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### U.S. Monetary Policy, 'Imbalances' and the Financial Crisis

Pierre-Olivier Gourinchas

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# **U.S. MONETARY POLICY, 'IMBALANCES' AND THE FINANCIAL CRISIS**

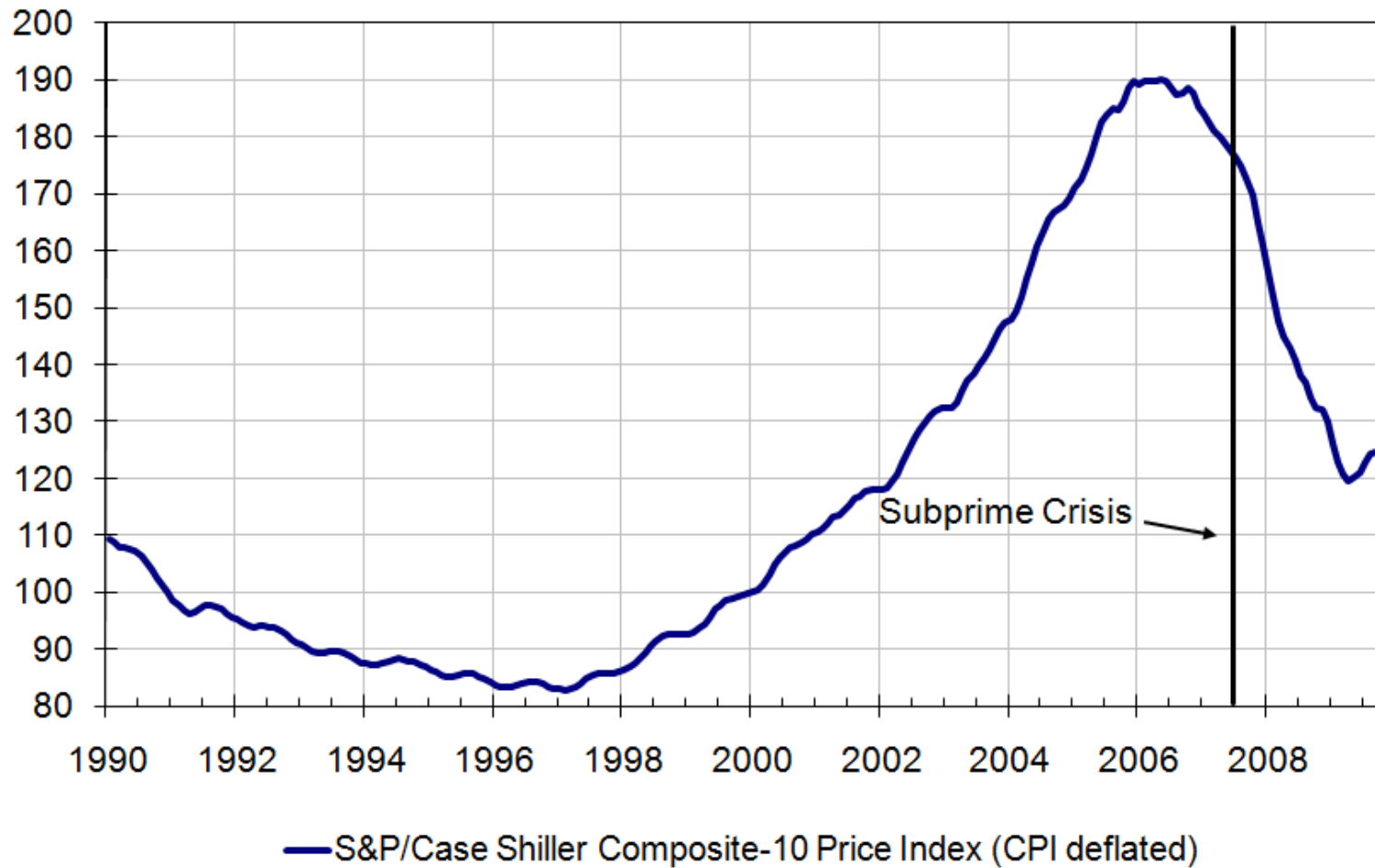
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**Prepared for the Financial Crisis Inquiry Commission Forum,  
Washington, Feb. 26-27 2010**

