

Interview

Andrew Scott and Thomas Sargent

Transcript

Andrew Scott: Great. Well thank you very much Tom for joining us for this interview for the EABCN. It is obviously a very interesting time to be a macroeconomist who is interested in business cycles. I just wondered what you had been doing during the recession. Have you enjoyed it? What do you make of it all?

Tom Sargent: Well I don't think anybody has enjoyed it. So in some sense, what we have observed is new variations on things that we have seen over and over again in the past.

I guess you would say "Enjoy." We don't get observations on big crises in advanced economies like this very often fortunately. But, when they occur they're informative about aspects of the system that we generally don't have observations on. They are things that as observers and as "scientists" we try and take advantage of.

Andrew: Completely agree. Of course, you mentioned there new variations on a theme, but also we don't often get observations of this magnitude. In what way do you think it is special? Do you think it is different this time? Do you want elaborate a bit more about new variations on things we have seen before?

Tom: Yes. One of my favorite quotes is by George Stigler who said, "A war can ravage half a continent, but raise no new issues in economic theory." And in some sense these crises are like that. As I look at this crisis, there are two wise things from the past that keep coming back and haunting me.

The first is the passages in Friedman and Schwartz where they raise the possibility that the establishment of the Federal Reserve System, which was designed to arrest a crisis, might actually make them worse. They sketch a mechanism, basically only in footnotes, that by making people think they didn't have to worry about crises; they actually caused people to make decisions that made it more likely that crises would happen. That was one thing.

The other thing was that the establishment of a Federal Reserve arrested some mechanisms in earlier crises that the market had worked out to halt crises. They occurred both in England and the United States and took the form of temporary suspensions of convertibility by banks. They were a stopper of runs. And they noted that the Fed stopped that. So, that is the other thing that haunts me a little bit.

Fast forward to the 1970s and in the Journal of Business and the late 70s, I think '78; there is a pair of articles, one by Merton and one by Kareken and Wallace. These articles were written before the massive deregulation in the United States and at a time when many people in macro, like the leaders like Friedman and Tobin, uniformly celebrated deposit insurance.

Kareken and Wallace wrote down a model in which if you didn't have deposit insurance there would be equilibrium where depositors would be vigilant. And they worked out equilibrium where if depositors wanted deposits that were safe they would choose banks that had safe portfolios.

Then they described an equilibrium where you had banks of indeterminate size with safe portfolios. Then they did the experiment. They put on deposit insurance, which is not correctly priced. And they re-analyzed the problem of depositors and the banks. Well the depositors didn't care. They had no reason to be vigilant. The banks did care because they had the incentives to become as large as possible and as risky as possible.

This is 1978 so what Kareken and Wallace concluded is if you are going to have deposit insurance then you are going to have to regulate bank portfolios. Or else you are going to have to price it right.

So this was a warning against deregulation. Kareken and Wallace's message was ignored for various reasons although I do not think it is really the fault of economists that it was.

I will give you an example. A friend and colleague of mine in Hoover wrote a book after the Reagan administration. He was a member of the Reagan administration. In it, he proudly said that the Reagan administration took advantage of no academic paper that he knew of. And my friend Jose Scheinkman made a list of the ten academic papers that the Reagan administration should have looked at. And number one was Kareken and Wallace. Because in the 80s we got into this problem, we got into a mini crisis with the savings and loans. But, we didn't learn the lesson.

Andrew: Obviously not. And of course if you look at the way regulation is going now do you take any hope that they are listening to that lesson anymore?

Tom: Yes and no. What really frightens me is one of the slogans that you hear. One slogan that you hear is "wait: in the middle of a crisis is no time to worry about moral hazard". If you kind of think that through that is the time inconsistency problem totally naked, standing right before you.

The moral hazard problem is exhibited most vividly right at the height of a crisis; because that is the time when the government is most tempted to extend deposit insurance that was implicit to really make it explicit, almost explicit through precedent.

A lot of what the central banks were forced to do actually created precedents that are going to be very costly.

They really call for drastic rethinking about regulations. That is just not happening. I know the United States better. That is just not happening. (Editor's note: please note that this interview occurred before President Obama belatedly decided to endorse some of Paul Volcker's recommendations.)

Andrew: It happening to the UK and to differing degrees elsewhere as well. Now there are a number of things there that I could pursue. Let's start off with is those papers you mentioned. The focus on those is looking at the incentives of financial intermediaries in the decision-making that they do.

Now one of the things that macro seems to have been surprised by is the behavior of financial institutions during this period. There are a lot of people saying we missed it. We didn't focus on the money enough. We didn't focus on the credit decisions. We didn't have any model of financial institutions. We tend to just focus on the central bank interest rate. And it had a complete black box about what was happening in the financial system. Do you agree with that?

