Taylor Book Blames Fed, Government, For Causing, Prolonging Crisis

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March 17, 2009
Market News international

The Federal Reserve comes in for sharp criticism in a just-released book authored by John Taylor, one of the world's most renowned monetary economists.

Taylor, a Stanford University Professor who has consulted with the Fed and other central banks, blames the Fed and other governmental authorities for causing and then mismanaging the crisis.

The title of the short book says it all: "Getting Off Track: How Government Actions and Interventions Caused, Prolonged and Worsened the Financial Crisis."

Or, as Taylor sums up his findings, "They caused it by deviating from historical precedents and principles for setting interest rates that had worked well for twenty years. They prolonged it by misdiagnosing the problems in the bank credit markets and thereby responding inappropriately, focusing on liquidity rather than risk."

"They made it worse by supporting certain financial institutions and their creditors but not others in an ad hoc way, without a clear and understandable framework," he writes.

Taylor, a former member of the Council of Economic Advisors under Presidents Carter and Bush the elder and Undersecretary of Treasury for International Affairs under the younger President Bush, is perhaps best known for his Taylor Rule, which prescribes changes in the federal funds rate as inflation and/or output diverge from target.

He reserves some of his harshest criticism for the Fed, which he confesses is not easy for him to do, given his long association with the Fed, which has included perennial appearances at the Kansas City Fed's prestigious Jackson Hole conference.

But he says "some central bankers quietly say they agree with me.
Others thank me for doing it, one saying, for example, 'Your courage in putting forth your criticisms directly is admirable.'"

Taylor contends that "monetary excesses were the main cause of that (housing) boom and the resulting bust."

In cutting the federal funds rate to 1% in 2003, keeping it there for "a considerable period" and then raising it only at "a measured pace," Taylor says short-term rates "fell below what historical experience would suggest policy should be."

"This deviation of monetary policy from the Taylor rule was unusually large," he writes. "No greater or more persistent deviation of actual Fed policy had been seen since the turbulent days of the 1970s."

The Fed's easy money stance "accelerated the housing boom and thereby ultimately led to the housing bust," he charges

Former Fed Chairman Alan Greenspan, a long-time Taylor associate, as well as current Chairman Ben Bernanke, have argued that the housing boom was not caused by the Fed keeping the funds rate too low for too long, but rather because a "global savings glut" kept more important long-term rates low when the Fed was trying to tighten financial market conditions in the 2004-2006 period.

But Taylor rejects the Greenspan/Bernanke argument.

"The main problem with this explanation is that there is no actual evidence of a global saving glut," he writes. "The positive saving gap outside the United States was offset by an equal-sized negative saving gap in the United States."

Besides, he says, the housing boom was not due just to low long-term rates. "Housing demand also depends on short rates because of adjustable rate mortgages, which were about one-third of the mortgage market during the height of the boom," he writes.

"Moreover, the failure of long-term rates to adjust to monetary policy during this period was in part due to the decision to hold short rates down for too long, which likely affected expectations of future short rates and thereby long-term interest rates," he continues. "In other words when bond investors and traders observed the small or negligible movement of the short-term rate, they might have felt that the Fed had departed from the kind of rule that formed the basis of the larger long-term interest rate responses in earlier years."

Taylor contends that the European Central Bank and others also "deviated" in depressing rates under the Fed's influence.

Excessively accommodative monetary policy interacted with other government policies that fueled the subprime mortgage bubble, Taylor maintains. "Excessive risk-taking ... was encouraged by government programs designed to promote home ownership, a worthwhile goal but overdone in retrospect."

"The government-sponsored agencies Fannie Mae and Freddie Mac were encouraged to expand and buy mortgage-backed securities, including those formed with the risky subprime mortages," Taylor writes, noting that proposed legislation to reform the GSEs in 2005 was not enacted.

Taylor acknowledges that private sector players also bear some culpability, but says firms' search for higher yields "was partially due to a low interest-rate policy. In addition, existing regulatory and supervisory oversight rules were not enforced properly by the Federal Reserve or the Securities and Exchange Commission."

Not only did the Fed and other agencies cause the crisis, they prolonged and intensified it, according to Taylor.

His main contention is that, when the crisis first erupted in August 2007, the Fed incorrectly inferred that financial institutions and markets were experiencing a liquidity shortage, when in fact he contends the problem was "counterparty risk."

Based on his analysis of movements in the spread between the three-month London Interbank Offering Rate (LIBOR) and the three-month overnight index swap (OIS), Taylor says "the market turmoil in the interbank market was not a liquidity problems of the kind that could be alleviated simply by cnentral bank liquidity tools."

"Rather it was inherently a counterparty risk issue, which linked back to the underlying cause of the financial crisis," he continues.
"This was not a situation like the Great Depression, where just printing money or providing liquidity was the solution; rather the situation was due to fundamental problems in the financial sector relating to risk."

"The increased spreads in the money markets were seen by the authorities as liquidity problems rather than risk problems," he says.
"Accordingly their early interventions focused on policies other than those that would deal with the fundamental sources of the heightened crisis."

As a result, he argues, the crisis was "prolonged" by such Fed programs as the Term Auction Facility (TAF).

Taylor also alleges that the Fed cut interest rates more than necessary in 2008, with the result that a depreciating dollar drove up the price of oil to more than $147 per barrel, adding to contractionary pressures on the economy.

In the September-October 2008 period, when the crisis intensified, Taylor says the problem was not just that Lehman Brothers was allowed to fail, but that the government threw financial markets into uncertainty about how it would handle this and other failures.

When the $700 billion Troubled Asset Relief Program (TARP) was created, there was "no mention of oversight and few restrictions on the use," he writes, adding that markets were roiled by "the public's realization, shock and fear that the intervention plan had not been fully thought through and that conditions were much worse than many had been led to believe."

"At a minimum a great deal of uncertainty about what the government would do to aid financial institutions, and under what circumstances, was revealed, thereby influencing business and investment decisions at the time," he says.

He cites a Nov. 5, 2008 survey by the Securities Industry and Financial Markets Association (SIFMA) showing that 94% of securities firms and banks found the TARP "lacking in clarity about its operations."

The seeds of uncertainty had been planted long before when the Fed financed the JPMorgan Chase purchase of Bear Stearns in March of 2008, Taylor says.

"The implication of that decision for future interventions was not made clear by policymakers," he writes. "This lack of predictability about Treasury-Fed intervention policy and recognition of the harm it could do to markets likely increased in the fall of 2008, when the underlying uncertainty was revealed for all to see."

Among the lessons Taylor draws is that "policymakers should rethink the idea that frequent and large government actions and interventions are the only answer to our current economic problems."

"Such a philosophy could take us further off track and ... could make things worse rather than better," he warns.