Optimal Monetary Policy

If the Friedman Rule is the gold standard in monetary policy, why isn’t it implemented?

By Melody Galen

Anyone who’s taken an economics class will recognize Milton Friedman’s name. His contributions to economics are numerous, including the Friedman rule for monetary policy. Simply put, the Friedman rule says that the optimal monetary policy is one in which the inflation-adjusted interest rate is set to zero. While the Friedman rule might be considered the standard bearer for how monetary policy should be conducted, no country has implemented it.

Kenneth Lay Chair in Economics Joseph Haslag along with Joydeep Bhattacharya of Iowa State University, Steven Russell of Indiana University Purdue University Indianapolis and Antoine Martin of the Federal Reserve Bank of New York have wondered why that is. They’ve come up with one simple explanation: if you start in a world in which the Friedman rule is not being implemented by the central bank, and you move to one in which you do implement it, there’s a cost that accompanies that change. “It had not been herefore recognized, but that cost is that you effectively redistribute resources from those who don’t have a lot of cash to those who do,” says Haslag.

As long as there are different levels of money holdings by different people — Haslag calls that heterogeneity — that transfer of resources will occur upon implementation of a Friedman rule. That is one possible explanation for why no country uses the Friedman rule as its monetary policy.

“If everybody starts off with the same quantity of money, if we all had $100 in our pockets, and that’s where we start, then our result disappears, and we’d fall back into the same world — the Friedman rule would be the best policy in our setup as well,” Haslag explains. “But as soon as you take into account heterogeneity and the redistribution that occurs with the Friedman rule, then questions start to arise about whether it’s the best thing or not.”

Haslag and his group experimented with ways to undo that transfer of resources. They theorized that using an arbitrary starting date is important. So they extended time backward infinitely far and forward infinitely far to run their model. It did make a difference; when the starting point was relaxed, it got rid of the heterogeneity issue. “It’s kind of like the economics version of a black hole. You get a singularity by eliminating the starting date,” Haslag says.

Under that scenario, there’s no punishment for holding cash. Unfortunately, relaxing the starting date is a theoretical experiment that can’t be performed in the real world. Heterogeneity does exist, and that makes the Friedman rule impractical to use. The point is that implementing monetary policy is done in the real world and in real time. Consequently, central bankers must deal with thorny issues like differential impacts on cash-rich and cash-poor individuals. Sometimes, these thorny issues make it impossible to do what would be best in a controlled setting.
From the Department Chair

By David Mandy

What a fantastic year this has been to be an economist! Although we are all deeply concerned about the economic downturn and the fragile state of world financial markets, these events present unique opportunities to study the operation of the financial system, ponder policy responses and educate our students and the general public.

Student interest in economics as a major continues to increase, driven partly by a desire to understand current events and partly by expanding recognition that economics may be the “just right” liberal arts major (see the David Colander article in the March 6, 2009, issue of the Chronicle of Higher Education). The cover story in this issue of Communique features the Missouri State University economics economics major and Kenneth Lay Chair in Economics Joe Hasla’s research on monetary policy. This research has been featured in three highly visible academic journals and informs Joe’s perspectives on the financial crisis, which appear on Page 9 in a special supplement to the Chronicle of Higher Education.

Also included in this special supplement are Middlebush Professor of the Social Sciences Jeff Milloy’s discussion of the politics of targeted Federal spending, my thoughts on possible causes of the meltdown in mortgage-backed securities markets; and Middlebush Professor of Economics Shawn Nii’s discussion of housing prices and the effect of fundamental imbalances on macroeconomic performance.

Another feature story describes Peter Mueser’s research into measuring the effectiveness of job-training programs. Peter spent much of this past year in Washington, D.C., working with a research team funded by the U.S. Department of Labor to study individual outcomes from job-training programs and the extent to which those programs improve the employment and wage potential of program participants. Their report to Congress is titled Workforce Investment Act Non-experimental Net Impact Evaluation and is online for free from the U.S. Department of Labor.

Two changes to the faculty have occurred since last year’s installation of Communique. Ronald Ratti retired from MU and accepted a position in Australia at the University of Western Sydney. Ron’s tireless dedication to the research program, through many years of service as director of graduate studies and advising of countless graduate students, and his acclaimed undergraduate and banking career will both be missed. We wish Ron well in his latest endeavor.

