

# PREVENTING BUBBLES: REGULATION VERSUS MONETARY POLICY

*David Malpass*

Over the years, there has been a lot to consider in the Federal Reserve's choices of monetary policy and their relationship to bubbles. My conclusion is that mistaken U.S. monetary policy, usually related to the Fed's indifference to the value of the dollar, has repeatedly caused harmful asset bubbles in the United States and abroad. Policy is again at risk with the Fed's imposition of near-zero interest rates and its decision to conduct large-scale asset purchases (termed "quantitative easing"). Regulatory policy has often been ineffective at identifying or addressing asset bubbles, especially those caused by Fed policy. The solution is a parallel track to improve monetary policy so that it provides a more stable dollar and fewer asset bubbles; and to strengthen regulatory policy so that it provides a more reliable base for growth-creating free markets.

In an October 1999 speech at the Cato Institute's Annual Monetary Conference, I criticized U.S. monetary policy for strengthening the dollar, driving gold and commodity prices down, and creating unsustainable deflationary pressures in developing countries. While the United States felt satisfied with the tech boom and low unemployment, the inflow of hot money driven by the strong and strengthening dollar was creating an artificial global capital allocation that ended in a bust and recession. I think the Fed should have sought a strong and stable dollar in the late 1990s, not a strengthening dollar, and encouraged stronger regulatory scrutiny in those financial markets where it perceived irrational exuberance.

---

*Cato Journal*, Vol. 31, No. 3 (Fall 2011). Copyright © Cato Institute. All rights reserved.

David Malpass is President of Encima Global LLC.

This approach would have resulted in faster, more balanced global growth.

Speaking again at Cato's Annual Monetary Conference in October 2004, I criticized the Fed's manipulation of the overnight interest rate (down to 1 percent over false concerns about deflation) and its policy of measured rate hikes—what became a 0.25 percent limitation on rate hikes despite fast growth, rising inflation, a rapidly weakening dollar, and consequent booms in gold and commodity prices (Malpass 2005). The excess liquidity caused by the Fed's mistaken monetary policy soon turned into excess U.S. house construction and bubbles in real estate prices around the world. Again, a Fed policy choice of a strong and stable dollar as a guidepost for monetary policy would have allowed a better capital allocation.

Current circumstances require another strong challenge to the Fed's policy mix. The U.S. regulatory pendulum has swung from harmful laxness to barriers—tax, accounting, capital adequacy, and others—against normal commercial lending. Rather than fixing the regulatory problem implicit in the massive excess reserves banks are depositing at the Fed, the Fed is instead applying near-zero overnight interest rates and an average \$75 billion per month in net balance sheet expansion through longer-term Treasury purchases.

This policy mix is creating many problems. Developing countries are suffering asset bubbles and inflation, the direct result of the Fed using excessive monetary policy rather than improved regulatory policy. The mistaken Fed monetary policy has induced a commodity price spike, costly to U.S. growth and working against the Fed's full employment mandate. Moreover, the Fed is causing currency volatility and providing concentrated profits for traders at the expense of broad global living standards.<sup>1</sup>

## Misguided Monetary Policy

The Fed has often framed the asset bubble issue in terms of its role in identifying or controlling bubbles. Instead, it should adopt a monetary framework less prone to causing asset price volatility. The starting point for this is for the Fed to recognize dollar instability as a

<sup>1</sup>Stanford economist Ronald McKinnon (2010) has pointed to the dysfunction the Fed is causing in the interbank market and why the zero percent Fed funds rate is a bad idea when there is no emergency.

root cause of asset bubbles and busts in recent decades. Rather than ignoring the dollar, the Fed should monitor its value versus gold, commodities, and other currencies as a principal indicator of monetary policy, and seek a strong and stable dollar as a key condition for meeting the dual mandate of price stability and full employment.

Instead, the U.S. has shifted into a policy environment in which credit is being rationed by regulatory policy rather than price, a decidedly harmful monetary policy development. As a result, capital allocation is increasingly being determined by governments, regulators, and big corporations—a negative for long-term growth (Malpass 2009).

Financial leverage has shifted rapidly from the U.S. private sector to the Fed and Treasury, where borrowing costs are low. In the short run, this shift has been stabilizing. However, the near-zero Fed funds rate hurts savers and distorts capital flows. The Fed's buyback of Treasury notes and bonds leaves the taxpayer exposed to potential Fed losses exceeding its capital and to rollover risk due to the short maturity of the national debt.

