

Discussion of Sargent's Where to draw lines: monetary and fiscal uncertainties

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Introduction

Events of the last two years have brought home how poorly economists, collectively, understand how financial markets function and the role they play in facilitating the operation of 'real' activities.

Financial services in the economy are like oxygen in the air we breathe.

When they are available we don't notice them.

We only notice their absence.

Introduction

Monetary economics languished during the Great Moderation, but the Great Recession is reviving it.

Tom touched on many of the traditional issues in monetary economics: price level stability, efficiency of credit markets, lender of last resort, deposit insurance, and moral hazard.

He also added a new one (for economists): the political economy of fiscal/monetary decisions.

His paper raises many good questions.

Overview of this discussion

Rather than try to answer them, I will respond in kind, and ask more.

My discussion will be organized in terms of the *functions* served by money and other 'social contrivances.'

Institutions and regulations (money, CDOs, the repo market, deposit insurance) should be evaluated in terms of how efficiently they perform/facilitate those functions.

Technology in the financial system, as elsewhere, changes quickly, but the main functions served by that system are rather stable.

It is easier to bring historical evidence to bear, important for studying rare events like financial crises, if we focus on functions.

What does the financial sector do?

Start by asking: What is money? What functions does it serve?

What can *individual* agents accomplish with money that they couldn't accomplish without it?

What does *society* as a whole want from its financial institutions?

What alternative assets/financial market institutions can serve these functions?

Functions for individuals: portfolio choice (Tobin)

Motives for holding various assets, including money

1. store of value / returns (households)
2. transactions (firms, households)
3. precautionary (firms, households)

Cash—M1—M2—MZM—T-bills—CP—long bonds—equity

short, liquid, low return—————long, illiquid, high return

As stores of value the long, illiquid, high return assets dominate.

For transactions the short, liquid, low return assets dominate.

(Definition of 'liquid'.)

For the precautionary motive, it depends which agents/risks are involved.

Households facing risk of unemployment? (Aiyagari, QJE 1992)

Financial institutions facing potential runs?

Social functions

Institutional arrangements also have aggregate (social) consequences.

Financial crises can have two types of social costs:

- (total) the resulting drop in employment and output.

 - (How much GDP has been/will be lost in the current recession?)

- (distributional) capricious redistribution of wealth, resulting from bank runs, bailouts, distorted asset returns, and so on.

What should society expect from financial institutions, regulations?

1. price level stability (unit of account function)
2. macroeconomic stability (income, employment)
3. minimize capricious wealth transfers

Price level stability and credit market efficiency

Must we choose between a stable price level and an efficient credit market?

Between a unit of account and a store of value? I want both!

Central banks, after learning about inflation in a post-gold-standard world (the 1970s), have gotten pretty good at keeping (goods) prices stable.

(We hope they don't forget the lessons of the 1970s.)

Credit markets—equity and bond markets—match borrowers and lenders directly: no maturity or risk transformation.

In the bad old days only the rich could participate (and diversify).

Mutual funds have opened up these markets to 'small' lenders.

Vanguard requires a minimum deposit of only \$3000.