Martin Perney, a former MU economics doctoral student, accepted a position in the department as assistant teaching professor. Martin brings primary responsibility for curriculum design and teaching of a new version of Walter Johnson’s textbook Economics 1051 (formerly Economics 51) course. Martin’s new position is also a sign and teaching of a new version of Walter Johnson’s textbook Economics 1051 (formerly Economics 51) course. Martin’s new position is also a significant step in the transition to the new curriculum developed by the faculty over the past several years. Xinghe’s efforts were recognized when the MU Graduate School awarded him the 2008 Director of Graduate Studies Outstanding Contribution Award.

Director of Undergraduate Studies Xinghe Zhang continued this year to manage the transition to the new graduate curriculum. Her task was made more difficult by the abrupt cancellation of several courses through the use of aftermarkets. Xinghe’s efforts were recognized when the MU Graduate School awarded him the 2008 Director of Graduate Studies Outstanding Contribution Award.
Faculty Kudos

Saku Aura's specialty is public economics. Recently his research has focused on property taxation, land markets in Hong Kong and economics of discrimination. Aura regularly teaches public economics at both graduate and undergraduate levels and has recently started coordinating the department's master's and honors seminars.

Emek Busker has teamed up with a Mizuho undergraduate, Alan Simpson, for a project testing the competitive effects of Wal-Mart's $4 prescription drug plan. They have obtained financial support from the Economic & Policy Analysis Research Center (EPARC) and from the Arts & Science Alumni Organization to pay for additional research assistants in this data-intensive project. Early results indicate that while many competing pharmacies lowered their prices for generic prescription drugs in response to Wal-Mart’s aggressive move, prices of brand-name drugs increased, resulting in higher drug costs for some consumers.

Chao Gu’s research interests lie in the fields of macroeconomics, money and banking and economic theory. He is working on the timing of payments in the large payment networks and asset price sets in the decentralized trading markets. She teaches intermediate macroeconomics and advanced money and banking.

This year Ron Harstad published an article on the theory of prices in games and economic behavior (on when prices aggregate diversely held information). He continues work on a revised edition of the Barron’s Bulletin. Kedel has begun research on the area of teacher compensation and performance pay.

J. Isaac Miller specializes in time series econometrics. His research interests include econometric models with nonstationary features such as mixed-frequency data, structural breaks or nonlinearity, with forthcoming research papers in the Journal of Applied Econometrics and Energy Economics. He recently developed a new doctoral-level course at MU featuring long-run and short-run consumption models popular in financial economics.

Jeff Milho was named the Middlesex Professor of Economics in Fall 2008. This year, Milho has taught an honors section of Principles of Economics, Law and Economics, Health Economics and a special topics seminar in Voucher, Dec- and the Center for Research on Longitu- dinal Data in Education Research (Ur- ban Institute). With collaborator Robert Chikhladze, he organized a national conference on reform of teacher re- form and teacher benefit systems for NCPI at Van- derbilt in February 2009. He collaborates in research on teacher compensation re- form with Department colleagues Shawn Ni, Cory Kedel and Mark Elhart. To- gehter they have several research con- tracts on the area of teacher compensation and many research papers in the pipeline. Over the past year he has given several talks around the country on the issue of teacher performance pay.

Neil Raymond's re- search is in under- graduate courses in mac- roeconomics and monetary econom- ics. His research on output and price over- combinations and money and banking. He likes

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Spring 2009

Martin Percyya is an assistant teach- ing professor who earned his doctorate in economics in 2008 at MU. He usually teaches general economics courses to students and money and banking. He likes
to spend his free time going to the mov- ies and playing soccer (soccer) and reading about economics.

Michael Podgursky continued his work on teacher compensation in Fall 2008. He is a former investigator with two national research centers funded by the U.S. Department of Education — the National Center for Performance Incentives (Vanderbilt) and the Center for Analysis of Longitu- dinal Data in Education Research (Urban Institute). With collaborator Robert Chikhladze, he organized a national conference on reform of teacher re- form and teacher benefit systems for NCPI at Van- derbilt in February 2009. He collaborates in research on teacher compensation re- form with Department colleagues Shawn Ni, Cory Kedel and Mark Elhart. Together they have several research contracts on the area of teacher compensation and many research papers in the pipeline. Over the past year he has given several talks around the country on the issue of teacher performance pay.
Of Bubbles and Information

By David M. Mandy

What caused the financial panic of 2007–09, and how did it come about? The first question is relatively easy to answer. It is what can be done to prevent a recurrence? Although we remain far from consensus on these questions, some limited answers are beginning to emerge.

A speculative bubble in house prices surely played a significant role. Shoven Ni discusses the housing bubble in this issue of Communiqué, so I will limit my comments to a thumbnail sketch of how this played through the financial markets.