In a letter I wrote to Fed Chairman Ben Bernanke (Malpass 2010), also signed by a large group of economists, we asked Chairman Bernanke to reconsider the Fed's asset purchases. The letter reads:

We believe the Federal Reserve's large-scale asset purchase plan (so-called quantitative easing) should be reconsidered and discontinued. We do not believe such a plan is necessary or advisable under current circumstances. The planned asset purchases risk currency debasement and inflation, and we do not think they will achieve the Fed's objective of promoting employment.

We subscribe to your statement in the *Washington Post* on November 4 [2010] that "the Federal Reserve cannot solve all the economy's problems on its own." In this case, we think improvements in tax, spending and regulatory policies must take precedence in a national growth program, not further monetary stimulus.

We disagree with the view that inflation needs to be pushed higher, and worry that another round of asset purchases, with interest rates still near zero over a year into the recovery, will distort financial markets and greatly complicate future Fed efforts to normalize monetary policy.

The Fed's purchase program has also met broad opposition from other central banks and we share their concerns that quantitative easing by the Fed is neither warranted nor helpful in addressing either U.S. or global economic problems.

The letter was not a criticism of the Fed's independence. Many of us who signed the letter are very strong supporters of Fed independence. Nor was our objection to the Fed's communication of the policy, as the Fed argued. Rather, the problem is the expansion of the Fed's balance sheet. People have been talking about this problem for a long time. John B. Taylor, one of the signers of the letter, has been focusing on this problem for almost two years, trying to get the Fed to stop going in this direction. So the problem is not merely one of communication, it is an argument about Fed policy—namely, the inadvisability of having the Fed grow a really big balance sheet at this particular point in history.

Quantitative easing won't help growth, jobs, or small businesses; it mostly benefits traders and Wall Street. By undertaking large-scale purchases of long-term assets with very little equity behind them, the Fed is drastically expanding its role in the bond market and in the economy. Owning long-term assets "financed" by overnight deposits is as far from garden-variety monetary policy as good banking is from bad.<sup>2</sup>

In a garden-variety monetary policy, the Fed owns short-term assets like Treasury bills, balanced by short-term "borrowings" from banks (i.e., deposits of reserves created by the Fed). Because the maturities are matched, interest rate increases would have little impact on the Fed's earnings or net worth. This assures the Fed a great deal of latitude in pursuing price stability, giving investors confidence that the Fed can sell Treasury bills and allow interest rates to rise as needed without itself losing money.

By buying longer-term assets, whose value will decline when interest rates rise, the Fed is engineering a fundamental change in the nature of U.S. monetary policy. This shift from Treasury bills only to credit allocation has undercut global confidence in the Fed, as reflected in high gold prices, dollar weakness, and large-scale investments abroad by U.S. companies and wealthy individuals.

<sup>2</sup>When the Fed buys assets, it creates new base money in the form of reserves held at the Fed.

My own view is that the Fed probably will hold those longer-maturity assets almost to maturity. Consequently, excess reserves are going to be bloated for a long time. That presents very real challenges for the operation of monetary policy, one of the main concerns raised in the letter to Chairman Bernanke.

Of equal concern, the Fed's asset purchases interfere with prices in the bond market, at least temporarily increasing the value of the bonds the Fed buys. Wall Street loves this aspect of the Fed's asset purchase program because it has been able to buy the assets before the Fed does, creating almost sure-fire profits. If the Fed were to expand into purchases of private securities, as some have advocated, the potential for bond market distortions and opportunities to profit by buying ahead of the Fed would be even greater.

As for the Fed's ability to foresee and combat inflation, a key question mark in the Fed's program to expand its balance sheet, the Fed claimed a moderation in inflation to justify its ultra-low interest rate choices in 2003 and forward. Yet inflation frequently topped 4 percent in 2005–08, with no evidence that the Fed has improved its crystal ball enough to avoid a repeat.

