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IS THE FED TO BLAME FOR ASSET BUBBLES?

When the housing bubble burst, it flattened investor portfolios across the country. From the start of 2008 to the spring of this year, the economic crisis has knocked $30 trillion off the value of global shares and $11 trillion off the value of homes, says Goldman Sachs.

So who is to blame?

In his opening remarks, the Senate Banking Committee’s top Republican, Richard Shelby, made the following statement: (paraphrased)

“The Fed kept rates too low for too long, fueling the housing bubble."

But is the Fed's easy rate policy solely to blame? Or was Fed Chairman Ben Bernanke right when he has said in the past that it was instead a global savings glut, a massive wall of savings, that came our way and helped create asset price bubbles?

And if the Fed is to blame, then why did Ireland, the UK, Spain, and many other countries experience a housing bubble on their shores as well?

Below I've given you what the best and brightest minds have to offer on this key debate, which has the future of the Fed's monetary policy, and your investment portfolios, in the balance.

You'll hear from David Henderson, a research fellow at the Hoover Institution; Gerald P. O'Driscoll, senior fellow at the Cato Institute; Todd J. Zywicki, law professor at George Mason University; economist David Malpass, president of Encima Global; economist Judy Shelton; and Vincent Reinhart, a former Fed official and resident scholar with the American Enterprise Institute.

The Fed is now facing the most threatening attack on its independence and powers since the 1913 bill that launched the central bank. One bill would strip it of its bank regulatory powers; another would subject it to audits of its monetary policy.

Bernanke faced searing crossfire at his re-confirmation hearing before the Senate on Thursday. He spent much time testifying as to whether the Fed has floated Hindenburg-sized bubbles, and is now blowing bubbles anew.

Bernanke now calls fighting asset bubbles "perhaps the most difficult problem for monetary policy this decade."

That, and its $2.2 trillion balance sheet that now equals in size the economy of France, has Congressmen Ron Paul and Alan Grayson sponsoring new legislation that would force the Government Accountability Office to audit the Fed's monetary actions.

The bill has Bernanke in knots, fearing the central bank would not be able to fight inflation or even bubbles as the central bank would lose its independence for good.

The legislation comes at a time when it's already criticized for being too close to the Congress, in which the Fed has bought U.S. Treasurys to keep rates down when the Congress is conducting epic, massive deficit spending. A Fed more beholden to, say, do more to fight unemployment in order to help politicians win re-election is really what's at stake.

Former Fed chair Arthur Burns raised the same independence concern about not being able to fight inflation in the '70s when the GAO was pushed to audit it for the first time -- a 1978 law that stopped short of audits of monetary policy.

Fed Comes Clean for the First Time

And for the first time in recent memory, the Fed addressed the bubble issue in light of its zero to 0.25% interest rate policy. Recently released minutes of the Fed's Open Market Committee meeting that took place in November offered this statement about the impact on asset prices of its near zero-rate policy:

"Members noted the possibility that some negative side effects might result from the maintenance of very low short-term interest rates for an extended period, including the possiblity that such a policy stance could lead to excessive risk taking in financial markets or an unanchoring of inflation expectations."

Translation: Fed officials are worried their actions are causing bubbles to foam, creating potential inflation.

However, other Fed officials, including Donald Kohn, warn that raising rates to thwart bubbles is a blunt instrument, the equivalent of taking a sledgehammer to drive in a tack, that could tip the economy into a recession once the hikes take hold.

Not so, says William Dudley, head of the New York Federal Reserve, who argues the central bank can burst bubbles with rate hikes, and indeed he says he's already seen five the central bank could've prevented (and that he actually speculated against three of them while at Goldman Sachs), reports indicate.

The gunning of the printing press has China officials fingerwagging Fed officials such as Janet Yellen and Kevin Warsh, the latter of whom is said to advise the central bank to be open-minded about the effect rates have on bubbles, as he is monitoring commodity prices, dollar and movements in the credit markets.

China is seeing asset bubbles in its corner of the world, though Bernanke in testimony essentially said it's not the U.S.'s problem to combat their bubbles, instead it's up to monetary officials there to deal with their own asset manias.

Bubble Trouble

Could the Fed have pricked earlier bubbles?

