

Monetary Policy Implications of the Global Crisis

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Overview

- Start from the position that we had a monetary *framework that worked* well for years before the crisis.
- Theory: Inflexibilities and policy rules.
 - Many examples in Volker Wieland's model database
- Practice: Reasonably rules-based strategy for adjusting money supply and the interest rate.
 - Performance was good when policy was close.
 - Policy was poor when policy was far away.
- Then monetary policy deviated from this framework.
 - Interest rate held too low for too long
 - Unorthodox operations
 - Poor performance again
- Policy Implication: Implement a policy like the one that was working. To avoid more market disruption, announce and follow a clear exit rule.

Models in the Wieland Model Database

1. Small Calibrated Models

- 1.1 Rotemberg, Woodford (1997)
- 1.2 Levin, Wieland, Williams (2003)
- 1.3 Clarida, Gali, Gertler (1999)
- 1.4 Clarida, Gali, Gertler 2-Country (2002)
- 1.5 McCallum, Nelson (1999)
- 1.6 Ireland (2004)
- 1.7 Bernanke, Gertler, Gilchrist (1999)
- 1.8 Gali, Monacelli (2005)

2. Estimated US Models

- 2.1 Fuhrer, Moore (1995)
- 2.2 Orphanides, Wieland (1998)
- 2.3 FRB-US model linearized as in Levin, Wieland, Williams (2003)
- 2.4 FRB-US model 08 linearized by Brayton and Laubach (2008)
- 2.5 FRB-US model 08 mixed expectations, linearized by Laubach (2008)
- 2.6 Smets, Wouters (2007)
- 2.7 CEE/ACEL Altig, Christiano, Eichenbaum, Linde (2004)
- 2.8 New Fed US Model by Edge, Kiley, Laforge (2007)
- 2.9 Rudebusch, Svensson (1999)
- 2.10 Orphanides (2003b)
- 2.11 IMF projection model by Carabenciov et al. (2008)
- 2.12 De Graeve (2008)
- 2.13 Christensen, Dib (2008)
- 2.14 Iacoviello (2005)

3. Estimated Euro Area Models

- 3.1 Coenen, Wieland (2005) (ta: Taylor-staggered contracts)
- 3.2 Coenen, Wieland (2005) (fm: Fuhrer-Moore staggered contracts)
- 3.3 ECB Area Wide model linearized as in Dieppe et al. (2005)
- 3.4 Smets, Wouters (2003)
- 3.5 Euro Area Model of Sveriges Riksbank (Adolfson et al. 2007)
- 3.6 Euro Area Model of the DG-ECFIN EU (Ratto et al. 2009)
- 3.7 ECB New-Area Wide Model of Coenen, McAdam, Straub (2008)

