THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W., Suite 740
Washington, D.C. 20006
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Bernanke's *Right Hand*

Exit interview with Federal Reserve Governor Kevin Warsh. In April, TIE *founder and editor David Smick sat down with the departing U.S. central banker.*

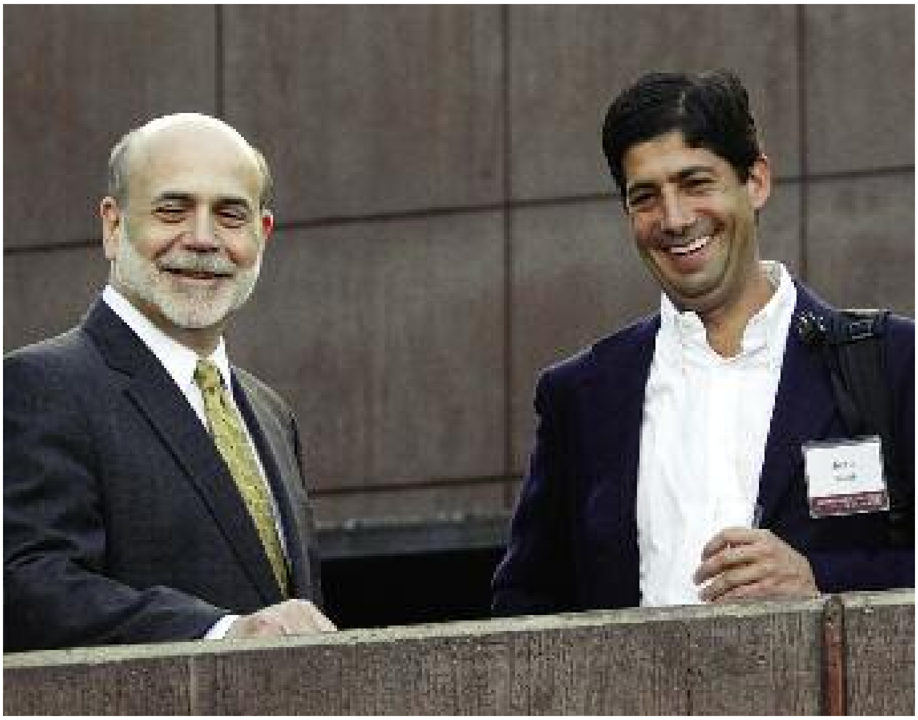
TIE: **The facts of the U.S. debt situation are terrifying. By the year 2025, according to the Congressional Budget Office, federal spending on entitlements and interest payments will consume 100 percent of government revenues. That means there's no money for anything else. In fact, unfunded entitlements may be larger than the size of today's public debt by a 9-to-1 margin. Shouldn't the Federal Reserve as an institution be sounding more of an alarm about this situation? At what point will the debt complicate the job of conducting monetary policy? Have Fed officials, through their bond purchases, unwittingly contributed to the lack of fiscal discipline in Washington?**

Warsh: The fiscal shortfall, even by the conventions used by the Congressional Budget Office and the Office of Management and Budget, is significant across all time horizons. And the unfunded, unaccounted for liabilities assumed by the federal government are even more consequential. We are on an unsustainable fiscal path. The sooner policymakers deal with this stark fiscal situation, the better. At this moment, markets appear reasonably tolerant of the fiscal trajectory, and they will remain so precisely until they are no longer tolerant. Policymakers must get ahead of the day of reckoning.

Washington just finished dealing with the 2011 budget, and while near-term spending issues are often described as being relatively small in contrast to these longer-term structural problems, it's best to put points on the board whenever feasible. I'm encouraged by the actions over the last couple of months.

While monetary policymakers must pay attention to the judgments of the fiscal authorities, the Fed should not try to compensate for their failings. Debt monetization ought not to be the business of the Federal Reserve. But highlighting the size, scope, and stakes of the fiscal challenge is a very constructive role for the Fed to play. And a clarion call for reform is needed.

TIE: **Do you buy the argument that sometimes the global bond market moves in a sequential series of vicious attacks? In other words, Stage One in the 1990s came with the market attacks during the Asian financial crisis. Stage Two is today's European sovereign debt and banking crisis. Stage Three will be market reaction at some point to America's deficits and debt.**



Kevin Warsh *[right] served on the Board of Governors of the Federal Reserve System from February 2006 to March 2011 under Chairman Ben Bernanke [left].*

Despite the dollar being the reserve currency and the United States being the world's largest economy, will there relatively soon be a day of reckoning? Standard & Poor's has issued its warning. Some European central bank regulators are quietly warning their banks about the perceived risks of the U.S. Treasury market.

