

How to Exit from Monetary Ease: A Historical Perspective

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Introduction

- Recent recession is familiar in the sense that it is within the realm of postwar recessions
- But it is novel in the sense that it was precipitated by a financial crisis consequent on the end of a major housing boom.
- The financial crisis is the most serious event since the Great Depression
- The crisis and recession were dealt with by vigorous orthodox policy responses.
- And by unorthodox quantitative easing and the creation of credit facilities.
- The recession is now over and the question arises how to return to normal growth and low inflation—the exit strategy.
- When should this happen?
- Two views: 1. because of the financial turmoil recovery will be slow and exit is far in the future

Introduction

- 2. The recovery will be V shaped as was the case in other serious recessions in the twentieth century including the Great Depression
- The risks facing monetary policy with respect to the exit strategy:
 - A) tightening too soon and creating a double dip recession
 - B) tightening too late leading to a run up of inflation
- The paper considers the lessons from U.S. monetary history of an incorrect exit .

Tightening too soon

- 1937-38 -Recovery from depression aborted by Fed doubling of reserve requirements 1936-37 because of concern that banks excess reserves would lead to speculation and inflation
- - This led to recession of 1937-38 after banks reacted by increasing precautionary reserves.
- 1981-82 Volcker tightening from Great Inflation 1979-1980 was halted in mid 1980
- Seen as signal Fed not committed to rolling back inflation
- New round of Fed tightening late 1980. This round which raised the FFR to 20% did succeed in reducing inflation but at the cost of a sharp and prolonged recession.

Tightening Too late

- 1966 and 1969. Credit Crunches aborted in face of political pressure
- 1973 Burns backed off from tightening under political pressure
- Belief in permanent Phillips curve tradeoff.
- 2001-2004 Fed expansionary policy to head off incipient financial crises which never materialized and mirage of deflation.
- Infusion of liquidity led to housing boom

Policy Lessons

- 1. Fed can avoid 1937-38 error by paying interest on reserves.
- 2. Following a stable nominal anchor can make exit strategy easier
- 3. Fed should avoid succumbing to political pressure

Empirical Evidence

- Plan to examine panel of past recessions 1920-2009
- 1. Descriptive table to compare timing in changes in Fed policy instruments to macro indicators eg inflation, inflation expectations, deviations of real GDP from trend, unemployment, asset prices, indicators of financial turmoil.
- Historical narratives
- 2. Regression of timing of exit on characteristics of the business cycle, measures of inflation and inflation expectations and indicators of financial turmoil.