
Inflation targeting, the financial crisis and macroeconomics: an interview with Mark Gertler

Few people have had such strong influence on macroeconomics in general and on the New Keynesian School of macroeconomics as Mark Gertler has. His work with Ben Bernanke and Simon Gilchrist on the role of credit and financial conditions on business cycles, and with Ben Bernanke on whether the central banks should respond to asset price bubbles, are some examples of his influential work. Mark Gertler is the Henry and Lucy Moses Professor of Economics at New York University, and visited the Reserve Bank of New Zealand for the Monetary Policy conference held in Wellington on 17-18 December 2009. The conference was organised jointly by the Reserve Bank of New Zealand and the Center for International Economic Development to mark the 20th anniversary of inflation targeting in New Zealand. Özer Karagedikli from the Economics Department of the Reserve Bank interviewed him.¹

Özer Karagedikli

Professor Gertler, welcome to New Zealand and thank you for taking time for this interview. I understand this is your first time in this part of the world and it is a pleasure having you here at the Reserve Bank. You are here for a conference to mark the 20th anniversary of inflation targeting in New Zealand. Twenty years ago New Zealand passed the Reserve Bank of New Zealand Act (1989), which gave the Reserve Bank the price stability role and independence “to achieve and maintain price stability”, which became known as inflation targeting. Do you think the inflation targeting framework has served us, ie, New Zealand and the twenty odd other countries that are using the same framework, well?

Mark Gertler

I think one of the remarkable achievements of central banks over the last several decades has been price stability. And I think a central factor in that has been inflation targeting: either of the explicit kind that New Zealand and other countries have adopted or of the implicit kind that the Federal Reserve has been following over roughly the same period. We have seen the benefits of price stability during the ‘great moderation’ era. There was a period of very robust growth and central banks didn’t have any reason to have to derail the growth because we had price stability. And I think the inflation targeting framework has helped in



Mark Gertler

the current crisis because things would have even got worse, had deflation took hold. But I think that for many countries the public are of the mind that central banks are committed to two percent inflation over the long term and that seems to have served us well in this crisis to help prevent deflation – so far.

ÖK

You said either explicit or implicit inflation targeting. I assume you see no difference between the two?

¹ Thanks go to Sophie Robins for the transcription of this interview.

MG

Well, it's hard to say. In the US, it seems to have worked thus far. Implicitly, it was very clear to anyone following the Federal Reserve that they had a goal of long-term inflation of two percent. If you look at the history of interest rates setting, you know any signs of inflation typically led to an increase in interest rates. I think the Fed has established a reputation. From an institutional perspective, it has come a little closer to formal inflation targeting in the sense that it now announces an inflation forecast for three years down the road. This forecast is effectively the target. It does remain that there is an open question as to how much difference going all the way to formal inflation targeting would make. Maybe there are some scenarios where it could make a difference. But this is probably less true for a country like the US which has built up credibility over a long period. It may be different for a central bank that has not had this long experience with price stability. It may be more important in that kind of situation.

ÖK

Coming back to the great moderation; do you think the great moderation was entirely, or at least mainly, due to better monetary policy? Or did other factors, such as better fiscal policy, inventory management or good luck play a role as well? I wonder whether you think the central bankers were too strong in arguing it was all monetary policy (inflation targeting)?

MG

For output stability, my back of the envelope calculation is 1/3, 1/3, 1/3 (policy, good luck, structural). For price stability, monetary policy deserves the lion's share of credit. It is true that we were probably too optimistic about the resilience of the economy and about what policymakers could accomplish.

ÖK

There is a belief in at least some part of New Zealand society and economic community that inflation targeting has led to

large asset price cycles, especially in house prices and the exchange rate. In New Zealand recently, we experienced two large house price cycles, with the second one being a rather large one. We also experienced large swings in the exchange rate. Do you think these large swings in asset prices are the by-products of inflation targeting?

MG

Well, I'm not sure that there is any kind of definitive evidence for that point of view. When I look at the asset price bubbles over the last decade, the first thing that comes to mind is low long-term interest rates and I think that has more to do with the global saving and investment in the world economy than the setting of short-term interest rates. The second factor, at least in the case of the US, was a general relaxation of lending standards, in particular sub-prime lending. At the peak of the housing boom, about 40 percent of new mortgages were non-prime loans. This undoubtedly played a factor in the run-up. I would think there was also complacency about risk – a sort of perverse effect of the great moderation. So credit-risk spreads across the board were much lower than they would have been otherwise. I think these factors were more important than short-term interest rates. Indeed, if you look carefully at the data, there is not a tight connection between short-term interest rates and bubbles. For example, the UK had a housing bubble roughly the same size as the US. But they did not have unusually low interest rates in the early 2000s. So if you look at the data very, very carefully, the evidence for that position is not so clear.

ÖK

And of course during the 1970s, real interest rates were negative.