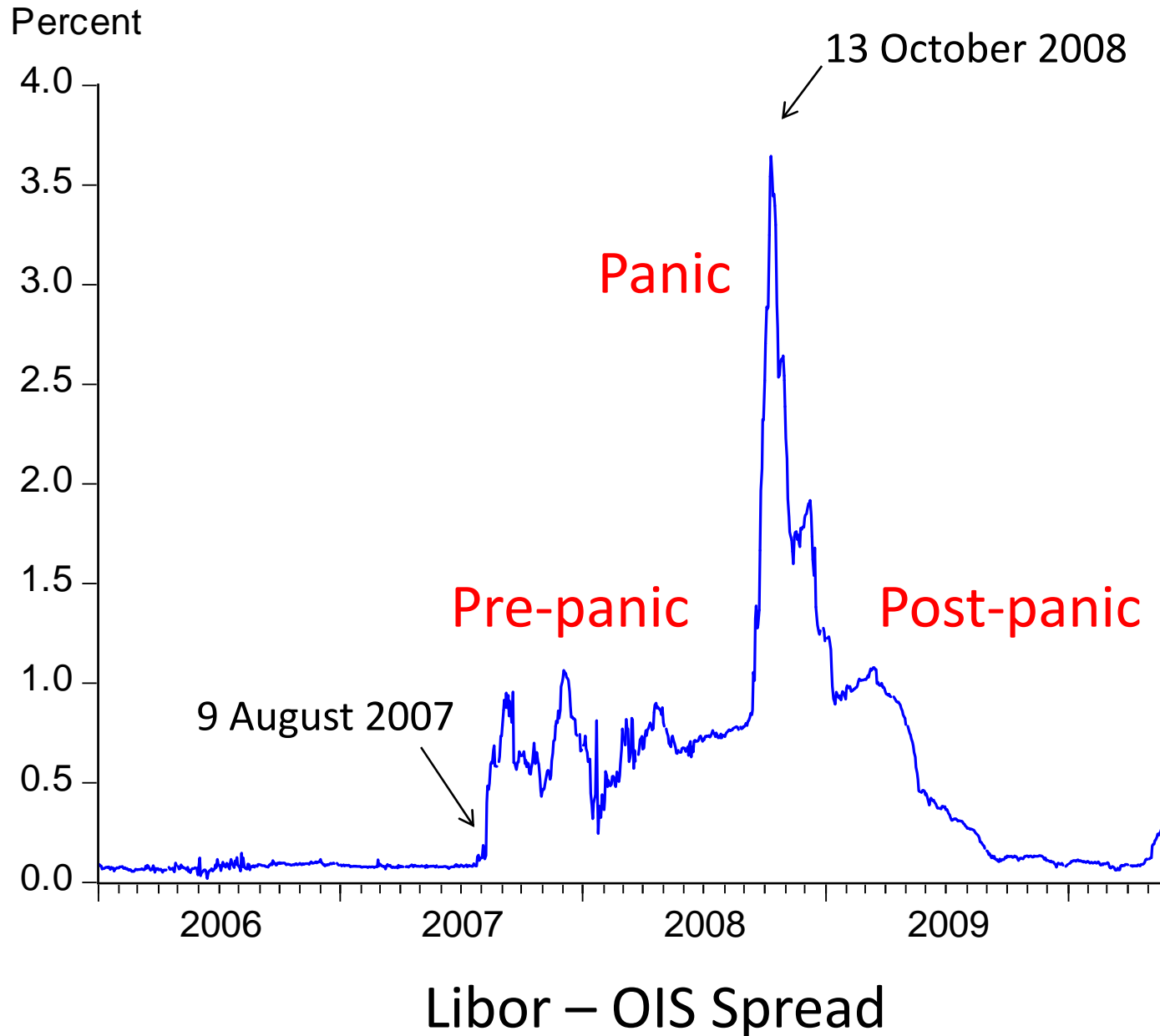
4. Estimated Small Open-Economy Models (other countries)

- 4.1 RAMSES Model of Sveriges Riskbank, Adolfson et al. (2008b)
- 4.2 Model of the Chilean economy by Medina, Soto (2007)

5. Estimated/Calibrated Multi-Country Models

- 5.1 Taylor (1993a) model of G7 economies
- 5.2 Coenen, Wieland (2002, 2003) G3 economies
- 5.3 IMF model of euro area & CZrep by Laxton, Pesenti (2003)
- 5.4 FRB-SIGMA model by Erceg, Gust, Guerrieri (2008)