One of the biggest complaints about the new Fed stimulus is that it directs the nation's credit toward the government and corporations big enough to issue bonds. Since small businesses, especially new businesses, create the lion's share of jobs, Fed asset purchases are likely to harm the nation's job creation by underpricing capital for the government and corporations, at the expense of small businesses. In the Fed's ultra-low interest rate experiment of 2003–07, funds went to home building and auto production—politically favored sectors—rather than new businesses. This left a double harm when the housing bubble popped without strength in other parts of the economy. Already in this global expansion, plentiful credit is being channeled to emerging markets and commodities at the expense of savers and small businesses. This creates a good opportunity for aggressive investors, but a loss for the many businesses that do not have access to cheap credit or have to compete with businesses that do.

Critics of the Fed's quantitative easing can draw parallels to the \$800 billion 2009 fiscal stimulus program—both are major expansions of government that are far-removed from job creation. This is the crux of the debate: expansions of government, whether fiscal or monetary policy, discourage private sector jobs by undermining

business confidence about future taxes, the stability of the dollar, and market interference by the government.

I think there should be a higher bar: unless Fed asset purchases are in some way necessary to the economy's survival, the assumed harm from an expansion of government, which is at the core of our principles of limited government, argue against Fed asset purchases.

One of the messages from the November 2010 election was a demand from the people to the government to downsize spending, taxation, power, and intrusion into America's economy and culture. This is a hard message for Washington to accept because it means less power, less influence. Both fiscal stimulus and Fed asset purchases raise the same giant red flag. As the government expands its role in the economy, business confidence and hiring decline as people recognize that there is no free lunch.

I think it would be relatively easy and nondisruptive for the Fed to wind down its asset purchases. Stopping quantitative easing would not tighten money. Quantitative easing is stimulative (and removal of it contractionary) only if banks are constrained by a shortage of reserves. The banks would take the new reserves and lend them multiple times, limited by reserve requirements. But banks are not constrained by a shortage of reserves, so additional Fed reserves (or discontinuance of the additions) would have no impact on the amount of their lending.

### Quantitative Easing Ineffective

As the Fed buys bonds, it credits banks with excess reserves. The Fed's balance sheet is bigger, but there's no growth in the overall balance sheet of commercial banks or any more money in the private sector. When the Fed buys a bond and pays for it by crediting a bank's reserves at the Fed, the banking system has the same asset and liability totals as before, but their duration has shortened.

The Fed's idea is that the private sector will then go looking for riskier and longer-duration assets to make up for the bond the Fed bought. But the evidence is clear that the banks have been shrinking, not growing, their assets as the Fed expands. Thus, the Fed could wind down quantitative easing with little negative impact. Wall Street will threaten a tantrum—the Fed's asset purchases are incredibly profitable for the Fed and for currency, commodity, and bond traders. If the Fed stopped quantitative easing, the dollar would stop

its slide, beginning to staunch the hemorrhage of risk capital from the U.S. and helping restart the small-business job creation process.

I am also skeptical of the argument that the Fed's quantitative easing is causing a flattening of the yield curve and the credit-risk curve, and that a cessation of quantitative easing would cause any steepening. In theory, we can consolidate the balance sheets of the Fed and Treasury and analyze the Fed's purchases as a government buy-back of Treasury bonds. The Fed's holdings of Treasury bonds offset Treasury issuance, while the Fed's liability to commercial banks (excess reserves) is parallel to Treasury's T-bill issuance. The net effect is that the same amount of U.S. government debt is outstanding, but it has an even shorter average maturity than before the Fed's quantitative easing.

If we assume the Treasury lengthens its maturity issuance to meet the Fed's demand, then the Fed's quantitative easing is completely sterilized—meaning that undoing the quantitative easing would be automatically offset by the Treasury's choice of issuance. Instead, if we assume the Treasury leaves issuance unchanged, then the only thing that happens through Fed purchases is a shortening of the maturity of the remaining marketable debt. The government could have accomplished exactly the same result as Fed quantitative easing by having the Treasury shorten the maturity of its issuance.

Through arbitrage, the shape of the yield curve is not dependent on the points of issuance, so it is questionable whether a shortening of the average maturity of debt issuance can have a lasting flattening effect. Germany's yield curve is flatter than the U.S. yield curve even though it is not doing quantitative easing. I think a Fed wind-down of quantitative easing might actually bring a small flattening of the U.S. yield curve by adding to confidence in the Fed, allowing more long-term capital formation (rather than the short-term financing encouraged by current policies.)