MG

True, the real interest rates were negative back then. Also, the stock market bubble in the late 1990s was not precipitated by unusually low interest rates. The reality is that there is no simple way to contain a bubble with conventional monetary policy. The second reality is that the effects of bubbles really

depend upon the leverage and the sector the bubble collapse hits. So going forward, I think the best strategy is to regulate ahead of the game to prevent the kind of risk exposure that happened in the past crisis.

ÖK

You have touched on this previously, but I would like to ask you if you think that the inflation targeting framework in this crisis has worked well?

MG

Well again, it is important to keep in mind that an inflation target has symmetric implications for movement of inflation above and below target. The goal in each case is to require that policy adjust to return inflation back to target. The announcement of such a target further helps anchor inflation expectations. In the current crisis, this was definitely a factor in keeping deflation from taking hold.

ÖK

You mentioned the symmetry in our inflation targets that implies we do not like high inflation and we do not like deflation either. However, it has been a long time since, apart from Japan, a developed economy, including New Zealand, experienced deflation. People and central bankers have seen high inflation in the recent past, and they have had to deal with it. But they have not had to deal with deflation. Given that central banks have symmetric inflation targets and given not many people remember it, do you think central banks should communicate the problems associated with deflation more with the public? I think economists have communicated the costs of inflation very well but perhaps not the costs of deflation. Perhaps as a consequence, the US economy experienced two scares of deflation inside a decade.

MG

I think we have a good idea of how to address the problem of stagflation that ravaged the economies of the 1970s

and early 1980s. Now the problem of financial crises and deflation has moved centre-stage and is likely to be with us for some time to come. So, yes, communication on this issue is important.

ÖK

I want to read out the beginning sentence of one of Ben Bernanke's *American Economic Review* articles from the 1980s: "Seismologists learn more from one large earthquake than from a dozen small tremors. On the same principle, the Great Depression of the 1930s would appear to present an important opportunity for the study of the effects of business cycles." Do you think the profession could have learnt more from events like the Great Depression or the 'lost decade' of Japan?

MG

Well, actually I had the privilege of hearing him say that in person. And, in fact, I asked him that very question – why he studied the Great Depression – and that was his answer. And that really kind of made a light go on in my head. I never really thought about that. I think as we look back, the answer is obviously – yes. I think maybe we had become too complacent about our ability to keep the economy stable. Certainly there is much to be learned from studying these episodes. And as everyone knows by now, it was Bernanke's knowledge of the relevant history that dictated his aggressive policy response.

ÖK

I want to talk to you about credit and its role in the business cycle. These things were studied in Gurley and Shaw (1960), for example. But I believe your paper with Ben Bernanke was the first one in the more modern era to address the role of credit and financial frictions and do you think this is another thing the profession missed?

MG

Well, I think these ideas kind of go back to the Great

Depression and Irving Fisher's theory of the Great Depression, which involved the debt deflation. There were others who worked on these ideas informally, like Shaw and Minsky. Even some of the early macro models included some balance sheet variables. I think we were the first, within modern literature, to incorporate balance sheet variables as factors in cyclical fluctuations.

ÖK

What is the message of these models? And do they explain phenomena like the Great Depression, the Japanese case and the current crisis?

MG

Imbalances in the financial sector (high leverage, etc.) can make the economy highly vulnerable to disturbances that might have only a modest effect on the economy. In these ways, the models help account for phenomena like Great Depressions and Lost Decades that might otherwise be very difficult to explain with conventional frameworks.

ÖK

I want to come to the current crisis. You noted that the run-up to the current crisis had more to do with the global savings and investment "imbalances" than the low short-term interest rates. What was the one thing monetary policymakers got wrong, if anything, prior to the crisis?

MG

I think nobody, monetary policymakers included, appreciated the risks of the banking system. I think nobody understood or anticipated the way the dynamics could play out. Take, for example, securitised mortgages. Nobody really appreciated that these mortgages couldn't be renegotiated in the event of default. Nobody appreciated these defaults would lead to foreclosures that would lead to further declines in house prices. And nobody appreciated how sensitive these securities were to falling house prices. So that is something that the profession missed, but I would say most everyone else missed it as well. There were a number of people who

predicted the crisis, but I don't think there was anybody who put their fingers on this mechanism. I'd say that not seeing this mechanism was the greatest lapse. In terms of policy mistakes, if I could pick one, it was allowing sub-prime lending.

ÖK

I want to come back to the current crisis which started with the burst of an asset price bubble. Your 1999 article with Ben Bernanke on whether or not central banks should respond to asset prices, at least in my opinion, was a very influential piece for central bankers. Are you still of the view that central banks should not lean against asset prices with interest rates?

MG

Well, I think I can still stand by what we said in that paper and I actually went back and looked at it, because I had a similar request from a reporter. We didn't say that central bankers shouldn't pay attention to asset price bubbles. We said that the interest rate was a poor tool for dealing with them. It is not the case that you can adjust interest rates and have no other effects on the economy. That's even before you get to the issues of identifying asset price bubbles. But what we did say is that the effects of bubbles depend upon leverage and it may be that the best way to deal with a crisis is to prevent excessive leverage through regulation.

