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OPINION

Bagehot's Lessons for the Fed

By RONALD MCKINNON

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No one needs to be reminded about the bad financial-market news. Sharp cuts in the federal funds rate down to 2.25% have provoked a flight from the dollar, and a weakening of the dollar against most foreign currencies. Every day brings word of new write-downs and write-offs, and the Federal Reserve has rolled out a bewildering variety of stratagems to help. But the economy is not responding positively.

What strategy or rule should the Fed be following to help the economy recover from recession, or curb what is now a spectacular inflation in commodity markets?



Getty Images

Walter Bagehot

For a decade before 2003, the Fed more or less did follow a rule, which was formulated by my colleague John Taylor of Stanford University. The Taylor Rule specifies how the fed funds interest rate by itself can smooth mild business cycles.

It presumes that the Fed aims for 2% annual inflation in the CPI. Thus, with an average short-term real interest rate of 2%, the fed funds rate should average about 4% in the "steady state."

At the top of the business cycle, or to combat a surge in inflation, the rate should be raised by 1.5 percentage points for every one percentage point of inflation above the 2%. It should be lowered during a cyclical downturn accompanied by deflation. The Taylor Rule worked well in facilitating high, noninflationary growth through the two-term Clinton presidency and most of the first term of George W. Bush.

Then – with CPI inflation at the putative target of 2% and moderately robust real economic growth of 2.7% – the Fed began cutting the fed funds rate in 2003. It was down to 1% at the end of the year and into early 2004 – a full three percentage points less than what the Taylor Rule would have prescribed. Worse, the Fed failed to raise interest rates fast enough or far enough in 2005 into 2006, even as inflation gained momentum, with a surge in output from unsustainable household spending stimulated by the housing bubble.

Now with rising inflation, falling output and the flight from the dollar, the U.S. economy has been knocked off the moorings that the Taylor Rule had provided. Although the Taylor Rule still correctly shows that the Fed cut interest rates too much

in 2007-2008, it understates the appropriate level of the interest rate. Moreover, its two key implicit assumptions – that equilibrium interest rates can always be found to clear markets, and that the foreign exchanges can be ignored – are no longer valid. At least temporarily, when so many financial markets have now seized up, Taylor's Rule has lost its ability to provide an unambiguous guide to the Fed.

But all is not lost.

Fast backward 135 years to 1873, when Walter Bagehot, the eminent Victorian institutional economist and constitutional scholar, wrote "Lombard Street." The London capital market was the center of world finance under the gold standard. Bagehot described the intricacies of how money markets worked, including counterparty risks and all that – but he also prescribed how the Bank of England should confront major financial crises.

Bagehot called a seizing up of internal markets "a domestic drain" (of gold), and the flight of capital abroad "an external drain." He wrote that "The two maladies – an external drain and an internal – often attack the money market at once." And what, he asked, should be done when this happens?

"We must look first to the foreign drain, and raise the rate of interest as high as may be necessary. Unless you can stop the foreign export, you cannot allay the domestic alarm. . . . And at the rate of interest so raised, the holders – one or more – of the final bank reserve must lend freely.

"Very large (domestic) loans at very high rates," Bagehot advised, "are the best remedy for the worst malady of the money market when a foreign drain is added to a domestic drain. Any notion that money is not to be had, or that it may not be had at any price, only raises alarm to panic and enhances panic to madness. But though the rule is clear, the greatest delicacy, the finest and best skilled judgment, are needed to deal at once with such great and contrary evils."

How does Bagehot's Rule apply to today's credit crunch? Bagehot was worried about gold markets to seize up even more and, worse, weaken the pound in the foreign exchanges. No assets, which itself worsens conditions in American markets. Additionally, foreign central banks, which are building up large dollar exchange reserves – much of which are invested in

U.S. Treasuries are the prime collateral for borrowing and lending in the multitrillion dollar "drain" of prime collateral from the already-impacted private U.S. markets. The depreciating

Consequently, there is a strong case for raising the fed funds rate as much as is necessary to prevent a domestic drain. Bagehot would have it – and to cooperate with foreign governments to halt and reverse the

By slashing interest rates too much in 2007-2008, the Fed has accentuated the foreign drain problem. Yet, despite this mistake, Bagehot would approve of other actions the Fed has taken to support domestic markets. These include (1) swapping Treasury bonds for less safe private assets, (2) providing liquidity to distressed borrowers, and (3) maybe even rescuing Bear Stearns. He would also approve of the relaxation of standards for mortgage lending. Yet these measures will be insufficient if the foreign drain continues.

To repeat Bagehot's Rule: "very large (domestic) loans at very high rates are the best remedy for the worst malady of the money market when a foreign drain is added to a domestic drain." The Fed, and the U.S. government more generally, should follow Bagehot's lead.

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