Financial crises and money demand

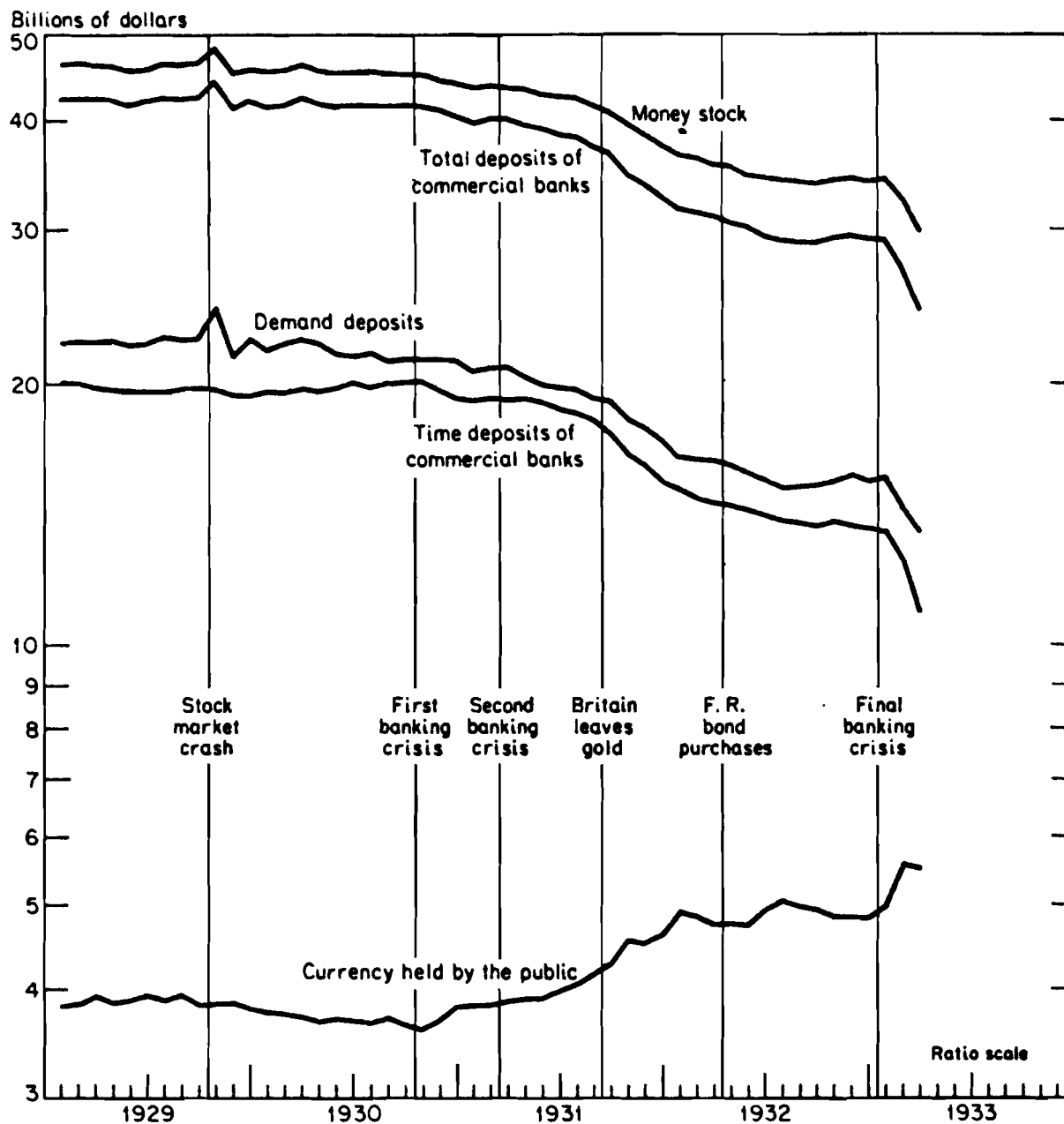
Financial crises (at least sometimes) involve a reduce ability to perform the 'medium of exchange' function.

The 'flight to quality' during a banking panic is an increase in the precautionary demands of various individual agents: households, non-financial firms, financial institutions.

The higher precautionary demand ties up liquid assets, so fewer are available to facilitate transactions.