ÖK

When it comes to regulation, do you think central banks should also be regulators, or should have a say in the actions of regulators? What kind of regulation do you foresee from this point on?

MG

Since central banks are responsible for containing the effects of financial crises, they need to have a seat at the regulatory table. The key regulatory problem to deal with is too-big-to-fail. Having some kind of resolution authority that would

permit a federal regulator to take a large financial institution in distress and liquidate its assets in an orderly manner would certainly help. It may also be necessary to extend capital requirements to all financial institutions that pose a systemic threat. Finally, we cannot tolerate the same kind of relaxation of lending standards as took place with sub-prime lending.

ÖK

I want to talk to you about another issue that you have recently worked on with Comin and Santacreu – productivity. There are different schools of thoughts about long-run growth, often centring on the role of institutions and geography. What is your take on the issue? What are good policies for a more productive economy and higher long-run growth?

MG

Well, I don't think that there is any simple answer other than to say a country's institutions should be strong and the education system should be strong as well. I think where we came into the literature is related to the following: If you look after big recessions – I have in mind the crises in emerging market countries – it seems like there is a persistent period of lower productivity growth, and also, countries do not revert back to trend quickly. The loss of output seems persistent. And to us it seems it is hard to account for that unless there is some dimension of endogenous productivity in it. So our interest in the area was more about linking business cycles and productivity growth.

ÖK

There has been something of a debate in the profession, and as far as I remember, you haven't entered into that debate, about how useful the models we have been using are and so on. In your 2007 *Journal of Economic Perspectives* article with Jordi Galí you say: 'The models we have described are still works in progress. Despite the recent successes, we cannot be certain without further experience how resilient these frameworks will prove as new kinds of disturbances

hit the economy. Indeed, we fully expect these models to continue to evolve as we accumulate more data, and experience more economic shocks.' What do you think the verdict is on our models?

MG

Well, actually it is nice to know that I said something that I can still stand by. But let's compare this to the 1970s, where the models were broken down and they had to be reinvented. I don't think that that is the case this time. I think that there is a pretty good basis on which we could build. It is more or less the need to modify these models. So it is not like we had to practically start from scratch, which is what we had to do in the 1970s. And again I think there is a lot of confusion in the public at large: A failure to forecast a crisis is not the same thing as a failure to have the working knowledge of what was going on and how to deal with it. What I mean is that it is certainly true that the crisis caught central bankers and everybody else off guard. But I can say certainly that Chairman Bernanke, based on his own life's work, saw what was happening as the crisis started to take hold and then used this knowledge to design the policy response. And in all of this, he also made extensive use of what was going on in the profession. He was not operating completely out of thin air.

ÖK

And where do you see the literature going in that direction?

MG

What I have always liked about macroeconomics is that it responds to real world events. Since the late 1980s, there had not been any kind of financial crisis in the US of significance. There were some that erupted but didn't have significant effects on the economy, like LTCM and the Russian bond default. But the recent crisis has exposed all sorts of new phenomena, like the shadow banking system and problems with securitisation markets. So there are all sorts of new

stuff to work on. And there is lots of work that is currently being undertaken.

ÖK

Do you see this in graduate classes? As you had put it elsewhere, is the new macro “pre-and-post August 2007”

MG

You certainly see it in PhD theses. There is now a lot of work on financial crises. Let me also say that I did not make that distinction to demean old macro. I think old macro was quite successful for the objective it took on hand, which was maintaining price stability in the face of supply shocks and other inflation pressures of the type that hit during the 1970s.

ÖK

What is your view on the future of the profession?

MG

I am optimistic. Yes, there are some issues we need to rethink and some priorities we need to reset. But we have a good base of work we can build off to understand this crisis and help avoid a repeat. It's not like the 70s where we had to start from scratch and build a completely new paradigm. As I suggested earlier, a failure to foresee the crisis is not the same as a failure to have the tools to comprehend it and make sure that it does not happen again. One other reason for my optimism: I was asked recently by a reporter who I thought were the top young economists. It was not hard to come up with the names of a number of young macroeconomists who fit the bill. And that may not have been the case a few years ago.

ÖK

My final two questions are going to be slightly different than the others. How did you decide to study economics? What influenced your decision?

MG

I liked math and I liked studying real world problems. Economics is a nice mix of the two.

ÖK

Would you be able to name two or three of the most important economists to you, and also non-economists?

MG

It was the generation of macroeconomists just ahead of mine that inspired me to go in the field – Bob Lucas, Tom Sargent, Neil Wallace, Stan Fischer, John Taylor, Ed Prescott and Robert Barro. I have also been privileged to work with many great co-authors, including Ben Bernanke, Jordi Galí, Rich Clarida and Rao Aiyagari.

ÖK

How about non-economists?

MG

I think my father Coleman; I guess I would say that.

ÖK

Great, thank you and enjoy your stay in New Zealand and hope to see you again.

MG

Okay, absolutely.