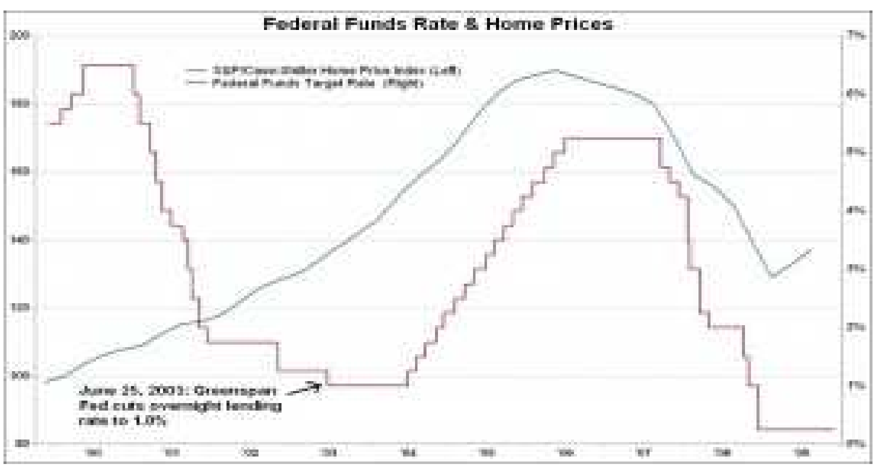
Take the dotcom bubble. The thinking of some Fed officials is that hiking rates would have zero impact on stopping the crazy valuations in dotcom stocks because, for one, Internet companies tended not to have a lot of debt on their balance sheets, so raising rates would not have made a difference.

But when that bubble cracked, and 9/11 happened, the Fed saw that businesses were not doing a lot of capital expenditures. To prod them, the Fed kept rates low, many now say too low, for too long, from 2001 to 2004.

What happened next?

Let's Take a Look at the Data

Fox Business senior editor Charles Brady, a whiz at statistics, has an interesting chart, reprinted below, that shows that home prices really took off when the Federal Reserve started to cut the federal funds rate in 2001, eventually down to 1% in June 2003, (at the time the lowest since 1958, Brady notes).



What Do the Experts Say?

Back in March the WSJ asked six economists and scholars if the Fed caused the housing bubble.

http://online.wsj.com/article/SB123811225716453243.html#printMode

DID THE FED CAUSE THE HOUSING BUBBLE?

Don't Blame Greenspan

By David Henderson

It's become conventional wisdom that Alan Greenspan's Federal Reserve was responsible for the housing crisis. Virtually every commentator who blames Mr. Greenspan points to the low interest rates during his last few years at the Fed.

The link seems obvious. Everyone knows that the Fed can drive interest rates lower by pumping more money into the economy, right?

Well, yes. But it doesn't follow that that's why interest rates were so low in the early 2000s. Other factors affect interest rates too.

In particular, a sudden increase in savings will drive down interest rates. And such a shift did occur. As Mr. Greenspan pointed out on this page on March 11, there was a surge in savings from other countries. Although he names only China, some of the Middle Eastern oil-producing countries were also responsible for much of this new saving. Shift the supply curve to the right and, wonder of wonders, the price falls. In this case, the price of saving and lending is the interest rate.

But how do we know that it was an increase in saving, not an increase in the money supply, that caused interest rates to fall? Look at the money supply.

Since 2001, the annual year-to-year growth rate of MZM (money of zero maturity, which is M2 minus small time deposits plus institutional money market shares) fell from over 20% to nearly 0% by 2006. During that time, M2 (which is M1 plus time deposits) growth fell from over 10% to around 2%, and M1 (which is currency plus demand deposits) growth fell from over 10% to negative rates.

The annual growth rate of the monetary base, the magnitude over which the Fed has the most control, fell from 10% in 2001 to below 5% in 2006. Moreover, nearly all of the growth in the monetary base went into currency, an increasing proportion of which is held abroad.

Moreover, if the Fed was the culprit, why was the housing bubble world-wide? Do Mr. Greenspan's critics seriously contend that the Fed was responsible for high housing prices in, say, Spain?

This is not to say that the Greenspan Fed was blameless. Particularly disturbing is the way the lender-of-last-resort function has increased moral hazard, a trend to which Mr. Greenspan contributed and which current Fed Chairman Ben Bernanke has put on steroids.

But to the extent that the federal government is to blame, the main fed culprits are the beefed up Community Reinvestment Act and the run-amok Fannie Mae and Freddie Mac. All played a key role in loosening lending standards.