Many residential mortgages were fi-
nanced by securitization rather than tra-
tional bank lending during the run-up in
housing prices. What, exactly, is “secu-
ritization”? The simple answer is that financial institutions bought large pools of mortgages from the mortgage compa-
ies and banks that originated the loans and then sold to investors various claims on the principal and interest payments those mortgages were expected to pro-
duce. The claims sold to investors were prioritized, meaning that some claims would be paid first from the incoming cash, some would be paid second, and so on down the line.

This process of prioritization made it possible to create high-priority claims that appeared to be quite safe from the dangers of homeowner defaults even when the underlying mortgages were low quality. After all, the high-priority claims would be paid even if many of the mortgages defaulted, because the default losses would be absorbed by the low-priority claims, right? Moreover, the chance of large default losses was small on mortgages that served as collateral for the mortgage could always be refinanced or repossessed and sold at even higher prices, right?

The ability to create seemingly safe
claims and hold off investors increased the risks. These mortgages were severely underpriced for the long-run average of less than 1 percent. Some regions experienced much higher percentage gains than the national average. Since 2007, as the housing market has acceler-
at ed, the survival of many financial institutions has been threatened by their holdings of bad assets, and the economic downturn has inflations. I argue here that while the hope of a quick fix has been placed in the government bailout and fiscal stimulus, the real fix of the funda-
mental imbalances that led to the cri-
sis requires adoption of different poli-
cies focusing on long-term growth.

Even before the current crisis, many financial data of the nation had already shown a troubling trend. The trade and government deficits are much to promote homeownership and also needing to hold cash in order to protect against their own
losses on mortgage claims.

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A Political Economy Perspective on Federal Spending

By Jeffrey Milos

T he past year has seen a dramatic increase in actual and proposed spending by the Federal government; one consequence of this increased spending is ‘pork’ that is doled out by members of Congress in order to secure re-election. But to what extent can incumbents buy votes? Is it likely that pork spending projects really help its most vulnerable incumbents, thereby confounding the relationship between pork and re-election success? In a path-breaking study from the mid-1990s, two economists, Steve Levit at the University of Chicago and James Snyder at MIT, solved this statistical puzzle and demonstrated that Federal discretionary spending does indeed help House incumbents get re-elected. Levit and Snyder showed that pork is inextricably linked to the vote: pork spending projects have direct benefits to incumbent members of Congress, because they increase government spending and help the incumbent’s share of the vote! Mean turnout for a U.S. House district was 52 percent, but pork spending projects increase the incumbent’s share of the vote by 2 percent (Levitt and Snyder 1997). Updating their estimates to current dollars, $100 million in pork “buys” the incumbent 3,724 more votes (Levitt 1994); so even campaign advertising is surprisingly ineffectual, albeit cheaper than pork as a vote-getting strategy. But politicians have to work long and hard to raise campaign cash; in contrast, raiding the Federal treasury in the guise of stimulating the macro-economy is essentially costless to an incumbent. So why do members of Congress buy, in the short run, we’re up for election.

References Cited


Macroeconomic Perspectives on the Financial Crisis

By Joseph Haslag

Frustation and education. By my measurements, American students are falling behind their counterparts in a number of European and Asian countries in math and science. Reforms through rewarding good teachers and encouraging competition among schools can better prepare students for the knowledge-based economy. These measures will not immediately increase foreign investment or improve the skill level of workers, but the implementation or even discussion of these kinds of policies raises the expectation of future returns to investment and inspires optimism. And the inspired optimism stimulates investment to the point of crisis. Addressing the fundamental imbalances in the U.S. economy requires investing in capital goods and R&D at the expense of current consumption and improving productivity. Economic research can help identify reforms needed to achieve these objectives throughout the economy, from industries to households. Carrying out these reforms involves costly adjustments. But the crisis serves as a strong motivation for taking on the challenge. A commitment to reform can speed up the recovery and lead to improvement in the nation’s long-term economic health.

Monetary Policy During the 2007–2008 Financial Crisis

By Joseph Haslag

Let me begin with the acknowledgment that monetary and fiscal policy are intricately linked. In its most independent form, monetary policy affects the expected inflation rate and therefore the real value of government debt outstanding. With these interactions accounted for, there is likely less, in the form of subtle modifications, for monetary policy to achieve its aims. For the purposes of this newsletter article, I will view recent Federal Reserve actions as if they are isolated, attempting to shed light on what these actions have meant over the past months as well as the risks that may be in store for the U.S. economy because of these actions.