Warsh: Like it or not, the United States is part of one imperfectly integrated global economy and financial market. Markets periodically test weakness. And they don't stop testing until they are confronted with overwhelming facts or overwhelming force, the former being my preferred policy response. Market participants tend to start with the weakest in the herd, but they rarely stop there. We saw it in the U.S. banking crisis, beginning with Bear Stearns and Lehman Brothers. The Europeans have witnessed it more recently with respect to countries in the so-called periphery.

The United States remains the largest, most resilient economy in the world, with great demographics, great productivity, and a great ability to innovate. But this is no time for complacency. The dollar's role as the world's reserve currency is no birthright. It must be earned every day. We should not take our low current financing costs in the Treasury markets as license to kick the can down the road. We should not fool ourselves into thinking that Treasury financing is immune to the laws of arithmetic. Fundamental reform is needed. If reforms happen sooner, they will be under the control of policymakers. If deferred, reforms will be forced upon the body politic at a time of the market's choosing.

TIE: **Imagine it's one month before the outbreak of the Great Financial Crisis. The yield on a ten-year U.S. Treasury bond is roughly 4 percent. I have a crystal ball which says that by the spring of 2011, the economy will be growing at between 2 percent and 3 percent with unprecedented levels of deficits and debt and a huge expansion in the central bank's balance sheet. In addition, in part because developing world economies have been growing at an astounding pace, commodity prices including oil are skyrocketing. Wouldn't you have assumed back then, given these factors, that the yield on the ten-year U.S. Treasury would be significantly**

Real Americans are not troubled when genuine merit gets rewarded, through compensation or profits or otherwise. But it is contrary to the ethos of our society when failure is rewarded, or when those that are well-connected benefit because of little more than their status.

China's Currency Dilemma

***TIE:* In China, inflation is soaring. Officials are trying to slow it down, but they're not yet talking about dramatic appreciation of the currency to deal with rising prices. Instead, they will continue to raise interest rates and use other administrative measures to slow down the economy. Can Chinese officials have any hope of controlling inflation without dramatic currency appreciation?**

Warsh: China's predominant objective over the course of the next couple of years is to ensure domestic tranquility. The Chinese leadership recognizes that inflation can lead to social unrest, and so dealing with inflation risks is a top priority. Foreign exchange rates can be an effective tool to deal with inflation risks, generally more so than *ad hoc* administrative controls. If Beijing were forced to slow the rate of growth over the course of the next couple of years in order to more effectively deal with inflation risks, then that's a trade-off I suspect they would pursue.

higher than 4 percent? Yet it has remained below that level for some time. What is the market saying about future inflation? Is the world so economically and financially perilous that the traditional U.S. safe haven status is affecting the yield curve? Or is the long end of the bond market simply influenced by the Fed's efforts to keep short-term rates near zero percent and to purchase bonds at the longer end of the yield curve? Or is a rise in long-term interest rates just around the corner? Or are we at the end of some strange historic cycle mired in global overcapacity?

Warsh: The financial crisis may have first manifested itself on U.S. shores, but it was, properly understood, a global crisis. And even to this day, funding costs for stronger countries around the world have remained relatively low. The U.S. government remains the largest beneficiary, with global investors continuing to prefer holdings of dollar-denominated assets in deep and liquid markets.

But we shouldn't take current Treasury funding costs as being indicative of future levels. Nor, in my view, are Fed purchases of long-term Treasuries materially impacting the yield of these securities.

Policymakers should take little comfort from backward-looking, model-based measures of low and stable domestic inflation. There continues to be massive monetary stimulus coming from the Fed and the world's other largest central banks.

Policymakers must consider what's happening across financial markets—including increases in commodity prices and the continued weakness in the foreign exchange value of the dollar—in order to gauge whether low inflation is a preordained and permanent phenomenon.