# REAL HOUSE PRICES, 1990-2009

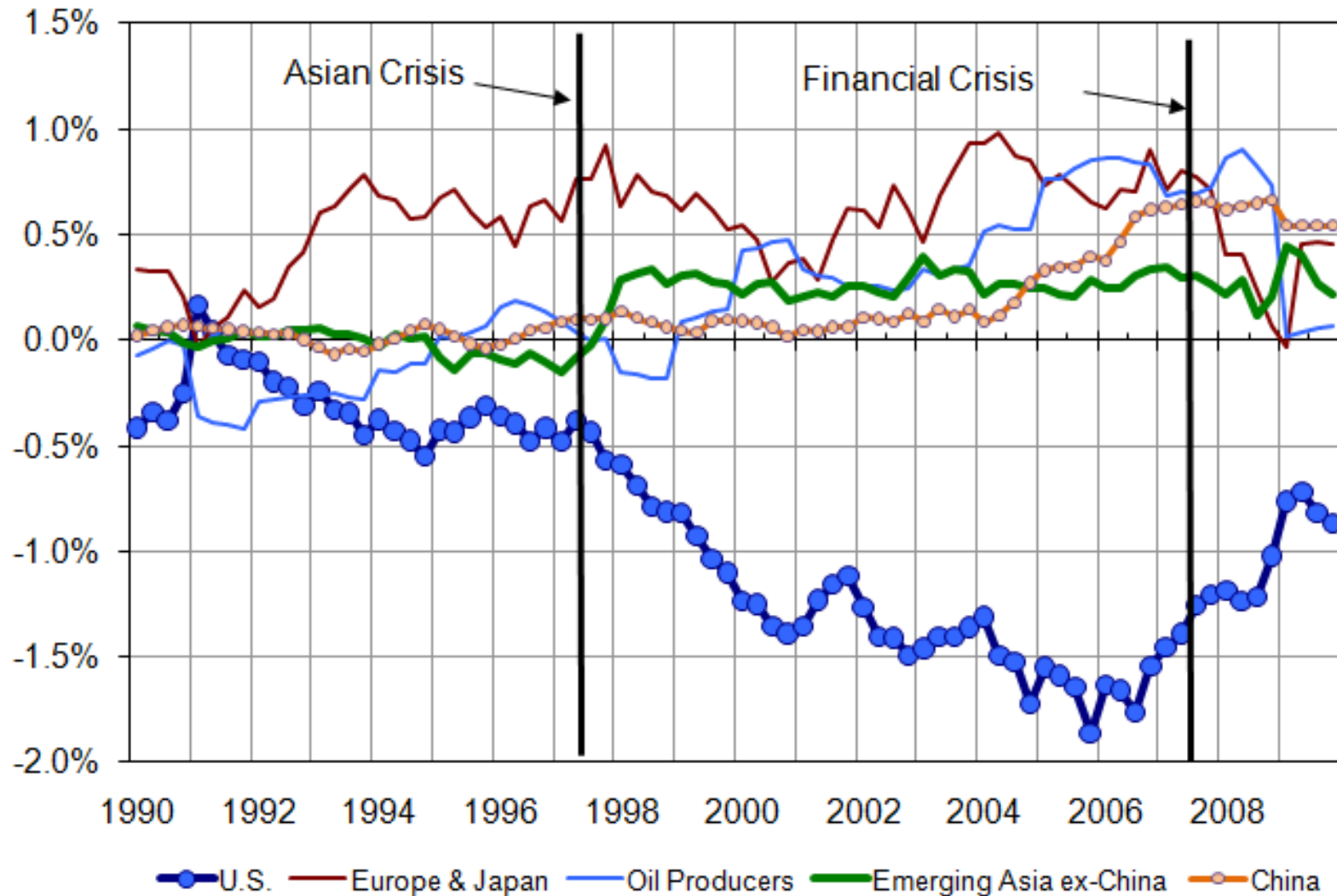
(DEFLATED BY URBAN CPI)



