# Fed Keeps Rates Low: Is Bernanke Making a 'Dangerous Gamble'?

Posted by Stephen Gandel Tuesday, September 21, 2010 at 2:49 pm
Submit a Comment • Related Topics: economy

*The Loan Dissenter: Kansas City Fed President Tom Hoenig* (Nati Harnik/AP)

Last month, economist Thomas Hoenig delivered a speech at a public meeting in Lincoln, Nebraska, called Hard Choices. The normally mild-mannered Hoenig said the Fed's recent policy of holding interest rates near zero was a "dangerous gamble." He said he feared the moves of the nation's most important bank were worsening the US economy, and might even create another financial crisis. "Monetary policy is a useful tool, but it cannot solve every problem faced by the United States today," Hoenig said. "In trying to use policy as a cure-all, we will repeat the cycle of severe recession and unemployment in a few short years by keeping rates too low for too long."

Economists, market forecasters and pundits regularly question monetary policy. So a critique, even a scathing one like Hoenig's, isn't that unusual. But what made Hoenig's critique unique was that it didn't come from some outside observer. Hoenig is one of the Federal Reserve's highest ranking officials and this year, he has become one of chairman Ben Bernanke's most vocal critics.

On Tuesday, the Fed's top policy makers voted, 8-1, to keep short-term interest rates near zero. The US central bankers said the pace of the economy had slowed in recent months and that they were "preparing to provide additional" support for the economy. In the past, the Fed has bought Treasury, mortgage and other bonds in order to drive down long-term interest rates, which are not set by the Fed, and promote borrowing and economic activity. In their statement, the Federal Reserve governors and policy committee said that the weak economic conditions "warrant exceptionally low levels for the federal funds rate for an extended period." Among the policy making group, which includes both Bernanke and Hoenig, the later was once again the lone dissenting voice. Hoenig said he believes keeping interest rates near zero was no longer necessary and could lead to problems in the future.

Traditionally, the idea of raising interest rates at a time when the economy is weak is frowned upon by economists. And indeed, these days most economists agree with the Fed that interest rates need to remain low for at least the rest of this year, and perhaps through 2011. But after nearly two years of near zero interest rates have appeared to do little to bolster the faltering economic recovery, a growing number of economists are asking whether low rates are doing more harm than good.

"I wouldn't be dissenting now," says William Poole, who is a former President of the St. Louis Federal Reserve Bank. "But Hoenig's dissent should be taken seriously. On monetary policy, Hoenig is a guy that you need to listen too."

Hoenig has had more company lately in saying interest rates are too low. Recently, top economist Raghuram Rajan, who has became famous for warning about the possibility of a financial crisis back in 2005, said he believes the Fed should raise the short-term interest rate to as high as 2%. Like Rajan, and others, Hoenig believes that keeping short-term interest rates near zero is dangerous because it encourages banks and investors to make and take risky loans that might not be worth it if they had to pay higher interest. He says low rates create asset bubbles like the one that formed in housing and led to the

financial crisis. Hoenig also says that by keeping interest rates at near zero and saying they will stay there the Fed is signaling to the rest of the country and the world that it believes the US economy is still weak. Raising interest rates would give the economy a boost of confidence.

Hoenig's distaste of low-interest rates dates back to his start at the Fed. Hoenig, 63, was born in the tiny Iowa town of Fort Madison, which on the Mississippi River. He went to Benedictine College in Kansas, and got his PhD in economics from Iowa State University. In 1973, he joined the Kansas City Fed as a bank supervisor. At the time, low-interest rates were fueling a speculative bubble in farm prices, commodities, oil and commercial real estate. Within a few years, those bubbles came crashing down, dealing a devastating blow to the US economy, but to the people of the Midwest in particular. In 1991, Hoenig says he doesn't want to see that happen again.

Still, most economists say raising interest rates when the economy is still weak could be disastrous. Former Fed governor and one of the founders of top economic forecasting firm Macroeconomic Advisers Laurence Meyer says the Fed is making the right moves. Meyer agrees low-interest rates are one of the precursors of asset bubbles, but not necessarily the biggest one. He says the Fed needs to be careful in monitoring how monetary prices are affecting market prices. "The economy is in a real terrible state," says Meyer. "So you don't raise rates."

Read more: http://curiouscapitalist.blogs.time.com/2010/09/21/fed-keeps-rates-low-is-bernanke-making-a-dangerous-gamble/#ixzz10ByN8DcV