

# Economic SYNOPSES

short essays and reports on the economic issues of the day



2011 ■ Number 18

## Is the FOMC's Policy Inflating Asset Prices?

Daniel L. Thornton, Vice President and Economic Adviser

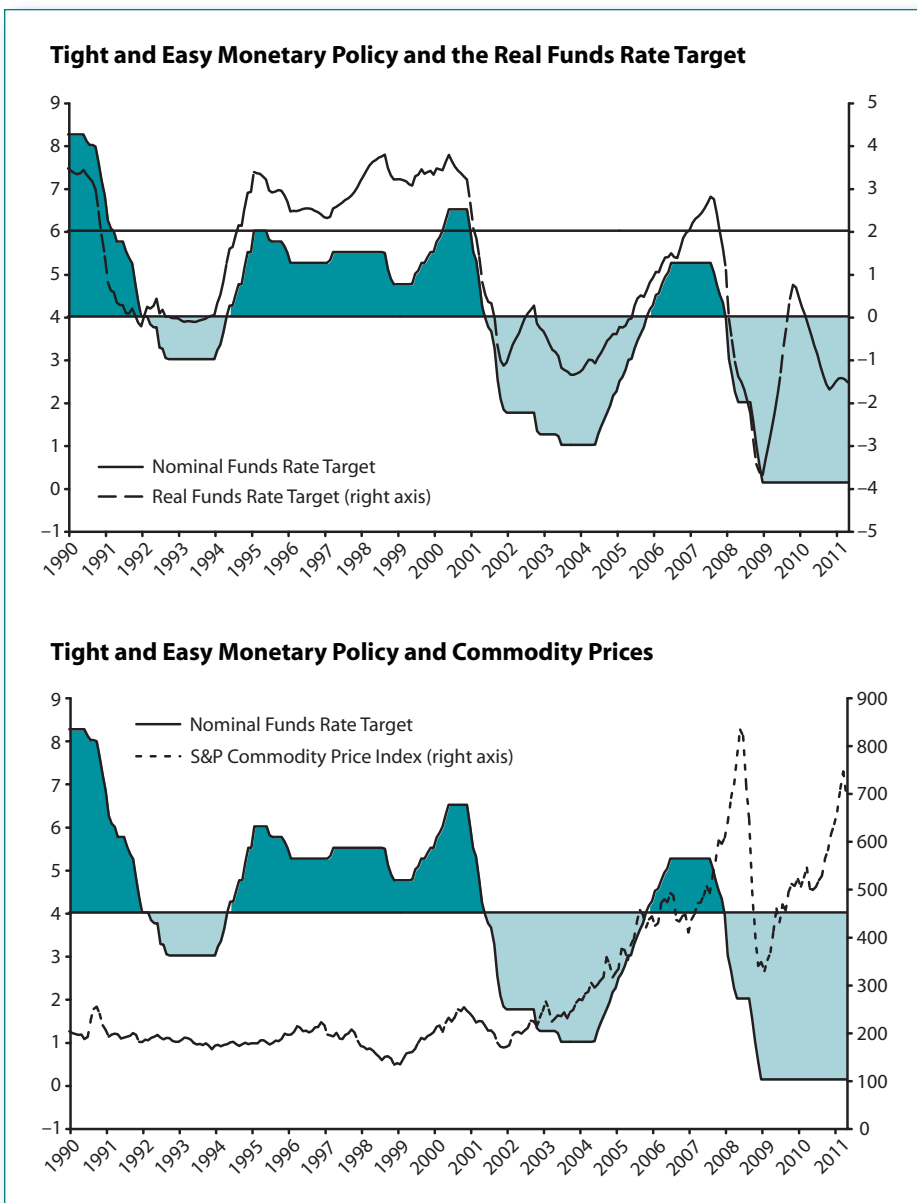
The Federal Open Market Committee (FOMC) has maintained the federal funds rate near zero since December 2008 and has indicated that it will continue to do so for an “extended period.” Some analysts and policymakers, most notably Thomas Hoenig, president of the Federal Reserve Bank of Kansas City, have suggested that this policy has significantly inflated asset prices.<sup>1</sup> This essay discusses the policy and the potential effects.

The charts provide a visual representation of a potential cause for concern: Both charts show the FOMC's target for the federal funds rate since January 1990 (refer to the left y-axis), relative to a 4 percent benchmark. This benchmark reflects two components: a historical real rate of return on default-risk-free assets of about 2 percent plus an FOMC inflation objective of about 2 percent. This 4 percent benchmark is a *neutral* nominal funds rate target—that is, one consistent with the FOMC's inflation objective. A funds rate target above 4 percent can be seen as a restrictive policy (dark blue); a target below 4 percent can be seen as an easy policy (light blue). The charts show that the funds rate target has been exceptionally and persistently low relative to this benchmark since the early 2000s.

The first chart's dotted line shows the real funds rate target (refer to the right y-axis), calculated as the nominal funds rate target minus the year-over-year consumer price index (CPI) inflation rate over the preceding year, relative to the 2 percent real rate benchmark noted above. By this measure, the real funds rate target has been not only persistently below the 2 percent benchmark over the past decade but, more often than not, negative.