Tom: No. So that is a comment that is made by people who either are not widely read or they are pretending to be not widely read. It's a comment that speaks a half truth because it selects a piece of literature. It is true, if you look at a subset of models in macro and finance. Let's say models that you could summarize as the New Keynesian models. Those models strip out a lot of things; they ignore a lot of things for the purpose of focusing in certain directions. It is true that the original models have very primitive structures of financial intermediation.

A couple things. First, one response to the crisis has been people have been repairing those models. That is a halfhearted response.

But, then there is this entire other literatures that were thriving. My colleagues participated in this, like Douglas Gale. There is a substantial literature that took off after the Diamond-Dybvig model. You can think of the Diamond-Dybvig model from the early 80s as basically the best case model, the best case model for the actions of the central banks.

The original Diamond-Dybvig model is a model of pure runs. There is no moral hazard in that model, something that Diamond-Dybvig are apologetic about at the end of their paper. They actually mentioned the Kareken and Wallace paper saying that they don't have that force in the model, and they are worried about it. But subsequently to Diamond-Dybvig, there is a literature of people writing papers about banks and their possibly misplaced incentives.

There are people within, for example, the Federal Reserve Bank of New York that are experts on these models and participate in them. Those people aren't the ones who are building the DSGE models, but they have had a lot to say.

There is the whole Bernanke-Gertler tradition that started to be important in these new DSGE models. I think it is true that if you stand back broadly and look just beyond the DSGE models there has been a lot of work in macro that has been really useful, subsets of which are being taken seriously by central banks.

Andrew: Yeah and I totally agree that there is a lot of repair work going on. And there is a huge literature that should have been embedded more in our policy focused models. Why do you think that literature didn't make more of an impact among those policy-makers? Do policy-makers just want to have simple models? Do they not really value academic research? Is it something to do with the researchers themselves?

Tom: This is a good question. I think there are different types of policy-makers. There are two policy-makers that I know of, Mervyn King and Ben Bernanke, both of whom I think take academic research both seriously and with a grain of salt just in the right sense. I think they are exceptional policy makers. You look at the composition of some of the committees and Bernanke and Mervyn King are real outliers. The committees typically have some good and well-informed people. And they have a lot of people who just by virtue of their training just struggle to keep up. Those committees that make these decisions are not committees of experts. Sometimes it is a mystery to find out how people are chosen.

When you say policy-makers that is one thing. Then there is the political economy of it. Clearly some of the policy makers are basically there because they are representing the interests of the financial intermediaries. So this is the kind of Stigler theory, the so-called "the regulated institutions capturing the regulators". If you look in the United States the causeway that goes between Wall Street and the Treasury and to some extent the Fed, you can't put aside those political economy things.

Andrew: I think that is very helpful and also that raises the other question too. Should academic researchers think that policy makers are their ultimate client in macro or should we do more independent, non-policy oriented research given the political economy issues present and problems of differing expertise?

Tom: Actually, I think macro can hold its head up really high. Because a lot of it lives up to the aspiration that research is directed at informing some decision, some public policy decision.

If you look at a lot research in other fields of economics they either don't live up to that, or the decisions that they are informing are not institutions that you would go to the barricades for. Helping Microsoft make better decisions I'm sure it is valuable, but it is not as lofty an aspiration as trying to get better macro economic performance. You know, that's what attracted lots of us into macro.

Andrew: Me as well. I guess that raises the question, obviously we do not know how this recession is going to play out. It looks like the economies are recovering. We don't know how sustainable that recovery is. But, there has been an enormous policy intervention. I'm sure you have seen the different charts comparing what has happened this time with the Great Depression. And the big difference does seem to be in the policy response.

I wondered, do you think that is true, that policy response has been different? Do you think we have avoided something worse than just the very painful recession we have seen and do you think that policy has been inspired by academic research?

Tom: Yes I think so. I can speak mostly for America. I was at that conference. It was Milton Friedman's 90th birthday party and Ben Bernanke was then a Governor. I was astounded. I think he meant it entirely as a joke. He was giving a presentation, and he turned to Friedman and said, "You and Anna Schwartz were right that we caused the Great Depression and we promise we won't do it again." I think he took that seriously. So if the Fed erred, it didn't err on the side of caution. After Lehman failed, they were just extremely aggressive.

Andrew: Obviously that's a great testimony to Friedman and Schwartz, but I wonder about the more modern research, and also the fiscal policy rather than monetary policy.

Tom: I think it's a testimony not only to Friedman and Schwartz, but to Bernanke and Gertler. Bernanke is inspired by his academic research. He has a model of what goes wrong when collateral values go down and how that can lead to contractions of output. He basically put his money in that model.

