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SPECIAL COMMENTARY

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"What Keeps Us Up at Night?"

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Three Issues That Keep Us Up at Night[1]

Three issues keep us up at night. They are the basis of what we see as fundamental movements in the economic sphere that are being met by policy makers in only a superficial way. Over the last year, we have repeatedly seen that these superficial monetary and fiscal policy moves have been ineffective in dealing with the three issues we will address here. We believe policy is piling on the Band-Aids while the source of the bleeding is left unattended.

Economics: More Than Just the Business Cycle

First, current economic difficulties reflect both cyclical and structural forces. Policy makers emphasize the traditional "Keynesian response" to a sudden drop in aggregate demand. There is an emphasis to getting us back to where we were. However, it is where we were that was out of step with long-run sustainable growth. There simply were too many retail stores, financial services and manufactured goods financed on credit to be sustainable. Going forward, the structural movement toward less-leveraged consumer/housing finance dictates a conflict between policy promises and economic reality. The pace of sustainable economic growth is likely to be lower over the next five years than during the five years prior to the recession. The attempt to "getting us back to where we were" should therefore entail policy actions that would sustain spending above the pace consistent with sustainable long-run trends. This will force spending, employment and fiscal deficits above the long-run equilibrium rate. Pricing and resource allocations are likely to be distorted.

Moreover, extensive promises of macroeconomic growth via stimulus tend to fall prey to the Lucas critique.[2] That is, policy advice based on conclusions drawn from large scale macro models fails because the parameters of those models are not structural – that is, not policy invariant. They would necessarily change whenever policy – the rules of the game -- changed. Therefore, policy conclusions based on those models have the potential to be misleading. Instead, parameters must reflect individual behavior. We can then predict what individuals will do by taking into account the change in policy, and then aggregate the individual decisions to calculate

[1] As prepared for presentation, March 25, 2009 at the Global Interdependence Center, Banque de France Conference. Paris, France.
[2] See Lucas, Robert (1976). "Econometric Policy Evaluation: A Critique." Carnegie-Rochester Conference Series on Public Policy 1: 19–46.

the macroeconomic effects of the policy change. These individual predictions must be built upon the micro foundations of individual household and firm behavior.

Yet, while policymakers talk of stimulus, many current policy proposals are anti-stimulus to the extent that they suggest policy actions that are disincentives to growth. Higher taxes, more regulation and greater trade protectionism are not pro-growth policies, and, if enacted, would offset much of the macro stimulus proposals.

Federal Reserve as Policeman

Second, credit policy appears aimed at sustaining institutions rather than addressing the fundamental problem of transparency and the quality of information. News coverage focuses on people and institutions with very little emphasis on the underlying problems. The misplaced focus has cost the economy, investors and taxpayers time and money. For example, the Federal Reserve has developed a plethora of specialized programs to address individual markets. Yet, the Fed appears like a policeman who stands on one corner to prevent crime, while crime persists wherever the policeman isn't. The Federal Reserve has provided significant liquidity to lower yields on federal funds and thereby lower LIBOR and the Ted spread. Yet, since January, spreads have widened on CMBS, high-yield and high-grade bonds. Treasury rates are lower, yet corporate high-grade and high-yield bond rates are higher. Market pricing remains inefficient and markets are incomplete reflective of the "Lemons problem."[3]

Financial problems began in earnest with the acknowledgement by BNP Paribas that it could not effectively price some assets in its portfolio in the summer of 2007; only then did the liquidity problems appear. The real issue is transparency and the quality of investment information. Where there is no transparency, policy makers have substituted taxpayer guarantees. These guarantees do not address the transparency problem. The guarantees provide a Band-Aid while the flow of misinformation on market prices and risk continue.

Decision Making: Collectivist Action

Third, we believe the process of decision-making itself is flawed. Two specific problems have developed in policy decision-making, in our opinion. Small distributional coalitions tend to form over time in countries. Groups, such as the housing industry, for example only, tend to form political lobbies and influence policies in their direction. These policies tend to be protectionist and thereby reduce overall economic growth by misallocating capital away from a free-market allocation. The benefits of these policies are concentrated among coalition members, while the costs are spread throughout society.[4]

A second issue with decision-making is its concentration. For example, in the United States we hear frequent proposals that regulation is too dispersed and that many problems during the last three years fell between the cracks. Yet, in Europe, regulation appears more concentrated and while problems have surfaced, the response appears to have been quicker and more effective in stopping the bleeding. In the U.S., by contrast, problems persist despite massive spending and the growth in the Federal Reserve balance sheet. That is what keeps us up at night.

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[3] See George Akerlof, The Market for 'Lemons'; Quality Uncertainty and the Market Mechanism, *The Quarterly Journal of Economics*, MIT Press, vol. 84(3), pages 488-500, August.
[4] See Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups*, Harvard University Press, 1965.

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