Three Phases of the Crisis: Pre-Panic, Panic, Post-Panic

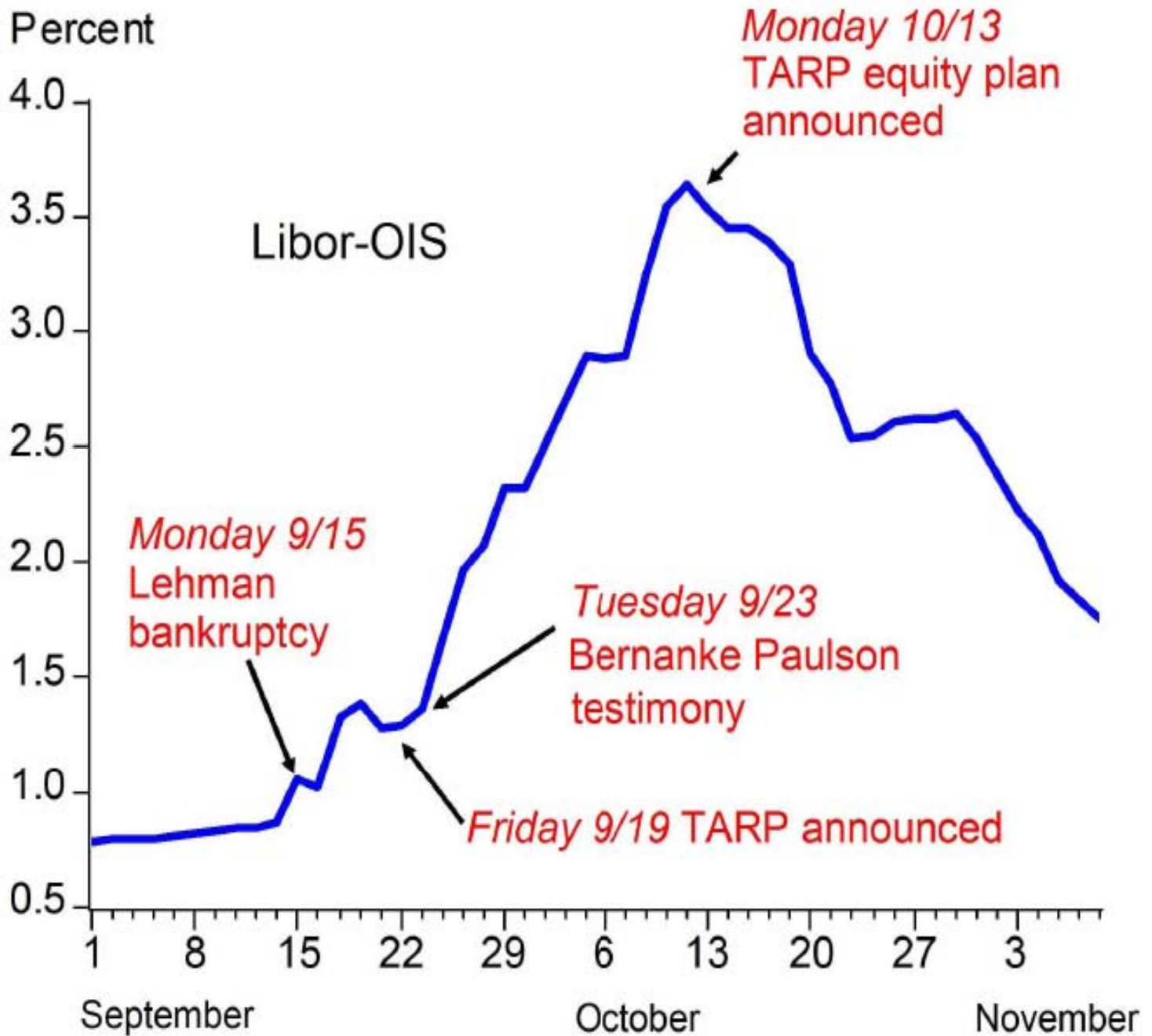


Before the Panic

- Unorthodox measures didn't work; some were harmful.
- Early on, TAF did not reduce tension in the interbank markets; drew attention away from counterparty risk.
- The chaotic bailout policy.
 - After Bear Sterns, people believed Fed's balance sheet would be available in the case of Lehman
 - But it was turned off.
 - Balance sheet then reopened to rescue creditors of AIG.
 - Then turned off again and the TARP proposed.
- These unorthodox policies were part of an unpredictable response to the crisis that led to panic.