## Fed Causing Asset Bubbles Is Not a New Problem

Going a little back into history, the Fed causing asset bubbles is not a new problem. After the 2000 stock market bubble, there was a huge debate over how the Fed contributed to it. After complaining about "irrational exuberance" in December of 1996, Greenspan tightened monetary policy, strengthening the dollar and drawing capital to the United States. The idea was to fight

irrational exuberance with higher interest rates. Instead, money flooded into the United States as the dollar strengthened. The Fed should have called for a strong and stable dollar and used regulatory policies to the extent that Greenspan was right in saying there was irrational exuberance. In the bond market, credit spreads had indeed narrowed drastically, raising natural questions about the regulatory framework that was responsible for reviewing this area of financial markets.

By 2002, there was a huge, unresolved issue about how the Fed was going to deal with bubbles. The Fed basically said it was going to clean them up after the fact. I do not think that is a satisfactory or a very fulfilling answer.

I laid out my views on this issue in a September 25, 2002, article “The Fed’s Moment of Weakness” (Malpass 2002), in which I argued:

Three major debates over monetary policy are in full swing: how to combat deflation, the central bank’s role in controlling asset-price extremes, and the proper response to fiscal deficits.

At the moment [2002] the debates are headed in the wrong direction. They don’t offer an explanation for the deflation of the 1990s, let alone a policy bridge to price stability, economic growth, and tax reform in the 2000s.

Fed Chairman Alan Greenspan explained at an August 30 [2002] speech in Jackson Hole, Wyo., that the Fed can’t anticipate bubbles and can only hope to soften the blow when they pop.

Mr. Greenspan is letting himself off the hook here. Instead of the tight-money, strong-dollar response to “irrational exuberance” in the late 1990s, a Fed commitment to currency stability and proper regulation would have allowed market forces to operate better, softening the boom.

The momentum-based capital inflow to the U.S. would have been smaller. The result would have been less of a U.S. boom, but also less of a bust and a better economy going forward. Global growth would have been more balanced.

By 2004, the Fed had settled on “measured” rate hikes, ignoring a sharply weakening dollar and rising inflation.

The core PCE deflator is the Fed's chosen indicator of inflation. It gets revised substantially, after the fact, making it a complicated benchmark for the conduct of monetary policy. The Fed uses it before the revisions. In the middle of 2005, the core PCE deflator, as originally published, was only at 1.5 percent year-over-year. So the Fed was imposing a very low Fed funds rate at that time on the basis that inflation was low. During 2006, the originally published data showed a moderation in inflation in the core PCE deflator that allowed the Fed to repeatedly pat itself on the back for the moderation in inflation that it had achieved.

Yet the revised data show much higher inflation. The end result of the policy in 2003–06 was that the Fed funds rate was too low, the dollar was weakening, and the United States ended up having a lot of inflation. The year-over-year core PCE deflator was sustained at well over 2 percent from 2004 to 2008, too much for quality economic growth.

The Fed is still using this backward-looking indicator, the core PCE deflator. Before revision, it applies current prices to the historical product weightings—what people used to buy. Then the revision occurs as they find out what people actually bought. Items in demand often have rising prices. This systematically understates inflation rates in the early releases of the data, contributing to the Fed's behind-the-curve monetary policy and to asset price swings.

## Gold as an International Reference Point

In November 2010, World Bank President Robert Zoellick, whom I worked with at both Treasury and State, wrote that the G20 (the group of 20 large economies) should consider employing gold as an international reference point:

The G20 should complement this growth recovery program with a plan to build a cooperative monetary system that reflects emerging economic conditions. . . . The system should also consider employing gold as an international reference point of market expectations about inflation, deflation and future currency values [Zoellick 2010].

The price of gold rose sharply in the early 1970s, signaling a devastating global inflation. From 1982 to 1997, during the successful Great Moderation, the price of gold stabilized around its 10-year

moving average. Under the tight money and loose regulation policies of the late 1990s, gold prices fell, signaling deflation that showed up in the crises in Asia, Brazil, and Russia. Now we are back to an inflationary mode.