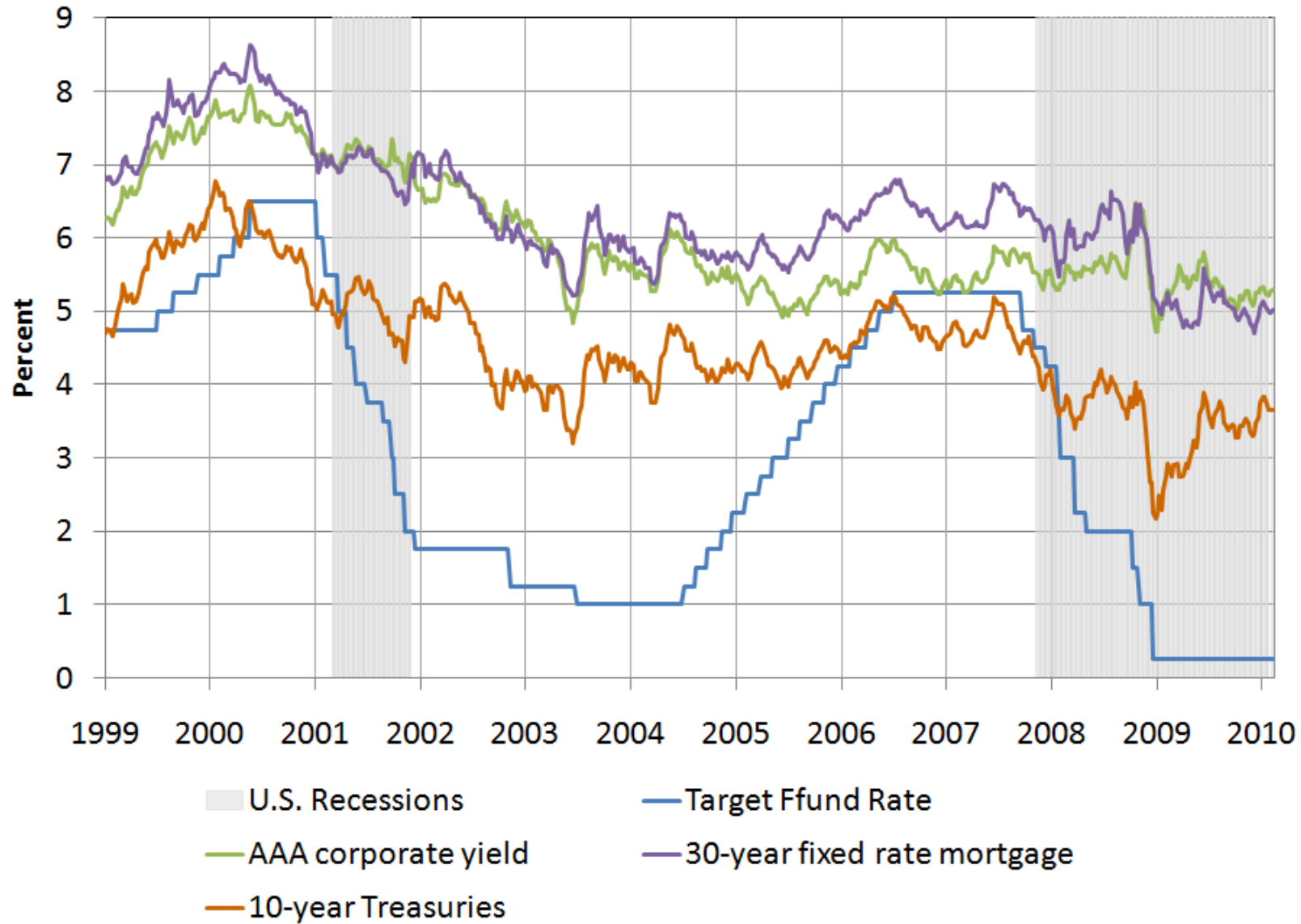
# GLOBAL IMBALANCES: 1990-2009

CURRENT ACCOUNT DEFICITS AS A % OF WORLD GDP

% of World GDP

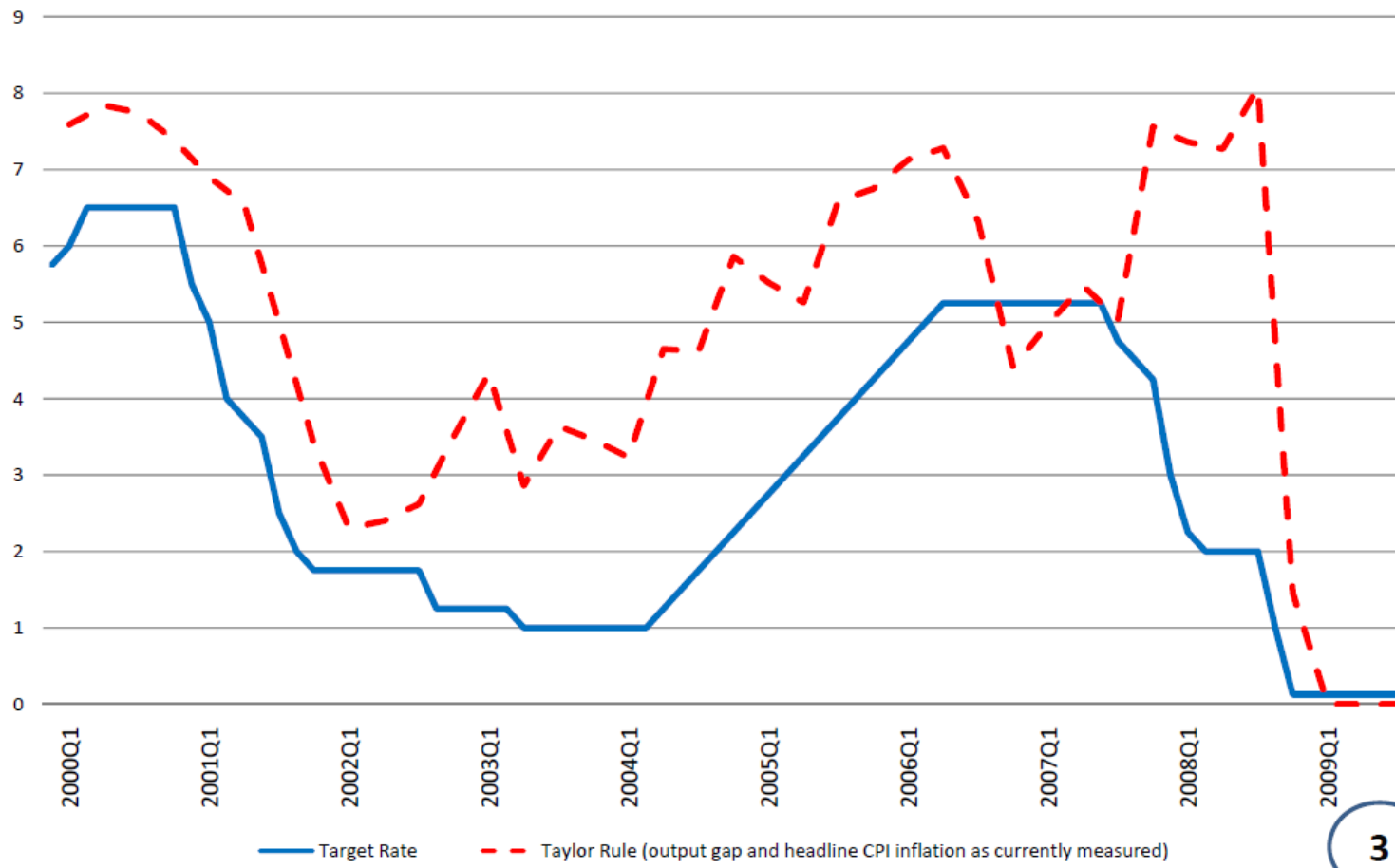


# U.S. MONETARY POLICY, 1999-2009



# TAYLOR RULE (FROM BERNANKE, 2010)

## The Target Federal Funds Rate and the Taylor (1993) Rule Prescriptions



Source: Federal Reserve Board, Bureau of Labor Statistics, Bureau of Economic Analysis, and Federal Reserve staff calculations.