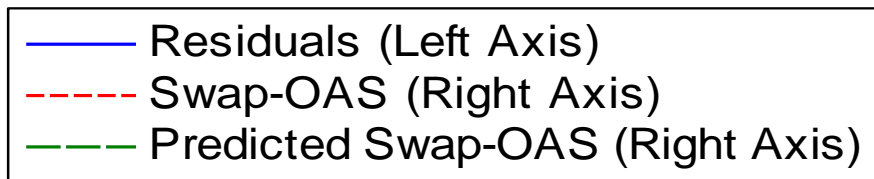
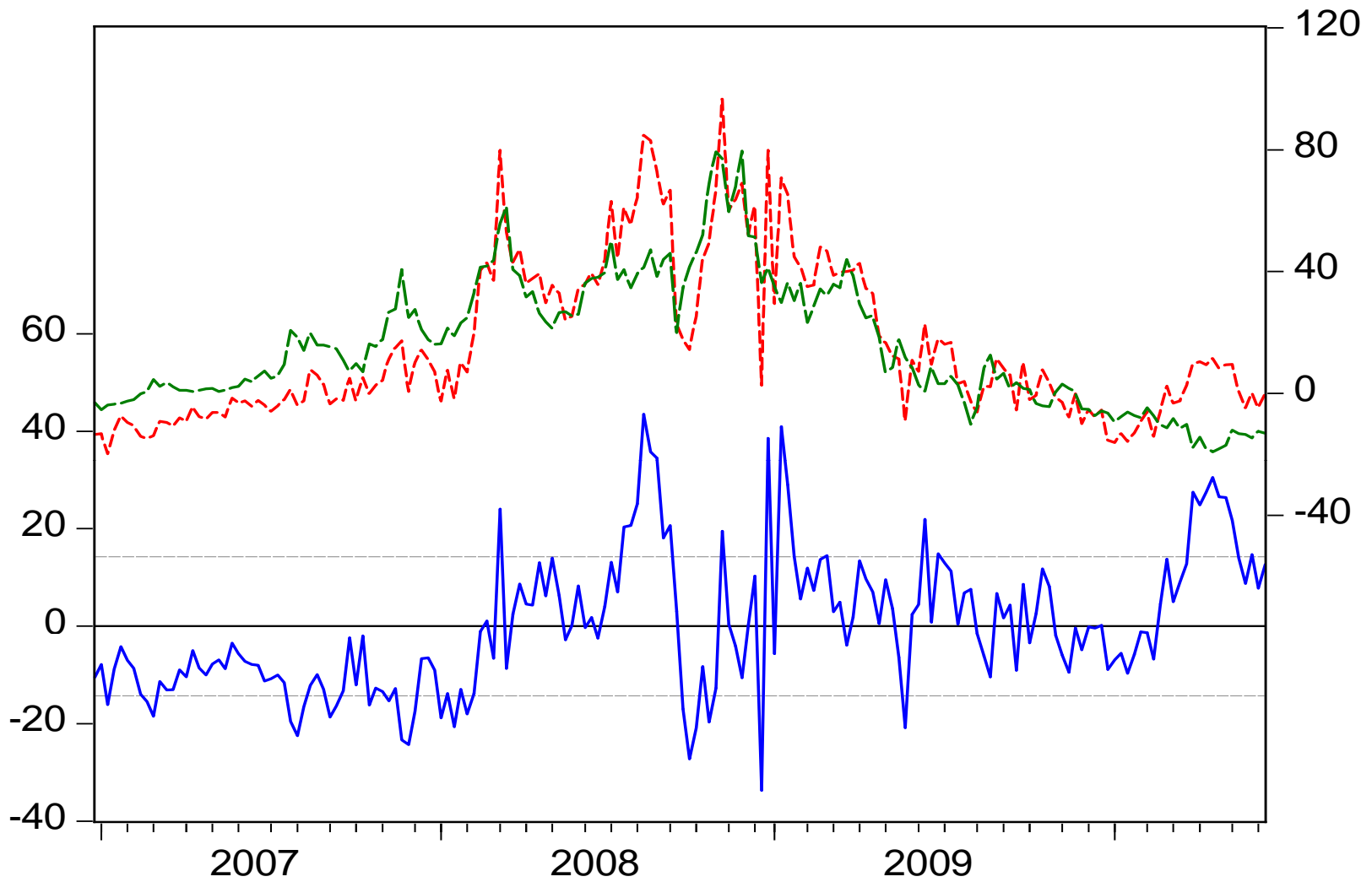
During the Panic

- Difficult to analyze because unorthodox measures were intertwined other actions
 - Such as clarification that the TARP would be used for equity injections.
- But AMLF and the CPFF were helpful
- Also helped restore confidence by quickly setting up new programs and working closely with other central banks on swap lines.