Policymakers are aware of the possibility that a persistent policy of exceptionally low interest rates could result in a

misallocation of credit and inflate asset prices. For example, at the March 16, 2004, FOMC meeting, Governor Donald Kohn first noted that the FOMC's “accommodative policy” should narrow the output gap more quickly than it had been



narrowing and then described more serious concerns: “Policy accommodation—and the expectation that it will persist—is distorting asset prices. Most of this distortion is deliberate and a desirable effect of the stance of policy. We have attempted to lower interest rates below long-term equilibrium rates and to boost asset prices in order to stimulate demand. But as members of the Committee have been pointing out, it’s hard to escape the suspicion that at least around the margin some prices and price relationships have gone beyond an economically justified response to easy policy. House prices fall into this category...” He went on: “If major distortions do exist, two types of costs might be incurred. One is from a misallocation of resources encouraging the building of houses, autos, and capital equipment that won’t prove economically justified under more-normal circumstances. Another is from the possibility of discontinuities in economic activity down the road when the adjustment to more-sustainable asset values occurs.” He concluded by saying that neither concern was “sufficient to overcome the arguments for remaining patient awhile longer.”<sup>2</sup>

### Keeping the policy rate significantly and persistently below “long-run equilibrium rates” may inflate asset prices.

John Taylor and others have argued that the FOMC’s policy of maintaining its funds rate target at (then) historically low levels in the early 2000s contributed to a bubble in house prices and that the FOMC bears some responsibility for the financial crisis.<sup>3</sup> Consistent with this hypothesis, the proportion of subprime loans made using variable-rate mortgages (i.e., mortgages with rates that were most affected by the FOMC’s interest rate policy) increased substantially during this period.<sup>4</sup>

Keeping the policy rate significantly and persistently below “long-run equilibrium rates” may inflate the prices of other assets as well. Economic agents with revenues in excess of expenditures can either lend or purchase real assets. With the real rate significantly below its equilibrium level, it is reasonable to assume that some investors might purchase real assets rather than lend at very low or negative real rates. One possibility is investors could purchase commodities—for example, industrial and precious metals or petroleum—rather than lend.<sup>5</sup> This possibility is supported by the second chart, which shows the S&P spot commodity price index and periods of tight and easy policy relative to the long-run equi-

librium rate. The commodity price index remained relatively constant from 1990 through late 2001, when the funds rate target was reduced significantly below the long-run equilibrium level, and then rose dramatically. The index leveled off as the policy rate approached and went above the equilibrium level before falling dramatically but temporarily in mid-September 2008. The commodity price index rebounded significantly despite relatively sluggish economic growth and anemic employment growth.

Of course, asset prices are global and the Fed is not the only central bank that has pursued an aggressively easy monetary policy. Moreover, the second chart is only suggestive. The dramatic increase in commodity prices since the early 2000s could be due to other factors independent of central banks’ interest rate policies. For example, the increased demand associated with a shift to commodities being assets in a portfolio should increase asset prices independent of Fed policy. Nevertheless, the extent to which excessively low nominal interest rates may affect a wide range of asset prices is an important research and policy question. If such an environment induces economic agents to switch from lending to investing in commodities, the result could be a commodity price bubble: As more investors purchase commodities, commodity prices rise, which causes more investors to view commodities as an attractive alternative to lending, causing commodity prices to rise even further, and so on and so forth. Once commodity prices rise to an unsustainable level—for example, if industrial metal prices rise to a level that cannot be sustained by the prices of the products they are used to produce—or policymakers return the policy rate to or above the equilibrium level, the bubble will burst. This possibility raises the question today: Are we getting the ill effects of such a policy without an appreciable increase in aggregate demand? ■

<sup>1</sup> See Thomas Hoenig’s speech, “The 2010 Outlook and the Path Back to Stability,” given January 7, 2010; [www.kansascityfed.org/SpeechBio/HoenigPDF/Hoenig.01.07.10.pdf](http://www.kansascityfed.org/SpeechBio/HoenigPDF/Hoenig.01.07.10.pdf).

<sup>2</sup> FOMC Transcript, March 16, 2004, pp. 56-57; [www.federalreserve.gov/monetarypolicy/files/FOMC20040316meeting.pdf](http://www.federalreserve.gov/monetarypolicy/files/FOMC20040316meeting.pdf).

<sup>3</sup> Taylor, John B. “The Fed and the Crisis: A Reply to Ben Bernanke.” *Wall Street Journal*, January 11, 2010, p. A19; [www.stanford.edu/~johntayl/2010\\_pdfs/Fed-Crisis-A-Reply-to-Ben-Bernanke-WSJ-Jan-10-2010.pdf](http://www.stanford.edu/~johntayl/2010_pdfs/Fed-Crisis-A-Reply-to-Ben-Bernanke-WSJ-Jan-10-2010.pdf).

<sup>4</sup> For some detail on subprime financing, see Sengupta, Rajdeep. “Alt-A: The Forgotten Segment of the Mortgage Market.” *Federal Reserve Bank of St. Louis Review*, January/February 2010, 92(1), pp. 55-71; <http://research.stlouisfed.org/publications/review/10/01/Sengupta.pdf>.

<sup>5</sup> Jeffery Frankel (“The Effect of Monetary Policy on Real Commodity Prices,” in John Campbell, ed., *Asset Prices and Monetary Policy*. Chicago: University of Chicago Press, 2008, pp. 291-327) finds a strong negative relationship between commodity prices and real interest rates in the United States.