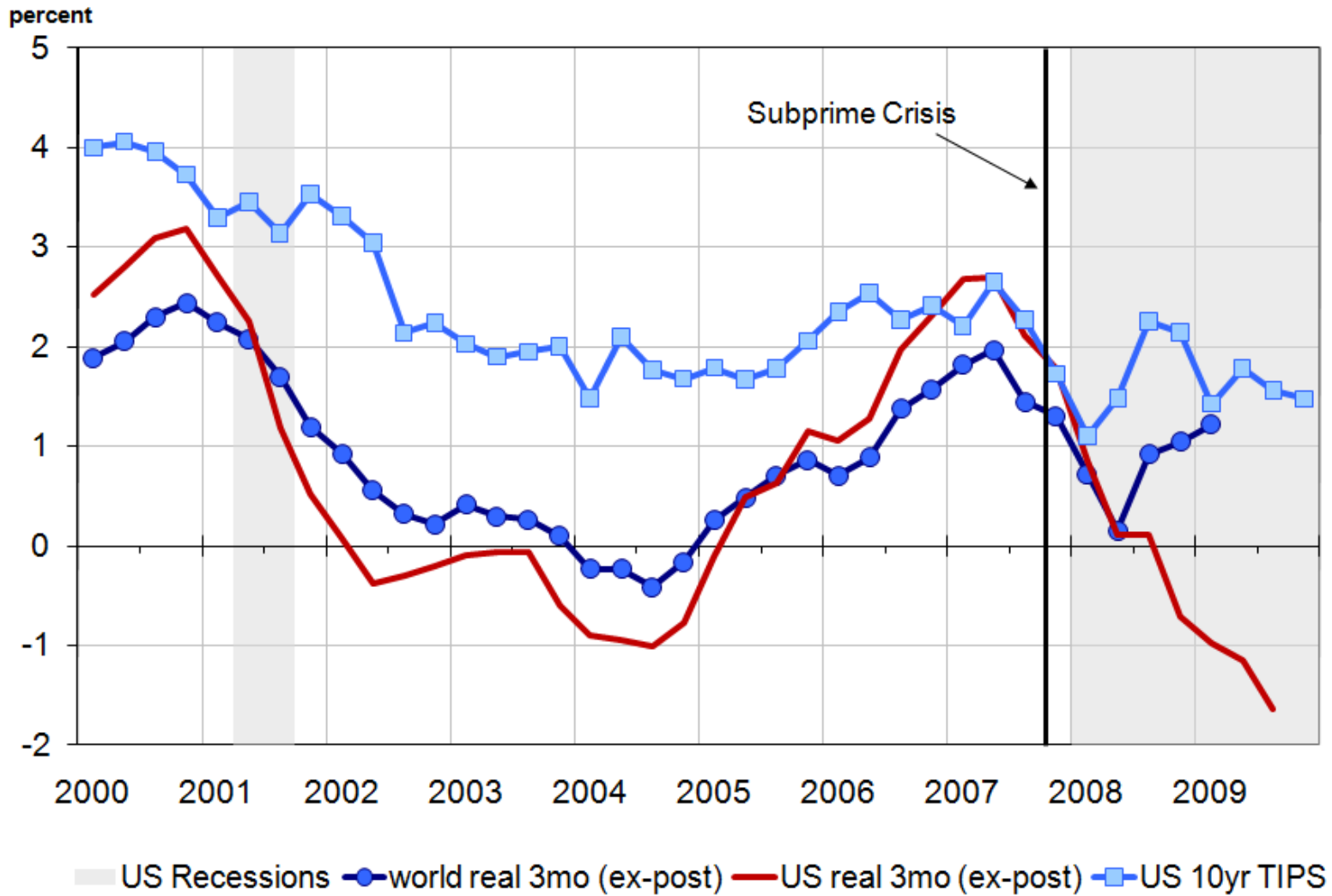
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# REASONS TO BE CIRCUMSPECT

- “Reasonable” Disagreements about:
  - Ingredients (measure of inflation, output gap)
  - Coefficients (on output gap, inflation...)
- Prescriptive content of the rule is not obvious
- Throughout the period, inflation remained stable and well-anchored, while output was also growing.