***TIE:* If you had to give a report card on QE2, what would the grade be? Taylor Rule calculations suggest that interest rates should be 300–500 basis points lower if the goal is to bring unemployment back to normal. Former White House economic advisor Larry Summers argues that QE2 could be relatively ineffective or it could be inflationary, but it can't be both. Which is it? Has QE2 complicated the global policy mix by quickly weakening the dollar? After all, the IMF and emerging markets are flirting with capital controls which are, they argue, the direct result of the Fed's policy. Critics argue that capital has flooded into emerging markets, threatening to create a series of bubbles. Some critics blame the rising price of oil on QE2. What's your view?**

Warsh: I remain quite skeptical of the risk-reward of QE2, but the final exam is yet to come. The ultimate grade for QE2 depends in part on the path of policy going forward. If Congress or market participants believe that the Fed will be the buyer-of-last-resort of Treasury securities whenever desired, QE2 will prove to be harmful. And if central bankers choose to follow their early and aggressive policy response with business-as-usual caution and continued loose policy even as conditions improve, then QE2 will prove to be destructive. If policymakers, however, understand the heightened burden to remove exceptional accommodation as appropriate, then the policy will deserve a more balanced assessment. In my view, there must be some symmetry in the policy reaction function. Central bankers must have the same courage on the way out that they had going in.

Different Taylor Rule formulations suggest dramatically different monetary policy judgments. I would hesitate to take any of these model-based outputs at face value.

Financial markets are far better transmission mechanisms now than they were in the darkest days of the crisis. And global policy rates are only a bit higher. So in effect, monetary policy is more accommodative than ever—even with the global economy performing much better. That should provide us a dose of caution.

***TIE:* Can governments and central banks have it all? In other words, can governments build up unlimited**

amounts of debt as long as the central bankers cooperate by being the sovereign debt purchasers of last resort? This is what the Fed did during World War II and for five or so years thereafter. What are the risks today that the Fed eventually ends up the sole purchaser of the U.S. Treasury debt? Does the Fed crowd out private investment? Or is the result inflationary? Put another way, we constantly hear how the United States has to control its debt in case the Chinese stop being major Treasury debt purchasers. The Chinese are still buying but only in modest amounts, nothing like what they were buying in previous years. What's the downside, if any, of central banks backstopping the world's debt? After all, by some calculations, we live in a world where public and private debt together amount to 300 percent of GDP. We may not have any choice in the matter.

Warsh: Milton Friedman was right: there are no free lunches. We cannot have it all. An ultimate accounting of a government's obligations demands consolidation of its financial statements. No government can go on funding itself over the horizon with its central bank as the serial purchaser of government securities. And no economy can ultimately prosper in that environment.

In the case at hand, the Fed must be mindful not to confuse lender-of-last-resort authority in crisis with being a serial purchaser in the long-term Treasury market. If markets perceive the Fed to be monetizing debt, however false that perception, there will be a crowding-out of private capital, an obfuscation of price signals, and harm could be done to the functioning of the Treasury market. Every asset everywhere in the world is predicated on the value of the U.S. Treasury bond as the risk-free asset, so great care must be taken. I am confident that Chairman Bernanke and his colleagues understand the risks.

TIE: **Let's talk about core inflation versus headline inflation. The Europeans have been very critical of the Fed, saying sarcastically that core inflation is a great indicator of inflation for policymakers who don't eat, drive a car, wear clothing, or buy health care. Where do you stand on this issue? Are there flaws in the data for measuring inflation? Because of the dominant role of housing in the way the CPI is constructed in the United States, is a bout of inflation statistically impossible short of a turnaround in housing? Could we have a situation in the future where the CPI becomes a flawed indicator, where inflation is actually higher than statistics state?**

Warsh: We should not, as the late Senator Daniel Patrick Moynihan famously said, define deviancy down. Central bankers should resist the temptation to dismiss measures of inflation that happen to be above their comfort zones. The challenge for central banks is to measure inflation on a going-forward basis. We do a decent job of saying what inflation was—that is, the change in price level across a basket of products and services. But we have an imperfect understanding of how inflation expectations are actually set. Hence, it is difficult to project with conviction where prices are going to be over the horizon. That is why market indicators should be an integral part of the central banker's dashboard

There are no free lunches.

We cannot have it all.

Central bankers shouldn't hew to a single measure of price stability. And the booms and busts of the last several years should remind us that asset prices—in addition to a basket of goods and services—can be materially affected by monetary policy.

TIE: **New York Fed President William Dudley gave a talk in Queens, New York, recently. When asked about inflation and prices, he said it's very difficult to measure inflation, and while commodity prices were rising, core inflation had barely moved. He talked about how the new version of the iPad was much more powerful than the previous version, yet costs less. A member of the audience shouted, "When was the last time, sir, that you went grocery shopping?" Another said, "I can't eat an iPad." It was an embarrassing indictment. Inflation hits the little guy the hardest. Are Fed policymakers here missing the boat?**

Warsh: Modern central banks consider price stability as a key objective, in large part, because unanchored inflation hits the most disadvantaged in our society the hardest. It is the cruelest tax of all. We should not be dismissive of changes in the prices of food and energy. Still, central banks are not price setters, nor should they be. Fluctuations in prices in market economies are expected when supply and demand changes. It would be a mistake to try to mask those price changes. But if changes in price of a broad basket of goods and services prove persistent, central banks must take notice, and ultimately, take action. They must insure that inflation expectations are well-anchored.