I think Krugman is reported, I didn't hear him say it, but I read it in "The Economist" magazine, he said that all macroeconomic research over the last 30 years is either useless or counterproductive. Technically, that's just wrong in the former sense. The models in the class that Bernanke and Gertler made turned out to be extremely influential for better or for worse. These guys had a vision of what would go wrong when these capital values are going down, and they moved to cut through all this stuff. They're moving to arrest the decline in those capital values. So they're acting on a theory, for better or worse.

When Krugman says it's useless, he's just not reading the newspaper. It was used a lot.

Andrew: There's something else I want to pick up on you said earlier on. It was a comment about footnotes in Friedman and Schwartz. You made two comments. One was about moral hazard issues, but another one was how when people feel safer, they start, I assumed you were going to infer, behaving in a riskier way.

Do you want to elaborate on those things a little bit? Was that a correct interpretation? In particular, I'm thinking about the Great Moderation. I'm thinking about the financial support which made people, because they thought aggregate risk was less, change their

expectations of the world and start to behave in a more aggressive way. Is that the sort of mechanism you were thinking of?

Tom: I'm projecting some of my own thoughts and actually things I learned or mislearned from conversations with Neil Wallace back in the '70s and '80s about Friedman/Schwartz.

Well, I have two things in mind. I'll come back to the other thing about the Great Moderation later. If you look in the '20s, there's lots of miscommunication about what the policy of the Fed was. The Federal Reserve Act, it's actually full circle. It's a circle with what happened now.

The Federal Reserve Act actually had written into it a version of the Real Bills Doctrine, which, by the way, Friedman didn't like. I actually like it. That Doctrine said what the Federal Reserve was supposed to do. It was a rule about open market operations. The Fed is supposed to conduct open market operations in safe private assets. This Real Bills Doctrine goes back to Adam Smith. That's actually written into the law. So that created an expectation on the part of the private sector about the way the Fed would be operating.

But there was something else that was contradictory that was written into the Federal Reserve Act, and that was that we were supposed to stay on the gold standard and there are gold reserves that have to stand behind these notes. There's an ambiguity, a contradiction, between those two things. If there's an ambiguity written into the strictures that are supposed to govern the policy and the public can't figure out, it's not feasible for the policy-makers to do what they're supposed to do.

So that could create a lot of difficulty in forming expectations. Then you can say, well, the public figured the government's on a real bills regime. They weren't going to take the gold standard that seriously. If you got into trouble, they would discount private stuff.

But when push comes to shove, the way I read it is that this isn't quite Friedman/Schwartz's. The Fed took the gold standard requirement much more seriously, and then departed from real bills and that led to a problem. They kind of fast forwarded to the current one partly because of Friedman/Schwartz. The real bills got killed off. Instead, the Fed would never touch anything private before the crisis.

Gertler and Karadi, in their really nice paper, talk about "unconventional monetary policy". What that means is real bills backed by private stuff. So in some sense, it's not unconventional; it's going back to the original Federal Reserve Act.

Andrew: That's interesting. I like that take. Perhaps I can move onto another which is linked into this. This is about expectations and people's changing expectations. Obviously, you originally did a little work on rational expectations and more recently, a work on learning. Again, one of the things everyone says in the crisis is we've got to change our models of expectations, that rational expectations are inappropriate or wrong or that we have to look at behavioral models or animal spirits.

As somebody who's contributed so much into this literature, I wonder what your take on that criticism was and also your inference in terms of what we need to do in terms of expectations given the events of the last few years.

Tom: OK, good. You hear that criticism from people who are completely unread. I'll tell you what I mean. Two things: first thing is, we basically do have one model that's very helpful in predicting the crisis, not the timing of the crisis because there are random variables, but in terms of predicting the measures that increase the probability of a crisis, and that's the Kareken and Wallace model.

That hinges entirely on rational expectations, that these greedy bankers figure out what the odds are and what's in the interests of their shareholders, and they increase these risks and they increase the probability of a crisis. That's a pure rational expectations reasoning.

Last year when Geithner proposed one of his plans, there are editorials criticizing it by both Stiglitz and Jeff Sachs. They're very nice editorials, and what do they go through? A simple rational expectations calculation about, given the probabilities and the odds that are set up by this government program and the incentives, who's going to benefit and who's going to lose. It is an entirely rational expectations calculation.

So the crisis has nothing to do about undermining rational expectations. The behavioral model is just not being used to talk about the crisis. When Stiglitz and Sachs want to say anything, they don't talk about behavioral economics. They do good rational expectations. That's one thing.

Then the other thing is the comment that rational expectations have been undermined is really insulting to young guys. If you go to any conference, anywhere in the world, the good young macroeconomists are routinely using rational expectations to produce really innovative results. It's their starting point for talking about the crisis.

The guys who make that comment are like Sidelsky telling people in the "Financial Times" how macro should be taught. He's never taken a macro class or read anything. He's not writing down models. I just don't take it seriously.