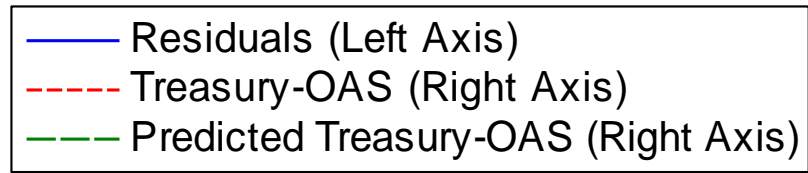
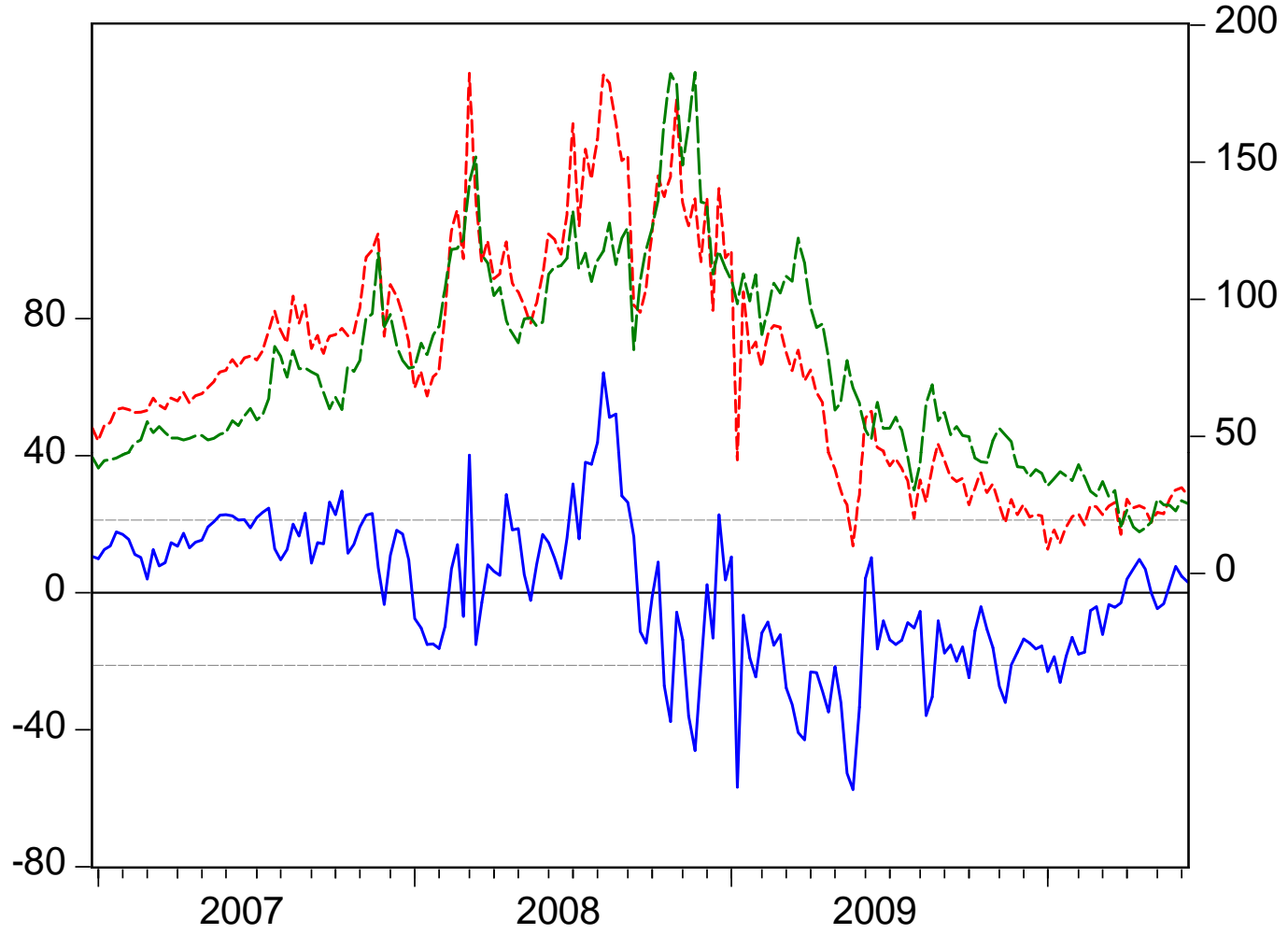
After the Panic

- Unorthodox policies now mainly asset purchases rather than loans
- Biggest was MBS program--\$1.25 trillion.
 - Without this, balance sheet would be back to normal.
- Stroebe and Taylor find that program had little or no effect...