# LOW REAL INTEREST RATES, 2000-2009





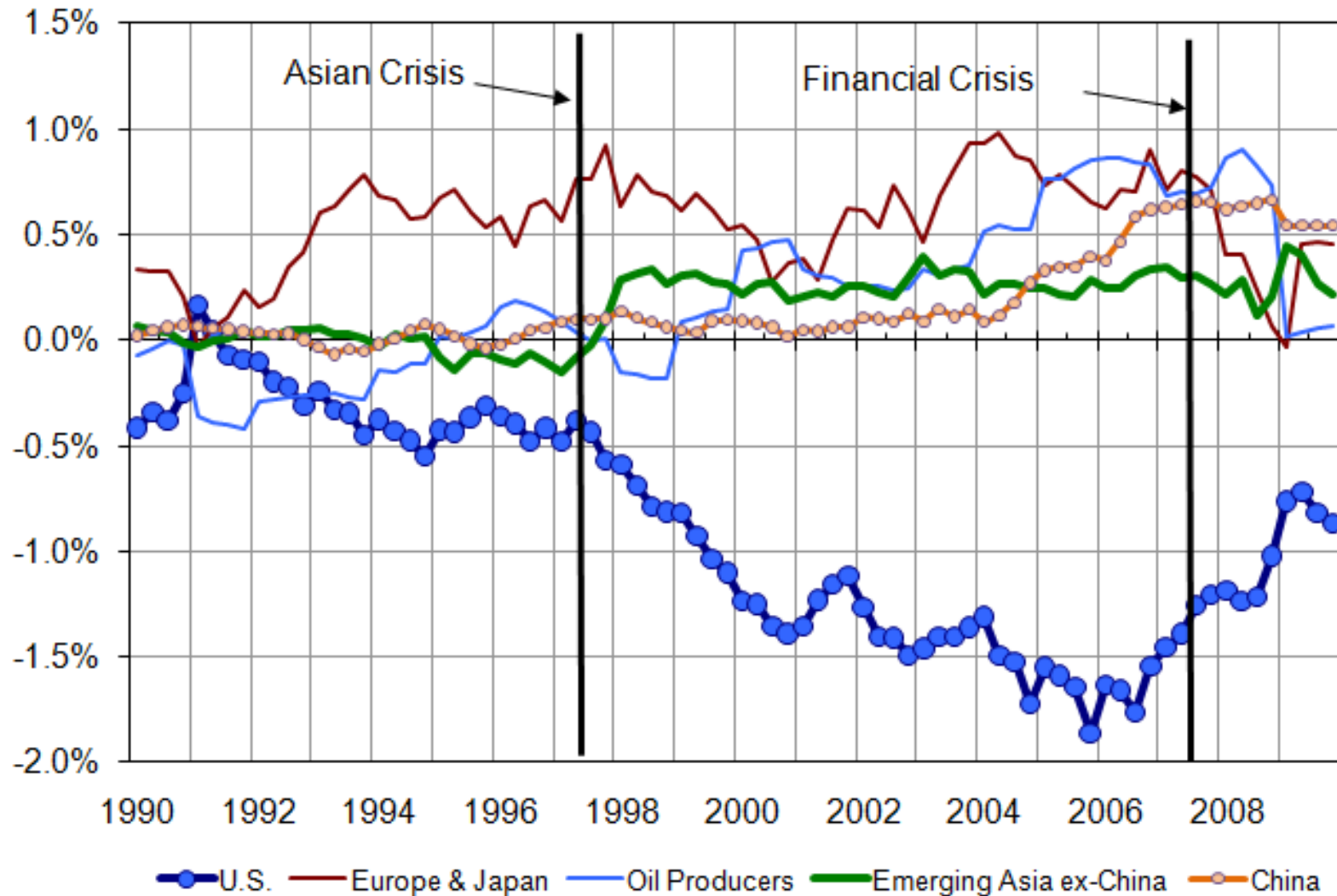
# DEALING WITH ASSET BUBBLES: SHOULD THE FED LEAN?

- The Fed's view:
  1. Markets take care of themselves
  2. Undesirable for price stability
  3. Difficult to identify bubbles
  4. Effectiveness of raising rates on bubble is unclear
  5. Interest rate policy can “mop-up”
- (1) and (5) casualties of the crisis
- But (2)-(4) remain. Interest rate policy may not be the instrument of choice.
- Bigger failure : Fed failed to remain vigilant.

