A Case Against “Do Something” Policymaking

BY ROBERT L. HETZEL

In response to the current world recession, governments and central banks have undertaken dramatic policy initiatives. They have enacted fiscal stimulus packages to jump-start spending by the public. Similarly, they created financial-aid packages to recapitalize banks and remove their distressed assets in order to restart lending and further jump-start spending by the public. But are these initiatives the result of calculations made by economists using models widely vetted and supported within the economics profession? Or are they simply meant to respond to the “do something” imperative of the crisis?

If the policy initiatives fall into the latter category, do they really treat the causes or merely the symptoms? A symptom of recession is that public spending is not at the level it would be if the economy were at full employment. But does it then follow that the government should make up the difference? Another symptom of recession is that banks do not lend at the full employment level. So, does it again follow that governments and central banks should make up the difference here?

Seemingly intuitive responses to the distress suffered during recessions can not only be ineffective but also harm long-term economic growth. In recession, the imperative to end suffering leads to policies that interfere with markets and supersede the working of the price system. Indeed, government intervention to deal with recessions creates the perception that government is fixing a problem created by free markets. These interventions tend to limit failures among financial institutions and restrict the market allocation of credit. A trade-off appears to arise between policies that engender secular growth and policies that mitigate cyclical fluctuations.

When economists examine the circumstances surrounding the fluctuations in output over time, they see a correlation between financial instability (reflected in interruptions in the flow of credit) and real instability. But to make policy, policymakers need to judge whether this correlation reflects the cause or the symptom. If financial instability is indeed the cause, what is its origin? Is it due to the excessive risk-taking arising from the herd instincts of investors — the proverbial speculative mania of greedy investors? Or is it due to the excessive risk-taking arising from a financial safety net that socializes losses while preserving private gains?

The understanding that policymakers have of the relationship between risk-taking in financial markets and macroeconomic stability will affect government regulation of risk-taking. The regulations will, in turn, affect the nature of financial innovation and, as a result, the ability of markets to increase living standards over time.

It’s important to remember that financial innovation has been a powerful contributor to the rise in welfare. For example, the ability of families to smooth their consumption over time through the use of credit can make them better off. This ability derives from the broader availability of credit instruments to individuals. So, the policy question should be whether the current system combines a financial safety net with government regulation of risk-taking by financial institutions that promotes the optimal amount of welfare-improving financial innovation. Policymakers should ask whether the current system skews innovation toward strategies that provide high returns to financial institutions in good times while imposing losses on taxpayers in bad times — and, if so, how to most effectively alter that incentive. The public might be best served if regulators devised ways of committing not to bail out creditors of financial institutions.

More generally, rules should replace discretion. With respect to monetary policy, many central bankers accepted the perennially popular explanation of cyclical fluctuations as a manifestation of speculative euphoria followed by a bust. At present, high-risk premia and the shift from securitization in capital markets to borrowing from banks appear as evidence that financial markets are no longer facilitating the transfer of funds between savers and investors. However, if these are only symptoms of the increased probability of default in recessions, the diagnosis diverts attention away from the money creation required to stimulate spending. As a by-product of intervention into specific credit markets that many central banks have undertaken, monetary authorities may eventually create enough money to stimulate spending. But there is no assurance that they will be aggressive enough. Moreover, there is no assurance that central banks will follow a longer-run strategy to withdraw the resulting monetary overhang when the economy recovers.

So, the creation of rules for monetary and regulatory policy that incorporate lessons from historical experience is important to the functioning of a healthy free-market economy. Central bankers will have to abandon the language of discretion for the language of rules and for the analytical framework of economics. And both central bankers and academics will have to take responsibility for conveying insights in a way that an informed public can understand.

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