I'm not claiming that we should have a Federal Reserve. We simply can't depend on getting another good chairman like Mr. Greenspan, and are more likely to get another Arthur Burns or Ben Bernanke. Serious work by economists Lawrence H. White of the University of Missouri, St. Louis, and George Selgin of West Virginia University makes a persuasive case that abolishing the Fed and deregulating money would improve the macroeconomy. I'm making a more modest claim: Mr. Greenspan was not to blame for the housing bubble.

Mr. Henderson is a research fellow with the Hoover Institution, an economics professor at the Naval Postgraduate School, and editor of "The Concise Encyclopedia of Economics" (Liberty Fund, 2008).

What Savings Glut?

By Gerald P. O'Driscoll Jr.

Alan Greenspan responded to his critics on these pages on March 11. He singled out an op-ed by John Taylor a month earlier, "How Government Created the Financial Crisis" (Feb. 9), for special criticism. Mr. Greenspan's argument defending his policy is two-fold: (1) the Fed controls overnight interest rates, but not "long-term interest rates and the home-mortgage rates driven by them"; and (2) a global excess of savings was "the presumptive cause of the world-wide decline in long-term rates."

Neither argument stands up to scrutiny. First, Mr. Greenspan writes as if mortgages were of the 30-year variety, financed by 30-year money. Would that it were so! We would not be in the present mess. But the post-2002 period was characterized by one-year adjustable-rate mortgages (ARMs), teaser rates that reset in two or three years, etc. Five-year ARMs became "long-term" money.

The Fed only determines the overnight, federal-funds rate, but movements in that rate substantially influence the rates on such mortgages. Additionally, maturity-mismatches abounded and were the source of much of the current financial stress. Short-dated commercial paper funded investment banks and other entities dealing in mortgage-backed securities.

Second, Mr. Greenspan offers conjecture, not evidence, for his claim of a global savings excess. Mr. Taylor has cited evidence from the IMF to the contrary, however. Global savings and investment as a share of world GDP have been declining since the 1970s. The data is in Mr. Taylor's new book, "Getting Off Track."

The former Fed chairman also cautions against excessive regulation as a policy response to the crisis. On this point I concur. He does not directly address, however, the Fed's policy response. From the beginning, the Fed diagnosed the problem as lack of liquidity and employed every means at its disposal to supply liquidity to credit markets. It has been to little avail and, in the process, the Fed has loaded up its balance sheet with dubious assets.

The credit crunch continues because many banks are capital-impaired, not illiquid. Treasury's policy shifts and inconsistencies under both administrations have sidelined potential private capital. Treasury became the capital provider of last resort. It was late to recognize the hole in banks' balance sheets and consistently underestimated its size. The need to provide second- and even third-round capital injections proves that.

In summary, Fed policy did help cause the bubble. Subsequent policy responses by that institution have suffered from sins of commission and omission. As Mr. Taylor argued, the government (including the Fed) caused, prolonged, and worsened the crisis. It continues doing so.

Mr. O'Driscoll is a senior fellow at the Cato Institute. He was formerly a vice president at the Federal Reserve Bank of Dallas.

Low Rates Led to ARMs

By Todd J. Zywicki

Alan Greenspan's argument that the Federal Reserve's policies on short-term interest rates had no impact on long-term mortgage interest rates overlooks the way in which its policies changed consumer behavior.

A simple yet powerful pattern emerges from survey data of the past 25 years collected by HSH Associates (the financial publishers): The spread between fixed-rate mortgages (FRMs) and ARMs typically hovers between 100 and 150 basis points, representing the premium that a borrower has to pay to induce the lender to bear the risk of interest-rate fluctuations. At times, however, the spread between FRMs and ARMs breaks out of this band and becomes either larger or smaller than average, leading marginal consumers to prefer one to the other. Sometimes the adjustment in the market share of ARMs lags behind changes in the size of the spread, but over time when the spread widens, the percentage of ARMs increases and vice-versa.

In 1987, before subprime lending was even a gleam in Angelo Mozilo's eye, the spread rose to 300 basis points and the share of ARMs eventually rose to almost 70%, according to the Federal Finance Housing Board. When the spread shrunk to near 100 basis points in the late-1990s, the percentage of ARMs fell into the single digits. Other periods of time show similar dynamics.

In the latest cycle the spread rose from under 50 basis points at the end of 2000 to 230 basis points in mid-2004 and the percentage of ARMs rose from 10% to 40%. The Fed's subsequent increases on short-term rates caused short- and long-term rates to converge, squeezing the spread to about 50 points by 2007 and reducing ARMs to less than 10% of the market.