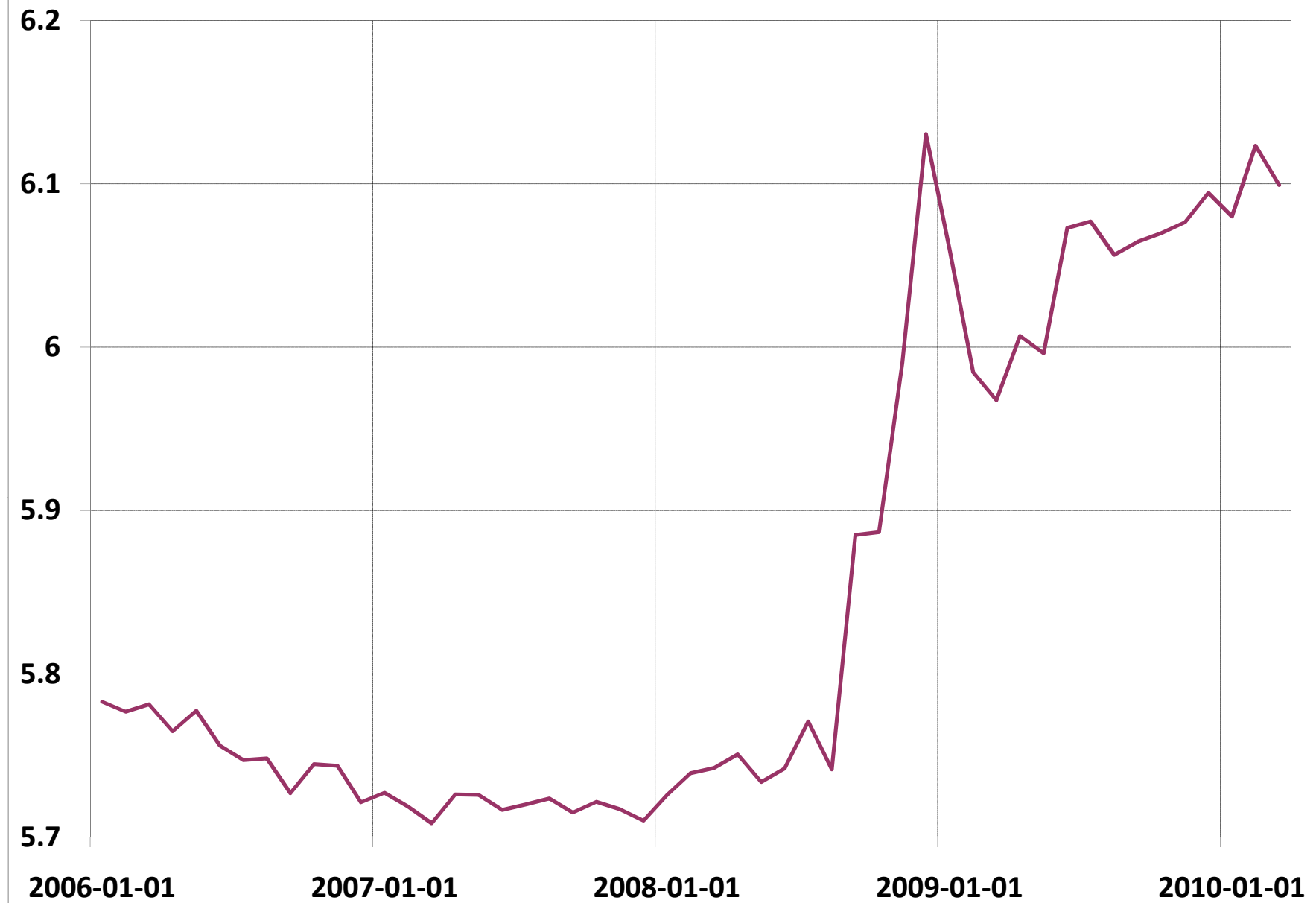
CHART 27

Money Stock, Currency, and Commercial Bank Deposits, Monthly, 1929–March 1933



SOURCE: Table A-1.

In (Demand deposits, \$billions), 2006-2010



Financial crises and bank runs

Bank runs are part of (exacerbate) the liquidity problem.

In the 19th century banks printed notes, to economize on the use of gold.

They promised to redeem these notes, on demand, for specie (gold).

During a financial crisis a bank, even a sound one, might suffer a run.

The resulting bank failures and/or suspensions of convertibility reduced the ability of the system to provide transaction services.

Friedman and Schwartz (1963) argue that more aggressive action by the Fed would have kept dampened the decline in the 1930s.

So there were two issues in the 1930s: bank failures and a passive Fed that refused to accommodate the higher demand for liquid assets.

Financial crises without bank runs

Deposit insurance has been successful in preventing bank runs, but that has solved only part of the problem.

Banks no longer issue their own notes, but institutions/arrangements that raise velocity perform a similar function.

Examples include sweeps, the repo market, and checkable deposits in accounts outside commercial banks.

The goal, as before, is to reduce the funds tied up in low-return assets.

These institutions/arrangements are also critical in facilitating transactions, so preventing runs on commercial banks is not enough.