# GLOBAL IMBALANCES: 1990-2009

CURRENT ACCOUNT DEFICITS AS A % OF WORLD GDP

% of World GDP

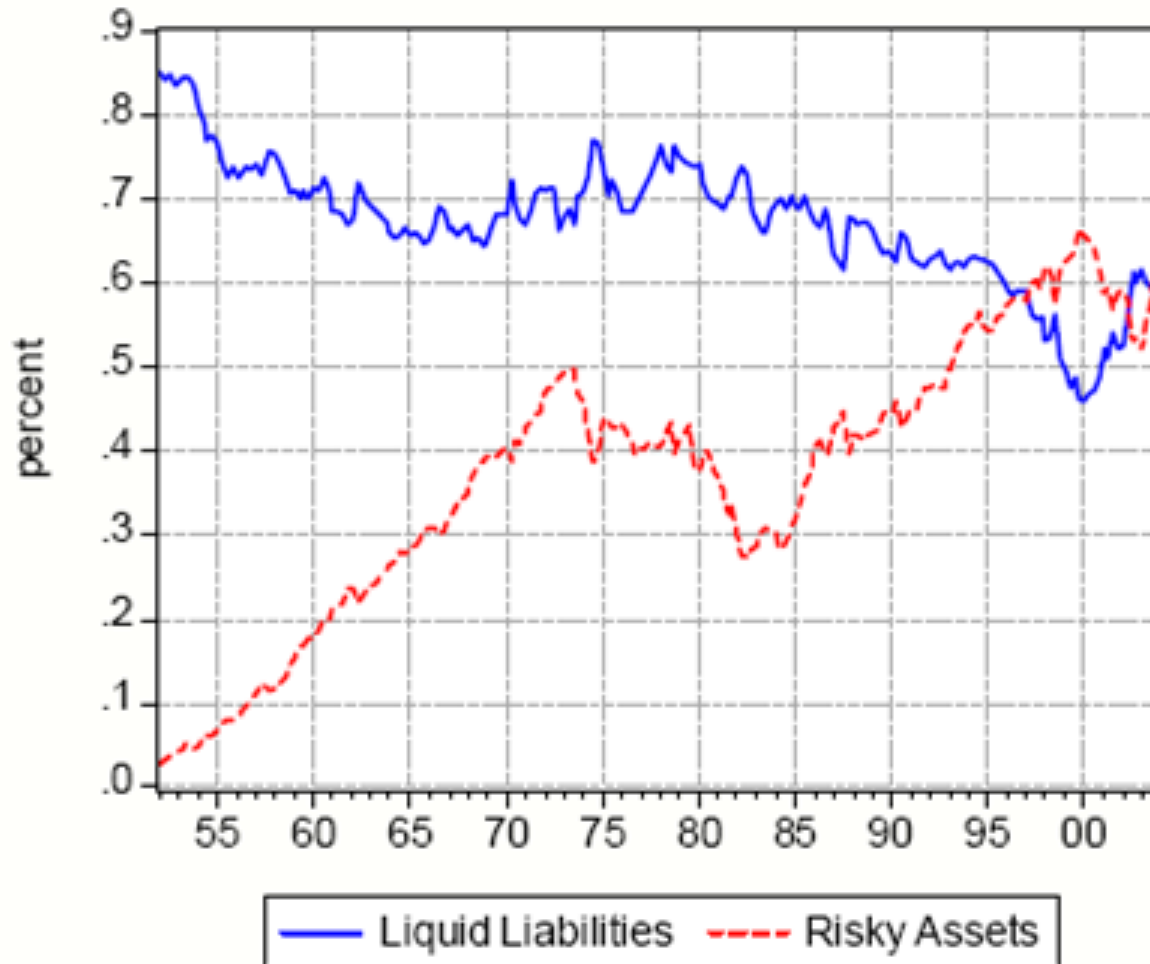


# WHAT GLOBAL FACTORS?

- Global Imbalances? Unlikely
  - What matters is global savings and global investment.
  - Could have “rebalanced” without changing the cost of funds
- Instead, post 2001 and 2004: massive surge in demand for U.S. “triple-A” debt instruments
  - Asymmetry between economic and financial development in emerging economies
  - Post 2001, rebalancing of portfolios
  - Surge in reserve accumulation from EM to insure against sudden stop
  - Sterilization policies from surplus countries to peg their currency in dollar terms.
- Why U.S.? Historical liquidity provider.

# U.S. AS GLOBAL LIQUIDITY PROVIDER

DEBT AS % OF GROSS LIABILITIES; EQUITIES AND FDI AS % OF GROSS ASSETS



# SAFE-ASSET IMBALANCE

- Global surge in demand for safe U.S. assets
  - Profit opportunity for U.S. financial sector: manufacture *quasi* triple-A debt assets from riskier assets (securitization)
  - Transfer demand for safe assets to other classes and fuels housing bubble. Wealth increases allows more borrowing. Feedback loop.
  - Synthetic assets much more vulnerable to systemic risk
  - When financial crisis occurs, run on structured credit instrument. Only bona-fide safe assets are U.S. Treasuries.

## CONCLUSION

- Monetary policy in 2001-2007 no immediate threat to the economy
- Interest rate policy is a second or third best instrument.
- But low real interest rates, strong growth and housing bubble should have pushed policymakers to be more vigilant and more creative
  
- Global imbalances played limited direct role
- More important was the demand for safe U.S. debt instrument.