

THE EFFECTS OF INTERNATIONAL POLICY

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The thunder and lightning outside remind me of the earliest childhood experience of which I have a definitive memory, one that I share with General Colin Powell, I learned when I read his autobiography three years ago. Crawling around on the dining-room floor, key in hand, I stuck the key into the electrical socket. Shocks are meaningful! And provided they are not too large, they are memorable and a cause for learning.

AN ASSESSMENT OF PRESENTED PAPERS

We are asked in this panel to respond to what has been said earlier in the conference, and to assess whether the causes of recession are identifiable and debate whether any policies could prevent or mitigate (and, I would also add, exacerbate) recessions. So let me turn to the content of the conference, pretty much in reverse order.

On the Schuh and Triest analysis and discussions by Caballero and Davis of labor force reallocation in business cycles, this is an important and interesting phenomenon. And labor market reallocation within business cycles is worth studying in greater detail. However, I remain skeptical that labor reallocation is itself an independent cause of most U.S. business cycles - recognizing, of course, that what we describe as aggregate shocks do have significant reallocative consequences and that understanding those consequences is important for understanding how aggregate shocks generate their business cycle effects. With respect to policy implications, though, I would focus more on the issue of how, in the United States, the economy may be affected by the prevalence or

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absence of large-scale redistributive shocks, and on the effect this may have had on the NAIRU.

One of the interesting things about the 1990s is that we have had a fairly long period, not of spectacularly rapid growth, but of fairly slow and stable growth, which has allowed unemployment rates to come down quite uniformly across the nation and across industries. And this may be a factor that is enabling us to achieve a lower aggregate level of unemployment without an acceleration of inflation. In Western Europe, I think we see a different phenomenon, which Davis alluded to: It is not the business cycle that is a source of concern there but the lack of flexibility in European labor markets, which has produced persistent increases in unemployment to very high levels. That is an important policy problem, even if it is not a cyclical issue.

With respect to the discussion of real business cycles, as indicated earlier I remain highly skeptical, to put it mildly, of the relevance of shifts in total factor productivity as a primary explanatory variable for U.S. business cycle movement. Indeed, I think the notion that adverse downward movements in total technology cause recessions is just plain silly. This is the theory according to which the 1930s should be known not as the Great Depression but as the Great Vacation.

Turning to the Temin paper and the discussion of it, I very much agree with Temin that we need to acknowledge that recessions in the United States, both prewar and postwar, have a multiplicity of causes. There is no single universal cause, although I would agree with Romer that Temin underplays a bit the role that monetary policy has played in some of our postwar recessions and also in our expansions, which are still more complex phenomena that have a multiplicity of economic causes. And it is not really possible, and in many cases not useful, to try and separate causes out as 50 percent this and 30 percent that. Both necessary and sufficient causes exist, and we cannot always isolate and separate them.

Concerning Bordo, Bergman, and Jonung and the discussion of their paper, I think important things are to be learned from looking at the pre-World War I cyclical experience and the interwar cyclical experience, although I would buy into Cooper's caution that the data are not that good and we probably do not want to emphasize too much the quantitative similarities in business cycle movements, in view of the fact that we are looking at economies that are very, very different in their economic structure now from what they were a century ago. My grandfather, who was born in 1855, witnessed the siege of Paris by the Prussians in 1871. That was a time in which the U.S. and the French and U.K. economies were very different from what they are now, and I would regard any similarity in business cycle movements more as a fortuitous accident than as necessarily an enduring feature of our economic systems.

Turning finally to the Sims paper, here I actually draw more comfort

from what is reported and how I interpret it in terms of the way I view business cycles, with monetary policy able to play, at least potentially, a relatively large role in avoiding major business cycle downturns. Sims himself finds, according to his policy simulations, that if the Fed had pursued the alternative policy of the postwar period during the interwar period, the level of industrial production would have been 18 percent higher in 1939 and about 10 percent higher over the preceding decade than it actually was. That is certainly worthwhile having as a consequence of better monetary policy! Moreover, Sims emphasizes that his analysis does not take into account what the role of monetary policy would have been in avoiding the effects of widespread bank failures, which Bernanke and others have shown both interfere with the direct functioning of the economic and financial system and have an enormous negative impact on confidence, as we are seeing now in Japan as well.

