in the midst of a large economic downturn, came under stiff criticism from both the left and right recently. Many observers instead favor looser monetary policy in order to combat the potential for deflation.

Yet as Macroeconomic Resilience points out, there is something more subtle going on here – Rajan does not want higher interest rates simply because he thinks that low interest rates drive risk-taking (though he does imagine this to be the case).

Rather, in a paper with Peter Diamond, Rajan has stressed the importance of interest rates in driving the financing structure of banks. As long as interest rates remain low, and central banks are committed to increasing liquidity – banks will be reluctant to hold capital for precautionary reasons. Instead, they will likely invest it in Treasury bills or hold their reserves in accounts with the Fed. As Rajan and Diamond point out:

If the authorities are expected to reduce interest rates when liquidity is at a premium, banks will take on more short-term leverage or illiquid loans, thus bringing about the very states where intervention is needed.

Nobel Laureate Eric Maskin, Janos Kornai, and Gerard Rold have raised these concerns as well. Central banks hold a dual role in modern economies. Aside from setting monetary policy through open-market operations on sovereign debt, they also typically operate as the lender of last resort during times of extreme stress. The mechanics of this operation have been famously echoed by Bagehot in his suggestion that banks lend freely against good collateral in stressed times.

Yet the Fed's decisions to provide increased amounts of liquidity and perform extraordinary operations during moments of crisis distort the incentives for banks. Instead of operating a stable capital structure and preparing for the eventuality of losses, banks can instead operate in a risky and leveraged manner –while counting on central bank provided liquidity-support in the event of a crisis.

In particular, banks will continue to gravitate towards cheaper short-term funding, such as repo financing. The effects of countercyclical and crisis-oriented



policies, though intended to stabilize the system, wind up impacting the expectations of private banks, and distorting their incentives to create a stable capital structure.

This is related to the so-called “Greenspan put.” Over the past decades, the Fed drastically cut short-term interest rates after every crisis – from the 1987 market crash to the 9/11 crisis. Once investors realized that Fed action would assist them in the event of a loss, this unofficial guarantee led to higher asset valuations and greater risk taking overall.

These problems are compounded by implicit guarantees by the federal government that the largest financial institutions cannot be allowed to fail. Explicit bailouts, in the form of TARP-like equity injections – as well as other policies that have become a part of the economic policy toolkit can all work to distort the risk-taking behavior of financial institutions.

Short of having credible mechanisms that would allow for the orderly failure of financial institutions, the next-best alternative would be clear guidelines mandating that banks hold sufficient long-term capital to meet losses, as well as cash on hand to handle potential liquidity problems in the event of a crisis. Unfortunately, both the recent financial regulation bill and Basel III appear to have missed the mark on both fronts.