Second-Guessing the Fed

By Kenneth Rogoff *Mon, Feb 4, 2013*

A Harvard professor and author defends the Fed against charges that it should have seen the financial crisis coming.

Critics of the US Federal Reserve are having a field day with embarrassing revelations of its risk assessments on the eve of the financial crisis. By law, the Fed is required to publish the transcripts of its Federal Open Market Committee (FOMC) meetings with a five-year lag.

While the full-blown crisis did not erupt until the collapse of Lehman Brothers in September 2008, it was clear by the summer of 2007 that something was very wrong in credit markets, which were starting to behave in all sorts of strange ways. Yet many Fed officials clearly failed to recognize the significance of what was unfolding. One governor opined that the Fed should regard it as a good thing that markets were starting to worry about subprime mortgages. Another argued that the summertime market stress would most likely be a hiccup.

Various critics are seizing on such statements as evidence that the Fed is incompetent, and that its independence should be curtailed, or worse. This is nonsense. Yes, things could and should have been done better; but to single out Fed governors for missing the coming catastrophe is ludicrous.

The Fed was hardly alone. In August 2007, few market participants, even those with access to mountains of information and a broad range of expert opinions, had a real clue as to what was going on. Certainly the US Congress was clueless; its members were still busy lobbying for the government-backed housing-mortgage agencies Fannie Mae and Freddie Mac, thereby digging the hole deeper.

Nor did the International Monetary Fund have a shining moment. In April 2007, the IMF released its famous "Valentine's Day" *World Economic Outlook*, in which it declared that all of the problems in the United States and other advanced economies that it had been worrying about were overblown.

Moreover, it is misleading to single out the most misguided comments by individual governors in the context of an active intellectual debate over policy. It is legitimate to criticize individual policymakers who exercised poor judgment, and they should have a mark on their record. But that does not impugn the whole FOMC, much less the entire institution.

Central banks' state-of-the-art macroeconomic models also failed miserably – to a degree that the economics profession has only now begun to acknowledge fully. Although the Fed assesses many approaches and indicators in making its decisions, there is no doubt that it was heavily influenced by mainstream academic thinking – including the so-called real business cycle models and New Keynesian models – which assumed that financial markets operate flawlessly. Indeed, the economics profession and the world's major central banks advertised the idea of the "great moderation" – the muting of macroeconomic volatility, owing partly to monetary authorities' supposedly more scientific, model-based approach to policymaking.

We now know that canonical macroeconomic models do not adequately allow for financial-market fragilities, and that fixing the models while retaining their tractability is a formidable task. Frankly, had the models at least allowed for the possibility of credit-market imperfections, the Fed might have paid more attention to credit-market indicators as a reflection of overall financial-market conditions, as central banks in emerging-market countries do.

Last but not least, even if the Fed had better understood the risks, it would not have been easy for it to avert the crisis on its own. The effectiveness of interest-rate policy is limited, and many of the deepest problems were on the regulatory side.

And calibrating a response was not easy. By late 2007, for example, the Fed and the US Treasury had most likely already seen at least one report arguing that only massive intervention to support subprime loans could forestall a catastrophe. The idea was to save the financial system from having to deal with safely dismantling the impossibly complex contractual edifices – which did not allow for the possibility of systemic collapse – that it had constructed.

Such a bailout would have cost an estimated $500 billion or more, and the main beneficiaries would have included big financial firms. Was there any realistic chance that such a measure would have passed Congress before there was blood in the streets?

Indeed, it was precisely this logic that me led to give a very dark forecast in a widely covered speech in Singapore on August 19, 2008, a month before Lehman Brothers failed. I argued that things would not get better until they got much worse, and that the collapse of one of the world’s largest financial firms was imminent. My argument rested on my view that the global economy was entering a major recession, and I had the benefit of my quantitative work, with Carmen Reinhart, on the history of financial crises.

I was not trying to be sensational in Singapore. I thought that what I was saying was completely obvious. Nevertheless, my prediction gained bold front-page headlines in many major newspapers throughout the world. It gained headlines, evidently, because it was still far from a consensus view, although concerns were mounting.

Were concerns mounting at the Fed as well in the summer of 2008? We will have to wait until next year to find out. But, when we do, let us remember that hindsight is 20-20.

Kenneth Rogoff is professor of economics and public policy at Harvard University. He won the 2011 Deutsche Bank Prize in Financial Economics.