Record-low ARM interest rates kept housing generally affordable even as buyers could stretch to pay higher prices. Low short-term interest rates, combined with tax and other policies, also drew speculative, short-term home-flippers into certain markets. As the Fed increased short-term rates in 2005-07, interest rate resets raised monthly payments, triggering the initial round of defaults and falling home prices. Foreclosure rates initially soared on both prime and subprime ARMS much more than for FRMs.

Why did the ARM substitution result in a wave of foreclosures this time, unlike prior times? During previous times with high percentages of ARMs, the dip in short-term interest rates was a leading indicator of an eventual decline in long-term rates, reflecting the general downward trend in rates of the past 25 years. By contrast, during this housing bubble the interest rate on ARMs were artificially low and eventually rose back to the level of FRMs. There were other factors that exacerbated the problem -- most notably increased risk-layering and a decline in underwriting standards -- but the Fed's artificial lowering of short-term interest rates and the resulting substitution by consumers to ARMs triggered the bubble and subsequent crisis.

Mr. Zywicki is a professor of law at George Mason University School of Law and a senior scholar at the university's Mercatus Center. He is writing a book on consumer bankruptcy and consumer credit.

The Fed Provided the Fuel

By David Malpass

The blame for the current crisis extends well beyond the Fed -- to banks, regulators, bond raters, mortgage fraud, the Bush administration's weak-dollar policy and Lehman bankruptcy decisions,

and Congress's reckless housing policies through Fannie Mae and Freddie Mac and the Community Reinvestment Act.

But the Fed provided the key fuel with its 1% interest rate choice in 2003 and 2004 and "measured" (meaning inadequate) rate hikes in 2004-2006. It ignored inflationary dollar weakness, higher interest rate choices abroad, the Taylor Rule, and the booming performance of the U.S. and global economies.

Even by the Fed's own backward-looking inflation metrics, the core consumption deflator exceeded the Fed's 2% limit for 18 quarters in a row beginning with the second quarter of 2004, while 12-month Consumer Price Index (CPI) inflation hit 4.7% in September 2005 and 5.4% in July 2008. This despite the Fed's constant assurances that inflation would moderate (unlikely given the crashing dollar.)

Despite its role as regulator and rate-setter, the Fed claimed that it could not identify asset bubbles until they popped (see my rebuttal on this page "The Fed's Moment of Weakness," Sept. 25, 2002). It is clear that the Fed's interest rate polices cause wide swings in the value of the dollar and huge momentum-based capital flows. These bring predictable -- and avoidable -- deflations, inflations and asset bubbles.

Beginning in 2003, the Fed filled the liquidity punch bowl. Low rates and the weakening dollar created a monumental carry trade (borrow dollars, buy anything). This transmitted the Fed's monetary excess abroad and into commodities. As the punch bowl overflowed, even global bonds bubbled (prices rose, yields fell), contributing to the global housing boom. Alan Greenspan singled out this correlation in his March 11 op-ed on this page, "The Fed Didn't Cause the Housing Bubble."

Given this power, the Fed should itself stop the current deflation and the economic freefall. It has to add enough liquidity to offset frozen credit markets, the collapse in the velocity of money, and bank deleveraging (which has reversed the normal money multiplier.)

The Fed was on the right track in late November when it committed to purchasing $600 billion in longer-term, government-guaranteed securities. Equities rose globally, and some credit markets thawed, including a decline in mortgage rates and corporate bond spreads. However, the Fed reversed course in January, delaying its asset purchases and shrinking its balance sheet. Growth in the money supply stopped. Since then, the Fed increased the amount of assets it intends to purchase, but lengthened the time period rather than accelerating the pace of purchases.

Given the magnitude of the crisis and the stakes, the Fed should be buying safe assets fast, not parceling out a few billion. Confidence and money velocity would also increase if the Fed committed itself to dollar stability, not instability, to avoid causing future inflations and deflations.

Mr. Malpass is president of Encima Global LLC.

Loose Money and the Derivative Bubble

By Judy Shelton

The Fed owns this crisis. The buck stops *there* -- but it didn't.

Too many dollars were churned out, year after year, for the economy to absorb; more credit was created than could be fruitfully utilized. Some of it went into subprime mortgages, yes, but the monetary excess that fueled the most threatening "systemic risk" bubble went into highly speculative financial derivatives that rode atop packaged, mortgage-backed securities until they dropped from exhaustion.