Andrew: Well, I'm very glad to hear that. How do you think the learning agenda is being moved forward by the crisis?

Tom: I like work that refines rational expectations. There are situations where learning or robustness or some kind of consideration of more insecurity about probability distributions than is cast in the usual rational expectations model is worth exploring. I like that work. It might explain a little bit of the cast of mind of various central bankers.

In the latest crisis it's not that the Fed or the Bank of England had one model in mind. They were trying to grope their way for what was a good model. I think the learning stuff has contributed to a mindset that's made people appropriately cautious about running too far with one model.

Andrew: One thing I can't quite grapple when I talk to people in general about the crisis and policy makers and academics, you talk there about the advantages of learning where you have to deal with the world where there's less security about probability distributions. Just how different is this crisis? Is it such a large shock that it undermines our faith in what we thought the possible probability distributions were? Or is it something you said earlier, new variations around something we've seen many times?

Tom: I think it's new variations around things we've seen many times. Also, we are a little isolated in the United States. There've been crises of this size all over the world in the last thirty years, one after the other. Argentina's gone through them. There are papers about, in the AER, impulse response functions after a big crisis. They tend to be in smaller countries.

Andrew: I should put a plug in for the Euro Area Business Cycle Network. We probably should do more than just study the U.S. data on business cycle experience, that's for sure.

Tom: Absolutely. Absolutely.

Andrew: I also can't help but feel that in this recession we're praying perhaps it's different this time. There seems to be a big demand by commentators that this is something exceptional. I tend to agree with you that we see it very, very frequently.

Tom: It might be exceptional magnitudes, but there're lots of differences in details. One of the differences I think you should focus on is the number of institutions that are called banks now, de facto, that have a put on the government when they get in trouble has expanded. That's not a difference in principle, but it's a difference quantitatively.

The people who write contracts with AIG don't have to worry as much about the propriety of the way AIG's conducting its business because the Fed's going to come in to support them. That's really disturbing. It's not a new principle. Now other institutions are like banks and they have incentives to take more risks. It's not behavioral economics that will help you with that. The government has created incentives for people. If they understand the distributions, they should behave in ways that increase the probability of these things.

Andrew: I want to just move on to a couple more things, Tom, before we finish the interview. One of the reasons I was keen to interview you was all the things everyone says we need to work more on, if I go back and look through your career and you've always worked on them. One issue that's suddenly up the agenda once again is the size of government debt and concerns about inflation and central bank independence. I just wonder what your own views were on that topic, given what we see at the moment.

Tom: Yeah. So you said, am I enjoying the recession? Well, part of the response is that there's going to be a resurgence of interest in stuff like that, unpleasant monetarist arithmetic and the four big inflations that I did a long time ago, unfortunately. I think the basic issues involved in government budget constraint, you're right, were set aside in

those new Keynesian models. They're pushed in the background. I think they're going to come up again.

Andrew: Do you worry about the inflation implications of what's been happening?

Tom: Yes.

Andrew: What do you think that means for monetary policy going forward?

Tom: Yeah, I do worry about it. There've been big changes. The ability to pay interest on reserves is a fiscal change.

Andrew: How do you think it will affect the actual operation of monetary policy in years to come?

Tom: I don't know. One of the scary things is there are Congressional reforms on the loose. Institutional design is being done at a bad time with people very emotional. So that's for political observers to say. It's a risky situation.

Andrew: One other thing which is to talk about the international dimension of the crisis. Do you think that's been a significant part of this crisis? Is that a scenario where we need more research or do you think that's not been a key factor?

Tom: I think it's significant. We need to do more research about the '30s. Read Friedman/Schwartz and you think it's a domestic U.S. thing. It's clearly not. I think there were lots of international things then and there are now, especially now, when markets are so interconnected.

Andrew: In terms of your own research agenda? Certain things have obviously been coming through in the crisis. What are you working on in the near term? Has anything changed in your research priorities?

Tom: I keep on working on robustness, trying to figure it out. I think that has something to say. And I'm working on government budget constraint issues.

Andrew: The robustness stuff, the new phrase that seems to be in the words of policy-makers is macroprudential. I wondered, is that a scenario that you think robustness is applicable too?

Tom: Yes. Yeah, I do. It's hard to think about, but yeah, I do.

Andrew: Relative to monetary policy and fiscal policy, it does seem to be an area where we don't really yet have an established framework to think about these issues.

Tom: No. I have students who are working on this. Some of it's pretty exciting. When you put robustness on, you get some additional avenues like disciplined ways to think about expectations management. We can talk about that some other time.

Andrew: OK. Well, that's been fantastic, Tom. Thank you very much for your time.

Tom: Thanks a lot, Andrew.

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