

Faulty powers

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The power of Central Bank

If you want a simple model for predicting the unemployment rate in the United States over the next few years, here it is: it will be what [Alan] Greenspan wants it to be, plus or minus a random error reflecting the fact that he is not quite God.

Paul Krugman (1997)

Faith is falling

- Since September 2007, interest rate is cut by 1.75% to 3.5%
- The lowest rate in 2003 is 1%
- Even Bernanke has given his blessing for a fiscal stimulus
- What lies behind the loss of faith on central bank?

The loss of faith

- Overly loose monetary policy in 2001–03 has got the economy into this mess
- Loose monetary policy fueled the housing and credit bubbles
- But America's housing boom is ending, Fed is less able to stimulate the spending that comes with **rising housing wealth**

Credit channel

- Interest rates are the cost of using tomorrow's income to pay for today's spending
- Lower rates lift spending by more **when there is access to borrowing**
- Firms and homeowners can borrow cheaply with good collateral, but **funds are less abundant when asset values are falling**
- Even if credit demand holds up, banks reeling from subprime-related losses are less willing to supply it

Not toothless

- Lower interest rate increases the disposable income of debtors
- The negative effect on lenders seems to be smaller, so the net effect may still be positive
- In sum, although the asset-price and **credit channels** are more constricted than in the past, monetary policy can still work through them

fiscal and monetary policy

- The drawback of fiscal policy is that it leaves decisions to politicians
- The case for fiscal policy: during the long or deep recessions, or when interest rate fall to zero