We should not take our low current financing costs in the Treasury markets as license to kick the can down the road.

TIE: There is suspicion in some circles that the Federal Reserve is mulling over the possibility of abandoning the current 2 percent inflation target and moving to a slightly higher target. After all, one argument offered for QE2 was the need to try to stoke up the fires of inflation a bit to avoid the danger of a deflationary scenario. What are the chances the Fed ups the inflation target a bit as a means of meeting its dual mandate?

Warsh: Changing the inflation goal posts in the middle of the game is a bad idea. Former Fed Chairman Paul Volcker is right: central banks that want a little more inflation tend to get a lot more of it. I am confident that Chairman Bernanke does not intend to change the Fed's medium-term inflation objective. Countries that have tried to inflate their way out of their problems find still bigger problems down the road.

TIE: The European Central Bank has seen a shift in the last several years. Influence and power have moved away from individual country central bankers to the Council in Frankfurt. Is a similar thing happening with the Federal Reserve? Has the power shifted almost completely away from regional presidents to the Board of Governors? If so, is that a good thing? Has the influence shifted to the Board simply because the Board is in command of the Fed staff and has control of the intellectual infrastructure that sets the terms of the debate?

Warsh: Since inception, the Fed's structure was intended to ensure that the broad diversity of the economy was ably represented in decision-making. The regional Fed presidents play a particularly important role in presenting their perspectives of the real economy. And they bring data and anecdotes alike from their regions, thereby ensuring that the policy discussion isn't overly focused on Wall Street and Washington. Reserve Bank presidents are able to have an impact on policy, and those with the best insights are able to be the most persuasive. Judgments made by the Board of Governors and the FOMC are made better by ensuring a breadth of opinion around the table.

TIE: If you listen to the public statements of the regional presidents as a whole, you would say they collectively are a much more hawkish group than the Board of Governors. Is there, in fact, a difference between the two groups? Are the regional presidents much more concerned about inflation, while the Board is perhaps more tolerant of letting the inflation target slide a bit, if need be, to comply with the Fed's employment mandate?

Warsh: There's a common objective. Relegating the price stability objective would do harm to the economy. It is true that some members of the FOMC are more vocal in expressing their views between meetings. Markets should come to understand that's part of the policy debate. And the louder group may or may not ultimately prevail. Serious and sober debate is owed on all sides in this time of consequence.

TIE: The current recovery has produced less than half the growth rates achieved during the recovery after the 1981–82 recession. For example, for most of 1983, growth stayed consistently above 8 percent and for a time exceeded 9 percent. Why do you think the current recovery has been so modest? Some would argue it's a Ricardo equivalence effect—the size of the public and private debt is inhibiting consumption. Others say the stimulus wasn't large enough. Others argue there's never been a major recovery without housing leading the way, yet housing is still in the basement. If you bought a house within two or three years of the peak, for example, negative equity makes it difficult to refinance even if interest rates are low. Banks still have a lot of inventory on their balance sheets, particularly with the level of foreclosures. Maybe banks don't want to write off bad assets until there are profits. Would removing inventory from balance sheets and putting it back in the market help clear this process and make housing more affordable—and thereby improve the prospects for a healthier recovery? Why has this recovery been so modest? Is the answer simply that recovery after financial crises is always difficult?

Warsh: Only by the standard of the deepest, darkest day of the crisis is this economic recovery even plausibly satisfactory. On a historical basis, the economic recovery is modest, and unacceptably so. Some describe this recovery as the "new normal" and suggest we should just get used to it. Others suggest that recoveries from global financial crises are inevitably weak, and so we should lower our standards. I call this the new malaise. Instead of lowering our standards, we should improve our policies and raise our expectations.

So why is the recovery weak? First, the symptoms have been confused with the disease. Some policymakers have tried to steer a housing recovery without an economic recovery. So there have been a dozen or so programs to "fix" the housing crisis on the theory that once that's repaired, the broader economy will come roaring back. These housing programs, however well-intended, have done little, in my view, to help the housing markets or the real economy. A housing recovery will begin when real household incomes improve, not before.

Second, intentions aside, the broad suite of macroeconomic policies has tended to favor the big over the small—big banks have been advantaged over small banks; big businesses have been favored versus small businesses; and those big multinationals with access to the global economy and global financial markets have benefitted more than those on the front lines of job creation.