Beginning in October 2008, the Federal Reserve modified its playbook. If the dominant central bank tool was the textbook book open market operation — where the Fed buys or sells U.S. Treasury securities — this is implied that we recognize the “wildcat” innovation. The Fed still bought and sold assets but extended the consideration for the easing policy to other traditional open market policies, a paper along with so-called toxic assets via the Term Asset-backed Securities Loan Facility, or TALF. Since October, the Fed has been in hot pursuit of “strategic” assets. Whatever the asset purchased, the effect on money supply is the same. Indeed, between October 2008 and February 2009, high-powered money decreased at an annual rate of 237 percent. Compared with the financial crisis of 1932, this is a 240-percent change in the growth rate of high-powered money (that is, between October 1929 and February 1932, high-powered money decreased at an annual rate of nearly 3 percent). Thus, the Fed has taken a much more aggressive role in this financial crisis than it did 70 years ago.

With such explosive money growth, the greatest concern is that inflation will rise sharply. I submit that the Fed has understood the risk of inflation. The Fed acted to ensure that the gains from the payment system network would fail. Furthermore, other important nodules appeared susceptible. Hence, the fear of contagion prompted the Fed to provide large amounts of liquidity, to provide insurance for a sinking Lehman Brothers, meaning that Lehman Brothers could not acquire enough liquidity through the payment system. The Fed’s actions increased the risk of systemic risk. And many questioned whether the Fed’s actions were necessary, providing insurance for a sinking Lehman Brothers.

Credit risk is not the only story, and I will come back to that part later. My main point is that the payment system has all the key characteristics of a network. The value of the payment system to shut out Lehman Brothers, meaning that Lehman Brothers could not acquire enough liquidity through the payment system. The Fed’s actions increased the risk of systemic risk. And many questioned whether the Fed’s actions were necessary, providing insurance for a sinking Lehman Brothers.

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Evaluating the WIA

Mueser helped lead the Department of Labor’s first thorough evaluation of one of its best-known programs, the Workforce Investment Act.

By Melody Galen

Most adults would agree that finding a good job is not always an easy thing to do. Especially in the midst of a recession. And it is certainly grim news to find that one’s employer is in a position to begin laying off workers. It can be difficult to feel completely secure, even with a job and benefits package, but there may be some measure of solace in knowing that there are programs in place to help out when faced with unemployment.

The Workforce Investment Act (WIA), passed in 1998, is the primary federal job-training program in the U.S. It was designed to provide aid to people who are having a hard time either because they’ve always had a difficult time finding gainful employment (disadvantaged workers) or because they’ve been laid off (dislocated workers).

When the WIA was enacted, Congress specified that the Department of Labor would be required to perform a rigorous evaluation of the program. Peter Mueser, professor of labor economics at MU, signed on as one of three lead researchers for that evaluation in fall 2007.

Mueser and Carolyn J. Heinrich of University of Wisconsin, and Kenneth R. Toskey of University of Kentucky, worked with a consulting organization to perform a comprehensive nonexperimental evaluation. One of their biggest hurdles was getting states to provide information on workers — eventually they had agreements with 12 states to provide existing data on people who had gone through their WIA programs. Part of doing a meaningful evaluation is having data on a comparison group, so the taskforce gathered comparison data from each of its participating states.

The group being studied — those who had participated either in the WIA’s Adult Program, which focuses on disadvantaged workers, or the Dislocated Worker Program — were compared to people who had received unemployment insurance or who had used the employment office in their state. The value of this comparison is that it gives an idea of what might have happened without the WIA programs.

“When people enter a program like this, they normally go through a period when their earnings are very poor,” explains Mueser. If a program were to essentially hold that person’s hand, make sympathetic noises and then wait for six months, that person would be likely to be doing better in six months — even without interventions.

“That’s because anyone caught at a low point is likely to do better later on,” says Mueser. “And so that kind of dip, called Ashenfelter’s Dip for the economist who first wrote about it, is a fact of any training program that you must take into account.”

This is where that comparison group becomes important. Mueser’s team had 160,000 WIA participants and about 3 million comparison individuals with whom to match them. What they were looking for was what would have happened to those people if they hadn’t used WIA. The people getting unemployment insurance suffer the same kind of drop in income as the people using WIA had suffered. Both groups were searching for jobs.

The value of having 3 million comparison individuals is that it let the evaluators match up each of the 160,000 WIA participants with someone as similar to them as possible. They matched people by location, gender, earnings history and occupational industry. After the number crunching was finished, and that took nearly a year, a report was submitted to the Department of Labor in December 2008.

It appears that the people who go through the Adult Program eventually earn up to $400 more per quarter than if they hadn’t used the services.

“They who think that a program like this is going to solve poverty are going to be very disappointed with those results. But the results we found are pretty much in line with results others have found for similar programs,” says Mueser.