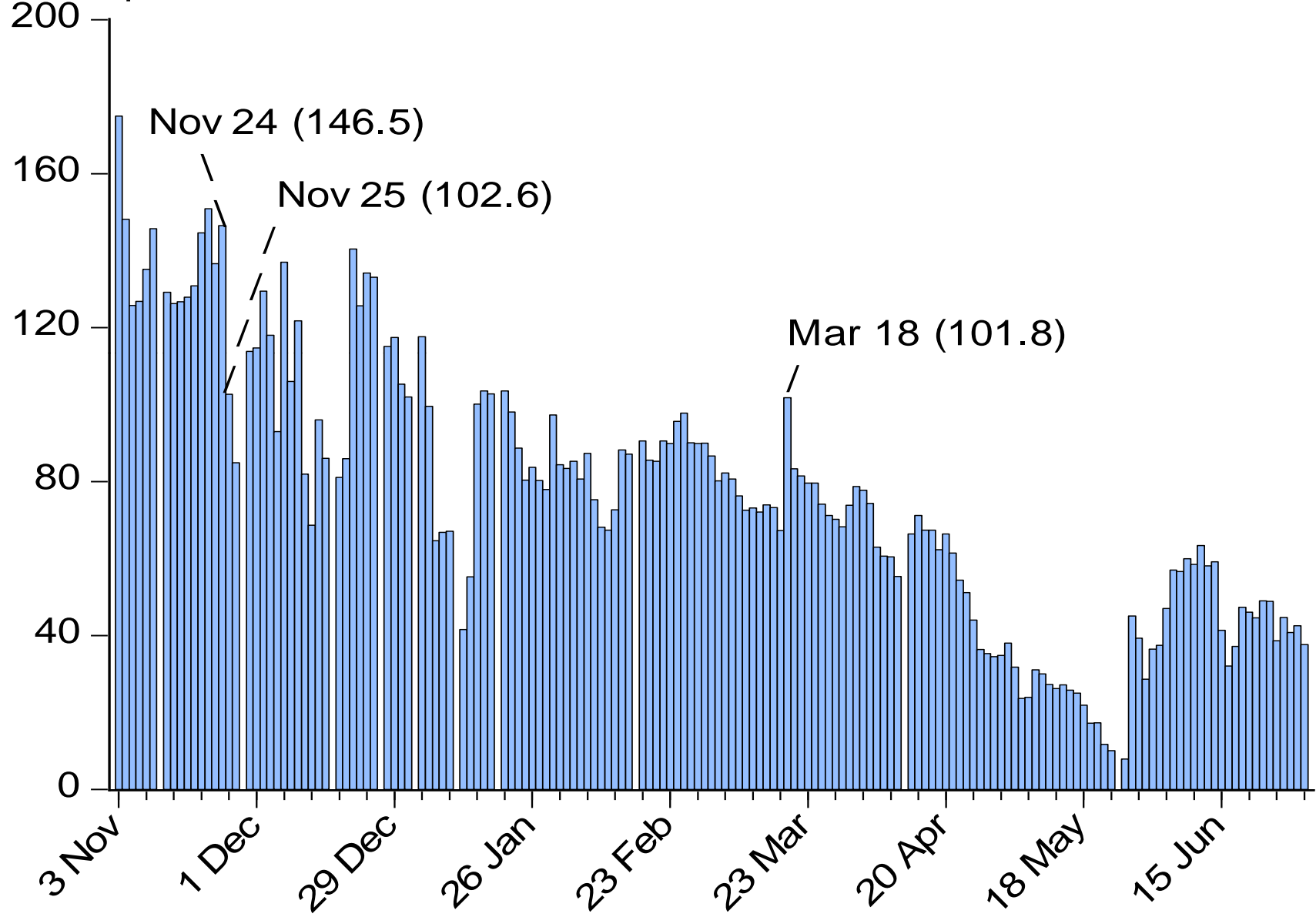
Basis points

Basis points



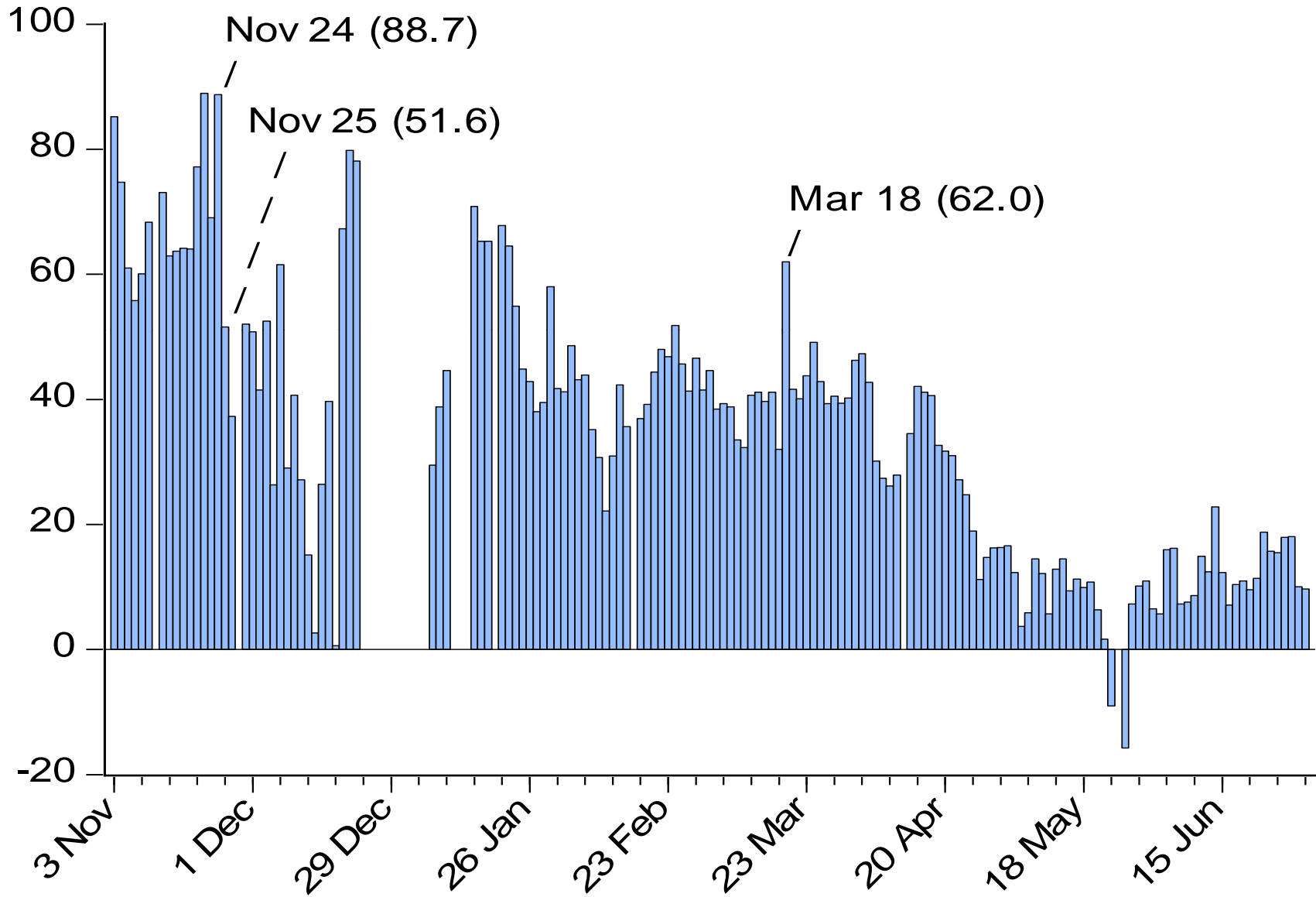
Treasury OAS

Basis points



Swap OAS

Basis points



It's Part of a Bigger Problem

- As described by Shultz, Boskin, Cogan, Meltzer, and Taylor in today's *Wall Street Journal*:
- “The history of recent economic policy is one of massive deviations from basic economic principles.”
- “The result has been a crippling recession and now a weak, nearly nonexistent recovery.”
- “The deviations began with policies—like the Federal Reserve holding interest rates too low for too long...”
- “The departures from sound principles continued when the Fed and the Treasury responded with arbitrary and unpredictable bailouts...”
- “The good news is that we can change these destructive policies by adopting a strategy based on proven economic principles. “