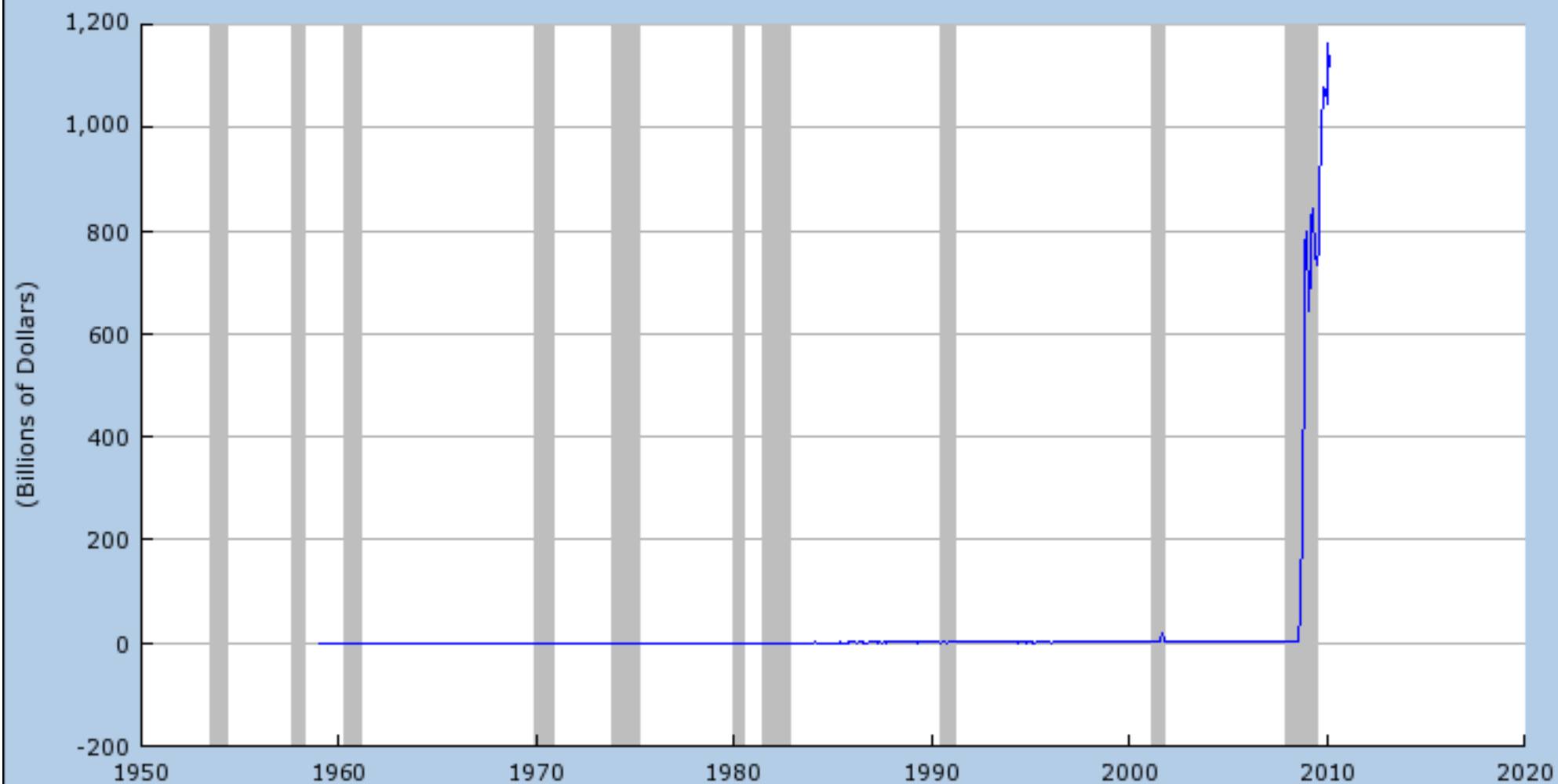
Financial crisis in the 21st century

In 2008 interbank lending plummeted, what Gary Gorton has called a “run on the repo.”

At the same time there was an enormous shift in the (precautionary) demand by financial institutions for highly liquid assets.

But this time the Fed increased reserves to accommodate the shift in precautionary demand, and also eased access to the discount window.

Excess Reserves of Depository Institutions (EXCRESNS)
Source: Board of Governors of the Federal Reserve System



Shaded areas indicate US recessions.
2010 research.stlouisfed.org

What went wrong?

But we got the Great Recession anyway, despite aggressive monetary and fiscal policy and the absence of bank runs.

What has gone wrong?

There was no hurricane or earthquake. No factories were destroyed.

The detonator and the bomb

The misallocation of resources in the housing market was substantial,
but was it large enough, by itself, to trigger a recession of this size?

Perhaps it was just the detonator that set off a much larger bomb.

Banks and other financial institutions in the modern world are tightly
interconnected.

Repos, swaps, synthetic CDOs, and other derivatives seem to make
the financial system more fragile in two ways:

- more connections, since there is no limit on gross positions;
- counterparty risk is harder to assess, since many contracts are OTC.

We lack models of the financial system that capture these features.

Financial crisis in the 21st century

What institutions/regulations would reduce the risk of a financial crisis?

Perhaps we should think about the electric grid for an analogy.

When a generator or a switching system fails, circuit breakers are triggered to contain the failure to a limited geographic area.

If we cannot prevent bank failures (or choose not to), can we limit the damage they inflict on rest of the system?

Can we invent circuit breakers that prevent contagion?

How can we protect the *functions* served by the financial system as a whole, without (necessarily) protecting individual banks or creditors?