

THE FEDERAL RESERVE MUST COUNTERACT ASSET BUBBLES

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November 24, 2009

The Federal Reserve Board's main job is to use its monetary policy tools to stabilize the U.S. macro-economy. To this end, it must take responsibility for recognizing and counteracting asset bubbles before they grow large enough to pose a danger. Both the stock bubble of the 90s and the housing bubble of this decade were easily recognizable based on the fundamentals in these markets. In both cases there were sharp divergences from long-term trends with no plausible fundamentals-driven explanation. For example, the \$8 trillion housing bubble which grew up in years 1996-2006 fueled by huge piles of debt, leveraged securities and massive banker bonuses, could have been easily recognized. There was a sudden acceleration of housing prices beyond inflation rates, departing from a hundred year long trend. There was no unusual increase in rents, demonstrating clearly this run-up was not driven by fundamentals. Yet the Federal Reserve, first under Alan Greenspan and then under Ben Bernanke, did nothing to counteract this bubble that has now burst and brought down our economy.

The Fed's failure to do anything about the bubble is an egregious error, not just because the bubble was easily observable, but also because the Fed has many tools at its disposal to allow it to limit asset bubbles while achieving its other important monetary policy goals, such as achieving full employment and price stability. The Fed must use these tools now to counteract asset bubbles as they develop.

First and foremost, the Fed should try to counteract asset bubbles by informing the markets and the public. This involves using its research staff to carefully document the evidence of the existence of a bubble and its potential dangers to the economy as a whole and to various sectors. The Fed should use its public platforms to widely disseminate this information. To ensure that the Fed is appropriately monitoring these dangers, it should make periodic reports to Congress, to be disseminated widely, on emerging asset bubbles. This information will put the investing community and public on notice that the Federal Reserve has the asset bubble in its sights and may be preparing to take action against it.

In addition, when appropriate, the Fed should use other tools under its control. These include:

- Imposing margin requirements on purchases of financial instruments. For example, the Fed should extend margin requirements now legally applicable to purchases of stocks to all major credit market instruments such as mortgage- and other asset-backed securities.
- Increasing regulatory scrutiny of banks and other financial institutions whose lending is supporting the growth of the bubble.

This increased scrutiny could be backed up by:

- Placing limits on loans to other financial institutions. This extension of existing law would reduce the level of inter-connectedness that fuels contagion in the system.

- And the Fed can implement new tools to discourage bubbles in a more automatic and systematic way. In particular, the Federal Reserve should consider implementing a set of asset based reserve requirements:
- Asset based reserve requirements (ABRR) are a systematically designed set of margin requirements on financial assets that could be raised on particular assets as price bubbles develop. To be fully effective, these would be designed to apply to all financial institutions buying these assets, and not just banks.

Finally, the Federal Reserve can also raise interest rates as a tool to attack asset bubbles, recognizing the cost to the larger economy. Used properly, a rise in interest rates, with the deflation of an asset bubble as an explicitly stated target, is likely to prove very effective. But these interest rate increases must be carefully designed to be consistent with the Federal Reserve's goals of maintaining full employment with reasonable degrees of price stability.

If the Fed refuses to take responsibility for counteracting systemically dangerous asset bubbles, then Congress should consider imposing a rule on the Fed that would require it, for example, to raise leverage or margin requirements on a given group of assets when any one or more of them rises above the historical norm and/or by more than 10% a year (or 2 1/2% a quarter). The prospects of such a rule would likely get the Federal Reserve's attention rather quickly.

References

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