He believes that the WIA programs are beneficial enough that it would not be inaccurate to put more resources into the program, given that unemployment is higher now than in recent years, and that more individuals stand to benefit from it. An earnings increase of $400 per quarter may not sound terribly impressive, but over the course of 15-20 years, it can make an appreciable impact in an individual’s life.

Noting that the presidential administration is pouring money into every stimulus package imaginable, Mueser thinks it’s possible that someone in that administration will wonder what is known about the net gains to WIA participants. He’s pleased that the work he and his colleagues did will contribute to the body of knowledge of how programs work in general, and, perhaps more important, to how effective the Workforce Investment Act is in particular.

Graduate Program Update

By Xinglu Wang

Eleven master’s and eight doctoral candidates graduated from the Department of Economics in 2008. Three of the master’s candidates moved on to pursue doctoral degrees or other advanced studies at institutions such as Cornell University and the University of Kansas. One graduate took a teaching position here at MU. The majority of the graduates now work in government and industries, including government ministries in Korea, a research fellowship at the Korea Economic Research Institute, a research associate position at the Federal Reserve Bank of Kansas City and an energy economist at the Missouri Public Utility Alliance.

Students were active presenters this year at regional and national professional meetings, including the Eighth Annual Missouri Economics Conference in Columbia, Mo., the Graduate Student Conference at Washington University in St. Louis and the Southern Economic Association Annual Meeting in Washington, D.C. Several students received awards for outstanding performances in course work, research or as a teaching assistant: Wei Zhou received the Harry Gunnison Brown Graduate Student Fellowship, Wilson Kang received the Harry Gunnison Brown Research Fellowship and several received the Harry Gunnison Brown Graduate Teaching Award.

During the academic year 2007–08, the department restructured our graduate programs, and the new programs are now in their first year. In the new master’s program, students write and present their research in a master’s research class under the guidance of the instructor and their own advisers. It is expected that master’s students can graduate in one and a half to two years.

The new doctoral program puts strong emphasis on research. The faculty is highly committed to guide work and our doctoral students to produce publishable research before their graduation. All doctoral dissertations are expected to contain original research that is worthy of publication in refereed journals. The new curriculum provides both opportunities and incentives for doctoral students to become well acquainted with research methods and techniques and gain research experience before their dissertation proposals. Doctoral students now take a series of classes on research methodology and literature, and they start their own research by writing research papers in their two chosen fields of specialization. We all look forward to the success of the current inaugural and future groups of students who pass through these redesigned programs.

Bubbles

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Much analysis remains to determine whether the ignorance explanation withstands further scrutiny. In any case, improved transparency regarding the true risks of prioritized mortgage claims should probably be a main ingredient of future prevention. Information that empowers investors to assess risk and to make informed judgments about how much risk to incur will let those who wish to speculate on very risky investments do so while also letting those who want safer investments confidently obtain them.
Department Appreciates Support of Alumni and Friends

By David Mandy

The Department of Economics relies on the financial support of our friends and alumni to provide scholarships, awards and research opportunities for both undergraduate and graduate students. The need is great, especially in the area of graduate student fellowships where the department has difficulty competing with better-financed institutions for the best students. Some gift funds also support the general teaching and research mission of the department by funding the purchase of computing and other equipment, data access, faculty and student participation in professional seminars and development of new curriculum materials.

We are immensely grateful for this support. A solid base of alumni support is one of the principal factors that distinguishes the best universities and departments from the rest. The need to enhance economic education is more pressing now than at any time in the past 80 years.

Please consider a gift of any amount. More information about the department’s gift funds is available in the alumni section of our Web site at economics.missouri.edu/alumni/index.shtml or directly from the department at the address below.

Gifts may be made online from the Web site or mailed to Department of Economics, 118 Professional Building, Columbia, MO 65211. Questions may be directed to our office manager, Sheila Akers, at 573-882-4776 or AkersS@missouri.edu, or to me at 573-882-1763 or MandyD@missouri.edu.

Monetary Policy

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growth roughly matched an explosion in the demand for money. When this happens, economic theory tells us that no upward pressure on the price level occurs. Money demand is tricky. At some point in the future, people will see that investment opportunities exist. When this occurs, the demand for money will shrink. The question, therefore, is whether the Fed can extract money supply from the payment system fast enough at the right time to avoid higher inflation. The answer is unknown. We have no historical blueprint for such monetary contraction. On the Fed’s side is the large quantity of private assets it has been purchasing over the past few months. In my mind, this is the biggest monetary policy challenge currently facing the United States.