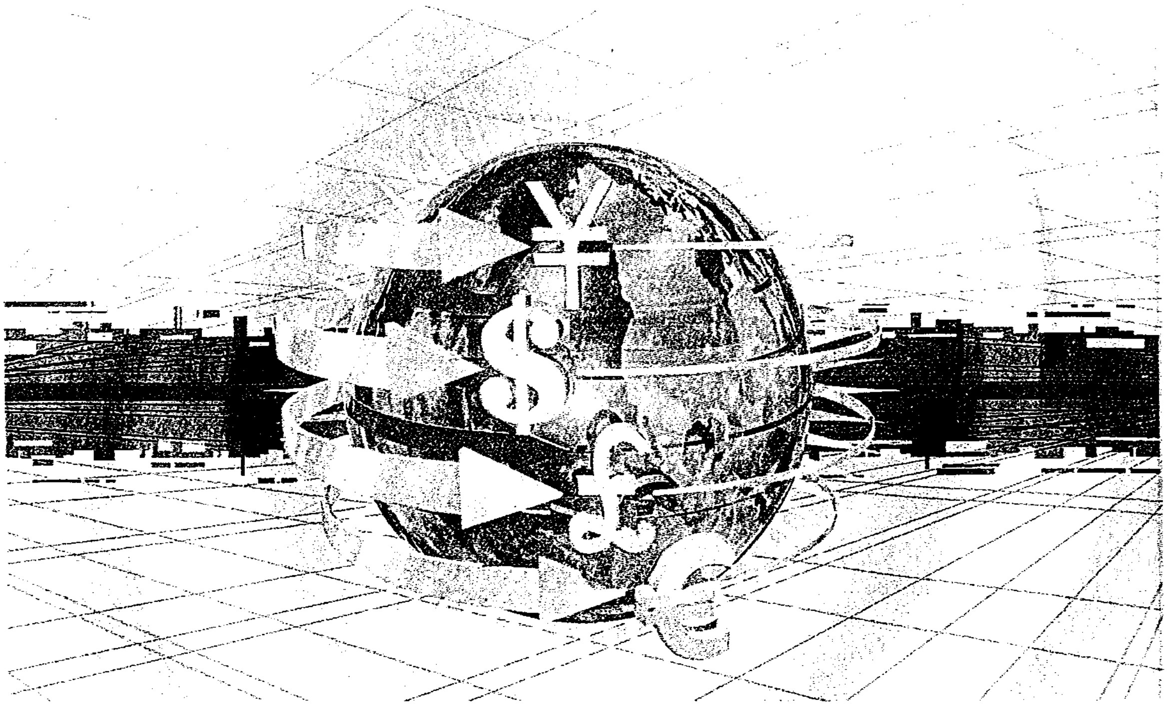
Monetary Policy and the Next Crisis

By John B. Taylor



At its annual meeting of the world's central bankers in Switzerland last week, the Bank for International Settlements—the central bank of central banks—warned about the harmful "side effects" of current monetary policies "in the major advanced economies" where "policy rates remain very low and central bank balance sheets continue to expand." These policies "have been fueling credit and asset price booms in some emerging economies," the BIS reported, noting the "significant negative repercussions" unwinding these booms will have on advanced economies.

The BIS emphasizes the view that international capital flows stirred up by monetary policy were a primary factor leading to the preceding crisis and that these flows would lead to the next one. This is in stark contrast to the "global saving glut" hypothesis—which says that the funds pouring into the U.S. in the previous decade originated largely from the surplus of exports over imports in emerging market economies.

The BIS should be taken seriously. It warned long in advance about the monetary excesses that led to the financial crisis of 2008.

The capital-flow story starts during extended periods of low interest rates, as in the U.S. Federal Reserve's low rates from 2003 to 2005 and its current near-zero interest rate policy, which began in 2008 and is expected to last to 2014. These low interest rates cause investors to search elsewhere for yield, and they buy foreign securities—corporate as well as sovereign—for that reason. Global bond funds in the U.S. thus shift their portfolios to these higher-yielding foreign securities and investors move to funds that specialize in such securities.

> Low interest rates and international capital flows, not a 'saving glut,' were to blame for the 2008 crash.

Low U.S. interest rates also encourage foreign firms to borrow in dollars rather than in local currency. U.S. branch offices of foreign banks play a key part in this process: As of 2009, U.S. branches of over 150 foreign banks had raised $645 billion to make loans in their home countries, making special use of U.S. money-market funds, where about one half of these funds' assets are liabilities of foreign banks.

This increased flow of funds abroad—whether through direct securities purchases or through bank lending—puts upward pressure on the exchange rate in these countries, as the foreign firms sell their borrowed dollars and buy local currency to expand their operations and pay workers. That's when foreign central banks enter the story. Concerned about the negative impact of the appreciating currency on their country's exports or with the risky dollar borrowing of their firms, they respond in several ways.

First, they impose restrictions on their firms' overseas borrowing or on foreigners investing in their country. But the differences in yield provide strong incentives for market participants to circumvent the restrictions.

Second, central banks buy dollar assets, including mortgage-backed securities and U.S. Treasurys, to keep the value of their local currency from rising too much as against the dollar. One consequence of these purchases is a foreign government-induced bubble in U.S. securities markets, as we saw in mortgage markets leading up to the recent crisis, and as we may now be seeing in U.S. Treasurys.

The flow of loans from the U.S. to foreign borrowers is effectively matched by a flow of funds by central banks back into the U.S. There is no change in the current account, and no role for the so-called savings glut.

Third, in order to discourage the inflow of funds seeking higher yields—which would drive up the exchange rate of their own currency—foreign central banks hold their interest rates lower than would be appropriate for domestic economic stability. There is much statistical evidence for this policy response, and, when you roam the halls of the BIS and talk to central bankers, as I did last week, you get even more convincing anecdotal evidence. Call it the lemming effect: Central banks tend to follow each other's interest rates down.

This is what happened in the lead up to the 2008 financial crisis, and it has helped fuel Europe's current debt crisis. In the 2003-2005 period, low interest rates led to a flow of funds into U.S. mortgage markets as foreign central banks bought dollars, aggravating the housing boom and the subsequent bust.

Moreover, the European Central Bank's interest rate moves during 2003-2005 were influenced by the Fed's low rates. By my estimates, the interest rate set by the ECB was as much as two percentage points too low, which also had the effect of spurring housing booms in Greece, Ireland and Spain. Ironically, the European debt crisis, which originated in the booms and busts in Greece, Ireland and Spain, now has come around to threaten the U.S. economy.

The Fed's current near-zero interest rate policy, designed to stimulate the U.S. economy, has made it harder for other central banks to combat credit and asset price booms. A group of 18 emerging market central banks—including Brazil, China, India, Mexico and Turkey—held their interest rates on average as much as five percentage points below widely used policy benchmarks—and global commodity prices doubled from 2009 to 2011, a boom rivaling the excesses leading up to the 2008 financial crisis. This global, loose monetary policy was likely a big factor pushing up commodity prices. The current sharp slowdown in most emerging markets coincides with an inevitable bust of this easy-money induced boom, and the decline of foreign demand for American goods is now feeding back to the U.S. economy.

The Fed needs to pay closer attention to global capital flows and the reactions of other central banks to its decision to set interest rates very low for long periods of time. This does not mean taking one's eye off the U.S. economy, but rather preventing booms and busts abroad from slowing growth at home precisely when we need it most.

Mr. Taylor, a professor of economics at Stanford University and a senior fellow at the Hoover Institution, is the author of "First Principles: Five Keys to Restoring America's Prosperity (Norton, 2012).