And third, looking at Sims's results, I think that there is something bizarre in the interwar results that probably biases downward his estimates of the interest rate mechanism for monetary policy. If you look at his Figure 2, you will see a negative relationship between innovation in currency and the movement of industrial production at the 12-month to 48-month horizon. Why is that? Well, in the '20s and '30s when people went to the bank to draw out currency and put it in the mattress, that type of innovation was associated with negative movements in industrial production. However, it does not follow that the indirect channel of monetary action to stimulate increases in the supply of currency, by cutting the discount rate or engaging in open market operations, would, through that indirect mechanism of expanding currency, have a negative effect on industrial production.

So my suspicion, from the Sims paper correctly looked at, is that a properly conducted monetary policy, including its quasi-fiscal component in providing support to weak banks, could have offset at least one-third to perhaps one-half of the loss of industrial production experienced during the 1930s. And if we add to that the operation of automatic fiscal stabilizers and prompt and forceful discretionary fiscal action in the face of a major economic downturn, then I think it is plausible to conclude that one-half of the Great Depression and perhaps even three-quarters might have been avoided by more forceful policy action in those circumstances. But I think it is important to recognize, and this shows up also in the Bordo paper, that the interwar period was one of exceptionally large shocks. I do not think there is much reason to doubt that it is a real phenomenon. And one needs to be careful about assuming that policy possesses the capacity to offset, virtually immediately, even very large shocks in the economic system. I think Zimmerman made this point as well.

IMPLICATIONS FOR POLICY

Finally, I would like to turn to a couple of concluding issues with respect to economic policies. When I was in the Reagan Administration, I used to believe that you should try to relate what it was you were trying to tell the President to one of his favorite movies. The President was really into movies, and if you could tie it into a movie, then he would get the point. So when we were trying to persuade the Germans and the Japanese to get their economies moving in the mid 1980s I said, "Well, the right movie here is *My Fair Lady*, in the scene at Ascot race track, when Eliza finally blurts out, as her horse is falling behind the pack, 'Move your bloomin' arse!'" That was the message needed at that time.

The Effectiveness of Domestic Monetary Policy

In the present discussion, I would point to two movies: first, the Academy Award winner for Jack Nicholson and Helen Hunt, *As Good As It Gets*, because for U.S. monetary policy over the past decade or so, it is, in my judgment, as good as it gets. "As good as it gets" also means better than one can normally expect it to be. Now I want to emphasize that I share Zimmerman's view that maybe the Fed should not have tightened quite so much in 1989 and particularly should have eased a little more rapidly in 1991. Maybe the Fed was a little too expansionary in '85 and '86 and that came back to haunt us in '87 and '88. I think they should have tightened by at least 25 basis points more a year ago: It would have slowed the economy a little bit, and meant a little bit less of a dilemma now. But those are really quibbles in what has been, by any standard of judgment in any period, really a remarkable record of monetary policy management. It has combined very good management with very good luck.

And I think it is unreasonable to expect that policy on average is going to be quite that good. Sometimes the economy is going to zig when you think it is going to zag, and you are just going to be caught on the wrong foot. Moreover, in some circumstances clearly the right thing for monetary policy to do is, if not create a recession, then at least seriously raise the risk that a recession will occur. That is what the Federal Reserve was doing when it began to retighten monetary policy in the spring of 1988 to resist rising inflationary pressures. Clearly, if policy was tightened through 1989, the expectation was that the economy would slow quite significantly. A slow economy, one that is growing at a little over 1 percent per year, is a candidate for recession, even if you had not had the shock that happened with the invasion of Kuwait. It had to be done in those circumstances, and that was a good recession, not a bad recession. The monetary authority, in its conduct of monetary policy, cannot

reasonably be expected to avoid all recessions. The principal objective is to avoid big recessions.