The whole point of having a central bank is to calibrate the money supply to the genuine needs of an economy -- to purchase goods and services, to fund productive investment -- with the aim of achieving maximum sustainable long-term growth. Since price stability is a key factor toward that end, central bankers attempt to finesse the amount of money and credit in the system; if interest rates are kept too low too long, it causes an unwarranted expansion of credit. As the money supply increases relative to real economic production, the spillage of excess purchasing power results in higher prices for goods and services.

But not always. Sometimes the monetary excess finds its way into a narrow sector of the economy -- such as real estate, or equities, or rare art. This time it was the financial derivatives market.

In the last six years, according to the Bank for International Settlements, the derivatives market exploded as a global haven for speculative investment, its aggregate notional value rising more than fivefold to $684 trillion in 2008 from $127 trillion in 2002. Financial obligations amounting to 12 times the value of the entire world's gross domestic product were written and traded and retraded among financial institutions -- playing off every instance of market turbulence, every

gyration in exchange rates, every nuanced statement uttered by a central banker in Washington or Frankfurt -- like so many tulip contracts.

The sheer enormity of this speculative bubble, let alone the speed at which it inflated, testifies to inordinately loose monetary policy from the Fed, keeper of the world's predominant currency.

The fact that Fannie Mae and Freddie Mac provided the "underlying security" for many of the derivative contracts merely compounds the error of government intervention in the private sector. Politicians altered normal credit risk parameters, while the Fed distorted housing prices through perpetual inflation.

At this point, dickering over whether Alan Greenspan should have formulated monetary policy in strict accordance with an econometrically determined "rule," or whether the Fed even has the power to influence long-term rates, raises a more fundamental question: Why do we need a central bank?

"There are numbers of us, myself included, who strongly believe that we did very well in the 1870 to 1914 period with an international gold standard." That was Mr. Greenspan, speaking 17 months ago on the Fox Business Network.

In the rules-versus-discretion debate over how best to achieve sound money, that is the ultimate answer.

Ms. Shelton, an economist, is author of "Money Meltdown" (Free Press, 1994).

To Change Policy, Change The Law

By Vincent Reinhart

Anyone seeking an application of the principle that fame is fleeting need look no further than the assessment of Federal Reserve policy from 2002 to 2005.

At the beginning, capital spending was anemic, and considerable wealth had been destroyed by the equity crash. The recovery from the 1990-91 recession was "jobless," and the current one was following the same script. Moreover, inflation was so distinctly pointed down that deflation seemed a palpable threat.

Keeping the federal-funds rate low for a long time was viewed as appropriately balancing the risks to the Fed's dual objectives of maximum employment and price stability. Indeed, the Fed was seen as extending the stable economic performance since 1983 that had been dubbed the "Great Moderation."

Over the period 2002-2005, the federal-funds rate ran below the recommendation of the policy rule made famous by Stanford Professor John Taylor. No doubt, the Taylor Rule provides important guidance on how that rate should change in response to changes in the two mandated goals of policy. First, it should move up or down by more than any change in inflation. Second, the Fed should respond to changes in resource slack. That is, caring about unemployment is not a sign of weakness in a central banker but rather that of strength in better achieving good results.

The Taylor Rule is less helpful to practitioners of policy in anchoring the level of the federal-funds rate. The rule is fit to experience based on a notion of the rate that should prevail if inflation were at its goal and resources fully employed, which is known as the equilibrium funds rate. That is an important technicality. Using a faulty estimate of the equilibrium funds rate is like flying a plane that is otherwise perfect except for an unreliable altimeter. The exception looms large when flying over a mountainous region.

From 2002 to 2005, the economic landscape appeared especially changeable, with the contours shaped by lower wealth, lingering job losses, and looming disinflation. To Fed officials at the time, this indicated that the equilibrium funds rate was unusually low. Simply, the only way to provide lift to an economy in which resource use was slack and inflation pointed down was to keep policy accommodative relative to longer-term standards.

That was then. Now, policy during the period is seen as fueling a housing bubble.

The Fed is guilty as charged in setting policy to achieve the goals mandated in the law. Fed policy makers cannot be held responsible for the fuel to speculative fires provided by foreign saving and the thin compensation for risk that satisfied global investors. Nor can the chain of subsequent mistakes that drove a downturn into a debacle be laid at the feet of the Federal Open Market Committee of 2002 to 2005. If the results seem less than desirable in retrospect, change the law those policy makers were following, but do not blame them for following prevailing law.

Mr. Reinhart is a resident scholar at the American Enterprise Institute. From August 2001 to June 2007, he was the secretary and economist of the Federal Open Market Committee.