The world would be dramatically different if the Fed said it thought Zoellick's suggestion was worth studying or had merit. But the Fed has repeatedly rejected the concept of using gold prices as an indicator of monetary policy. I continue to grapple with the problem that the U.S. Treasury and Fed embrace policies that cause an unstable currency. To promote economic growth and jobs, they should be seeking a relatively stable exchange rate over the long term.

Gold broke below its 10-year moving average at the end of 1996, almost to the day that Chairman Greenspan implied that the Fed was going to hike interest rates to fight irrational exuberance in financial markets. The Fed was using monetary policy rather than regulatory policy to fight what it thought was a market bubble.

## Policy Approach to Complement Clear, Strong Financial Regulation

In an effort to be concrete and constructive at this November 2010 conference, I have drawn up a list of policy suggestions that would help recover from the crisis of 2008. These are meant as discussion points. The goal is to draw investment capital to the United States to create jobs, prepare the Fed's exit from its emergency-sized balance sheet, and encourage profitable bank lending.

- State a preference for “strong and stable” dollar. Instead, what the U.S. government continues doing is saying that the currency reflects the fundamentals of the country—that we have a free floating exchange rate reflecting our fundamentals. That policy is highly pro-cyclical. As fundamentals weaken, the currency weakens and it causes a capital outflow that makes the economic fundamentals worse. As long as the United States keeps asserting that the dollar should reflect our economic fundamentals, I think we are on the wrong path.
- Wind down the Fed's Treasury purchases and gradually stop reinvesting Fed principal repayments from its MBS portfolio. This would be a strong statement of improved monetary policy,

adding growth and jobs to an otherwise weak recovery. Stopping the reinvestment of Fed principal repayments would gradually burn off some of the Fed's enlarged balance sheet.

- Lower the Fed's interest rate on excess reserves to 0.15 percent from 0.25 percent and then use the Treasury bill rate as reference rate. Right now, the Fed is overpaying for excess reserves, disrupting short-term credit markets, and costing taxpayers hundreds of millions. Paying less would encourage more lending to the private sector.
- Encourage banks to lower their prime rate.
- Unwind the Dodd-Frank provisions that shortcut bankruptcy processes and threaten open-ended FDIC taxes.
- Bank regulators should use judgment in applying GAAP and mark-to-market to regulatory capital. We still have the same pro-cyclicality of regulatory policy that was identified in October of 2008. Treasury Secretary Hank Paulson and the managing director of the IMF both gave speeches on it. Nobody really did anything to correct the regulatory problems they identified. I think Basel III may be making it worse.
- Raise the Fed funds rate gradually to 1 percent. Later move it higher in keeping with price stability and dollar stability. Use gold as a reference point.
- Hold back some Fed profits from Treasury so the Fed can build an equity cushion more in line with its massive bond positions. We are at risk now because the Fed has very little equity capital and yet is holding a highly leveraged portfolio, borrowing short and lending long. That could be addressed by more equity at the Fed as a temporary confidence-building measure until it exits its bond positions.

## Conclusion

The Fed has caused several asset bubbles through mistaken monetary policy. The risk is another round of asset price bubbles, this time in emerging markets, commodities, and related economic sectors. The Fed should revise its monetary policy to seek long-term stability in the value of the dollar using gold prices as a reference point. By reducing the number of Fed-induced asset price bubbles, regulatory policy would be better able to identify and address the market flaws causing asset price aberrations.

References

- Malpass, D. (1999) "Replacing the Vacuum in International Economic Policy." Speech given at the Cato Institute's 17th Annual Monetary Conference, Washington, D.C. (21 October).
- \_\_\_\_\_ (2002) "The Fed's Moment of Weakness." *Wall Street Journal* (25 September).
- \_\_\_\_\_ (2005) "Exchange Rate Protectionism: A Harmful Diversion for Trade and Development Policy." *Cato Journal* 25 (1): 107–10.
- \_\_\_\_\_ (2009) "Near-Zero Rates Are Hurting the Economy." *Wall Street Journal* (4 December).
- \_\_\_\_\_ (2010) "Open Letter to Ben Bernanke." *Wall Street Journal* (15 November).
- McKinnon, R. (2010) "Beggars-Thy-Neighbor Interest Rate Policies." Working Paper, Stanford University (November).
- Zoellick, R. (2010) "The G20 Must Look Beyond Bretton Woods II." *Financial Times* (7 November).