A Defense of International Policy

And here is where the second movie, *Titanic*, comes in. In thinking about the causes of the disaster that was the Great Depression, we should also ask, "What caused the sinking of the Titanic?" Well, the simple answer is the exogenous shock; an iceberg sank the Titanic. But the story is really not quite that simple. Errors were made in the design and manufacture of the Titanic, and there were certainly errors in the way in which the captain managed the ship: the failure of the lookouts to have binoculars, the excessive speed, the inadequate supply of lifeboats, the inadequate deployment of those lifeboats at a sufficiently early time, the failure of the California to recognize the distress signals—all of those things contributed ultimately to the magnitude of the disaster.

And I think business cycle disasters like the Great Depression are of that kind. There was an iceberg, but other things probably contributed to the magnitude of the disaster. However, some believe that the real disaster in the North Atlantic on that cold April morning was not that the Titanic sank, at a loss of 1,500 lives. It was instead that 800 were saved. Think of it. If we had had a policy of no rescues, we would have sent a message, a clear message that ocean safety has to be of paramount concern, to passengers, crews, and ocean shipping lines alike!

I say this only partly in jest, because of those who wave the bloody flag of "Moral Hazard" every time the international community steps forward and says, here we face an actual or potential disaster and here is an occasion in which it is relevant to provide support. Now moral hazard is a real phenomenon, and it is a regrettable phenomenon. And when national governments intervene to provide hundreds of billions of dollars of taxpayers' money as a gift to bail out the savings and loan industry or a trillion dollars to finance the reconstruction of East Germany, or when every time a transportation strike occurs in France the government bows before it and gives the workers what they want, well, we encourage a lot of behavior that we should not be encouraging. And there is always a concern that international financial support sponsored by the International Monetary Fund and others may have such adverse incentive effects. But that does not and should not stop rescue efforts in all circumstances.

We need to recognize that international financial support through the IMF is not a gift, it is a loan. The Mexicans have now repaid more than half their loan and have paid a quite handsome interest rate premium to the government of the United States. They repaid an important part of the loan to the Fund and continue to service that loan fully, as I am certain they will in the future. It is not a gift; the subsidy element is quite small.

Moreover, I think it simply silly to believe that a primary reason motivating capital inflow into Mexico was the expectation that a crisis would occur and an international financial support package would follow. That was not on the radar screen at that time.

I believe the same is true for Korea; despite the experience in Mexico, people were pumping money into the Korean banks because they believed Korea was a strong economy and they believed that if a problem were to occur, the Korean government would bail them out. It was not on the radar screen that the Korean government would not have enough reserves to carry out the bailout itself. Now, the bailout by the Korean government and the expectation of it were a source of moral hazard. But I assert that there was no widespread expectation that the Koreans would not be able to fulfill their guarantee of Korean banks and that international financial support would be called upon.

I draw a distinction here with Russia, because in the case of Russia the perception in the international financial community undoubtedly is that Russia is too important to fail. It is Indonesia, or potential Indonesia, with 10,000 nuclear warheads. And accordingly, there exists a perception that Western governments through the IMF or other means will be prepared to provide financial support to Russia to avoid a crisis, in a way that simply would not be done or even contemplated for other countries in similar circumstances. It was mentioned in the panel discussion yesterday.

There is no doubt in my mind that the problem of moral hazard does exist in the case of Russia: The issue remains what to do about it. If further support is provided, and that issue is being actively discussed, it will undoubtedly be associated with further significant actions by the Russian government. Those actions will probably need enactment by the Duma in advance of disbursement of most of the additional funds to address the critical problem, which is not the exchange rate but the fiscal situation in Russia. Nevertheless, residual doubts necessarily will remain about the effects of that package. And an element of moral hazard will be associated with any international support package. It will provide further evidence to those who believe Russia is "too important to fail."

So what? Moral hazard is with us in many private sector and public sector operations. And in each specific instance, a decision has to be made about whether the moral hazard problem is sufficiently important to outweigh the other relative considerations in making a key policy decision. Sometimes it will be, sometimes it will not. That decision needs to be carefully weighed and carefully decided. In my view, it was the right thing to rescue the 800 who survived the sinking of the Titanic.