Thursday, November 18, 2010 - 16:51

Fed's Plosser: Should Not Hike Just To Target Asset Bubbles

By Brai Odion-Esene

WASHINGTON (MNI) - Philadelphia Federal Reserve Bank President Charles Plosser Thursday voiced his opposition to the use of monetary policy to combat large upswings in asset prices, arguing that getting the Fed involved "will more likely be a source of discretionary mischief and mayhem than stability."

Rather than "chasing incipient bubbles," he said monetary policy should retain its focus on providing price stability as a means to support sustainable growth in employment and output over the long run.

However, to guard against bubbles, the Fed should raise its target interest rates in line with increases in underlying real interest rates, Plosser said in remarks prepared for the Cato Institute's Annual Monetary Conference. There was no mention of the Fed's latest quantitative easing program.

In the speech, entitled "Bubble, Bubble, Toil and Trouble: A Dangerous Brew for Monetary Policy," Plosser said he would not advocate raising interest rates "simply to lower asset prices when they appear to deviate from fundamentals."

Starting off by giving his outlook for the U.S. economy, Plosser said he is not one of those worried the economy might fall into a deflationary trap. "Indeed, I am more optimistic than many about the future path of the economy," he said.

Yet there are concerns that the Fed's extremely accommodative stance is fueling a rapid rise in asset prices similar to that seen in the housing market prior to the financial meltdown. Plosser warned, however, that targeting asset bubbles "is a policy that is easy to get wrong and fraught with risks."

So, even in the wake of the financial crisis, "I continue to advocate that the Fed follow a systematic approach that keeps monetary policy focused squarely on inflation and output growth, but especially on inflation."

The Fed official said policy aimed at influencing asset prices could encourage discretionary actions by the Fed that would draw it ever deeper into credit allocations and the determination of relative prices. "That should not be the role of monetary policy," he said.

Plosser believes that requiring the Fed to tackle asset-price gaps would push the central bank "well beyond" its capabilities. "It is challenging enough to calibrate and communicate our policy stance when we try to balance the perceived tradeoffs between output gaps and inflation," he said.

Also, it may be difficult to determine -- when asset values rise sharply in a bubble-like fashion -- whether the rise is based on market fundamentals.

He cautioned that due to the difficulty in discerning a genuine misalignment of asset prices from a change in asset prices driven by fundamentals, "monetary policy actions that respond to such price changes could generate even bigger inefficiencies than those it was designed to correct."

Additionally, asset prices are often volatile, Plosser noted, and creating expectations that the Fed will intervene directly to influence the price-setting mechanism "seems more dangerous" for the orderly functioning of markets than helpful even in the rare occasions when a true and significant distortion may actually exist.

So while using monetary policy to address the misalignment of asset prices would not necessarily ensure price stability or sustained output growth, Plosser does have a suggestion.

"In my view of monetary policy, the central bank should systematically vary its target interest rate in line with movements in an estimate of the real interest rate," he said.

So in the face of economic shocks that push up the real interest rate, Plosser suggested the central bank should respond by raising its target rate commensurately, as long as inflation is at or near its target. And if the shocks cause a decrease in the equilibrium real interest rate, then the central bank should lower its target interest rate to avoid disinflation.

"The policy approach that I have advocated would increase the interest rate target in line with the increases in underlying real interest rates as a systematic form of inflation targeting. That would most likely lead to raising rates as return on assets also rise," he said.

By following a more systematic approach to monetary policy, Plosser argued, policy actions provide "a natural response" to broad-based increases in real rates of interest that often accompany asset-price inflation. This systematic policy, he added, also provides a natural and predictable response as those rates decline, and does so in the context of maintaining a low and stable inflation rate.

** Market News International Washington Bureau: 202-371-2121 **