Third, macroeconomic policies, in my view, have been preoccupied with the here and now, not the long term. So going back several years, Washington has compensated for a faltering economy with temporary programs that plug quarterly GDP arithmetic, but do far less to support long-run growth. Massive stimulus has proven not to be as efficacious as many academic models would suggest.

TIE: **Political strategist James Carville once said that if he believed in reincarnation, he'd want to come back as the bond market. Instead, he should probably have asked to come back as a Wall Street banker. To what extent have American banking elites used their political power to gain support from Washington for efforts to try to prop up asset values on bank balance sheets that are simply not sustainable? I'm talking about asset values relating to real estate or, in the case of the Europeans, bank-held assets relating to sovereign debt. Looking back in thirty years, could the story be that authorities in addressing the financial crisis intervened in the market to prop up asset values at levels that were unsustainable, leaving behind huge deficits and debt? In other words, the banking elites won out at the expense of the fiscal future of middle-class workers. After all, zero percent interest rates may have been great for reviving the big banks' balance sheets but were devastating to those average folks dependent on income from savings.**

Warsh: First, markets have to clear for the economy to prosper. Governments can push asset prices around, but only for a time. In many markets, we are seeing market functioning improve, but we can be less sure that the prices now being assigned to assets are uniformly durable over the course of the next several years. Policymakers should be wary of interfering with the price setting function in asset markets that is essential for a real and long-lived recovery.

Second, in my view, real Americans are not troubled when genuine merit gets rewarded, through compensation or profits or otherwise. But it is contrary to the ethos of our society when failure is rewarded, or when those that are big—systemically significant is the newfangled term of art—are protected because of little more than their status. Now more than ever, the U.S. economy needs more innovation, more risk-taking, and more competition. We should not want an oligopolistic banking system where the largest serve more as quasi-public utilities than as vibrant competitors. If we go down that path and give particular privileges and perks to the largest of the 9,000 competing financial institutions in this country, harm will have been done not just to the business of banking but to the broader U.S. economy.

TIE: **Do you see central banks in general, and the Fed in particular, surviving the current onslaught of political pressure and criticism? We had severe and nasty financial volatility before the existence of the Federal Reserve. We've had nasty and severe financial volatility with the central bankers in control. The Bernanke Fed deserves enormous credit for its quick response to the crisis. But is the central bank ironically at risk of losing a lot of its political base of support? Its independence?**

Changing the inflation goal posts in the middle of the game is a bad idea.

Warsh: I don't do politics. But as long as the Federal Reserve operates within the clearly defined parameters of its charter, then an independent, strong, non-partisan, non-ideological central bank has a great future in front of it. If any institution wanders from its mission, that's when it runs into trouble.

TIE: **Ultimately, the Fed is confronted with this question: Can central banks effectively target asset prices? In 1996,**

Continued on page 62

Continued from page 13

Alan Greenspan identified what he saw as an equity bubble when he used the phrase "irrational exuberance." The Dow then was roughly at the 8,600 level. That, as Larry Summers noted, turned out to be a bubble that wasn't. Later, there was housing, which turned out to be a bubble that was. Isn't it extraordinarily difficult for central banks in a democratic political system to identify and burst asset bubbles? In other words, how do you identify scenarios that represent just healthy growth versus those that represent dangerous bubbles? Are central bankers being asked to do the impossible? Are boom-and-bust cycles here to stay?

Warsh: Central banks should not overpromise. If they do, they run the risk of under-delivering and undermining the credibility they inherited from their predecessors. Central banks should be exceptionally humble about targeting asset prices, purporting to know which asset prices are too low, which are too high, and which are just right. The Fed's incredibly knowledgeable staff has access to more information than possibly any institution in the world, but the Fed should hesitate before suggesting that it knows what the market clearing price should be for any particular asset.

Around the world, there seem to be new responsibilities being hoisted upon central banks and regulators. Namely, that central banks and regulators should be in the business of ensuring that bad things won't happen. Those that sign up for this task may well leave a trail of disappointment. Bad things will happen in the global economy. And central bankers should not take on board the burden of writing insurance policies upon which they cannot deliver. Instead, prudent, responsible central banks should do their utmost to deliver on their long-held objectives as a steady policy beacon. And for those with regulatory powers, they should do their best to bring equal parts regulatory discipline, capital standards, and market discipline to bear without favor. Some banks will fail, and they should. And those that fail should bear the consequences. We will run grave risks if some institutions are somehow immune from market discipline.

TIE: **Thank you very much.** ◆