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Fast and loose

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Illustration by Dettmer Otto

How the Fed made the subprime bust worse

ON JANUARY 3rd 2001 Mr Greenspan had a new-year gift for America's gloomy financial markets. Outside the normal schedule of its meetings, the Federal Reserve cut the fed funds rate by half a percentage point, to 6%. But the markets' joy did not last long: the dotcom bubble had burst and the economy was already sliding into recession.

Two and a half years and another dozen cuts later, the fed funds rate was fully five percentage points lower. The Fed had seen one reason after another to ease policy. After the tumble into recession in 2001 came that September's terrorist attacks on New York and Washington, DC. By 2003 Mr Greenspan was worrying that America might be on the way to deflation, with prices falling. In June, he says in his book, "deflation was Topic A". The Fed cut rates to 1%, the lowest since 1958, where they remained for a year.

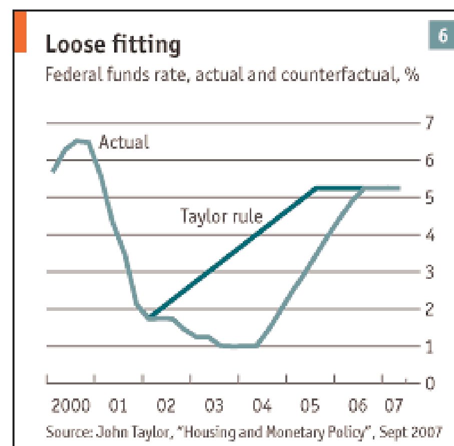
Gradually, the Fed took up the slack, but far more slowly than it had let it out. In quarter-point steps, the fed funds rate was raised to 5.25% by June 2006. It stayed there until September's cut. Now, as America surveys the aftermath of a housing boom and the distress of those unable to make their mortgage payments, it is worth asking what part the Fed played in creating the mess it is trying to clear up. Was monetary policy too loose?

Probably the commonest way economists measure the stance of monetary policy is the Taylor rule, named after John Taylor, the Stanford University economist who invented it. The rule is a guide to what interest rates should be, depending on the amount of slack in the economy and the inflation rate.

It says that if there is no output gap (ie, if GDP is in line with the economy's capacity) and inflation is equal to the central bank's target, then interest rates should be at a neutral level, causing the economy neither to accelerate nor to slow down. If an output gap opens up, so that GDP outstrips long-run capacity, or inflation rises above target, rates should be above neutral. If there is slack in the economy or inflation dips, policy should be eased.

Of course the Taylor rule is only a rough guide. The neutral rate and the output gap, in particular, cannot be measured precisely. But the rule can tell you whether policy is roughly right or a long way out. The Fed missed by a mile.

At this year's annual central bankers' symposium in Jackson Hole, Wyoming, Mr Taylor ran his own rule over the Fed (see chart 6). Had the central bank followed it, rates in 2002 would have been going up not down. By the time rates started to rise, the gap between the actual rate and that indicated by the Taylor rule was three percentage points. The gap was finally closed only last year—long after fears of deflation had been banished. The Fed has departed from the rule at other times in the past couple of decades, said Mr Taylor, notably in the autumn of 1998, "but this was the biggest deviation, comparable to the turbulent 1970s."

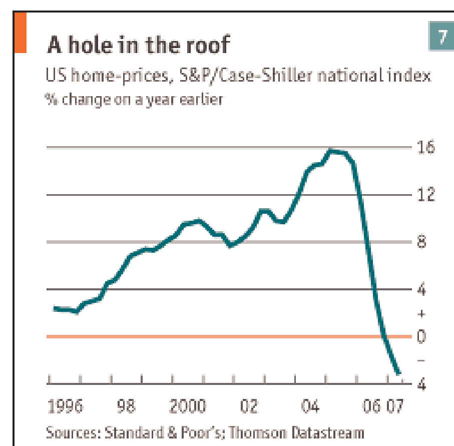


The Taylor rule is not the only gauge of monetary policy. For many central banks, the rapid rate of monetary growth has been a related source of worry. Their discomfort has been amplified by their lack of understanding of how the myriad innovations in finance affect the economy.

In Britain and the euro zone, the growth in money and credit has been in double digits. One measure at a global level is American base money plus global foreign-exchange reserves, which picks up the contribution of China's build-up of reserves. This has recently been growing by more than 10% a year, at times breaching 20%.

Economists can argue each other to a standstill over how precisely money indicates inflation. The ECB still formally rests part of its policy on the long-run correlation between broad-money growth and inflation. Many American economists are sniffy about the whole idea because money gives such a noisy signal. Long before it tells you anything, they believe, other indicators will have shown that inflation is gathering pace. Yet others, such as Mr King of the Bank of England, take a more nuanced position. In some circumstances, he believes, money and credit will give an earlier sign of inflation than other indicators do. You would be foolish to ignore it entirely.

Charles Goodhart, of the London School of Economics, and a former member of the Bank of England's Monetary Policy Committee, thinks the debate would shift if inflation were properly measured. Monetary growth is more likely to go with rapid rises in asset prices than with inflation in goods and services. "If inflation is (incorrectly) measured to exclude all asset-price inflation," Mr Goodhart concludes, "then the links between money growth and (true) inflation may be understated."



In any event, when the Fed started cutting rates America's housing market was already vibrant, despite the weakening of the economy as a whole. The S&P/Case-Shiller index of national home prices, the broadest measure of the American market, was rising at a rate of nearly 10% a year. Though the pace slowed in 2001, a poor year for the economy, the market was soon bounding ahead again (see chart 7).

In most markets, when prices go up, demand goes down. Housing can be different. People bought not just for the comforts that a house could offer or for the rent that it might yield, but in the expectation that prices would keep on rising. As the belief that you could not lose took hold, buying property for investment rather than for somewhere to live accounted for a rising share of the market. People even started "flipping", buying homes still on the drawing board with borrowed money in the hope of selling again quickly at a profit.

Housebuilders responded to the surge in demand. The number of housing starts jumped from 1.5m, at an annual rate, in August 2000 to a peak of 2.3m in January 2006. In 2005 housing construction accounted for 6.2% of GDP, the highest share since 1950.

The wrong price sensitivity

Although the Fed's easing of policy helped to make housing finance cheaper, it was not the only factor. Curiously, mortgage rates stayed low even after the central bank had started to increase official rates. The immediate reason was that the price of mortgages does not depend directly on official short-term rates but on

the longer-term rates at which lenders can secure funding. Longer-term rates did not rise in step with the fed funds rate: ten-year Treasury bond yields even declined at times, posing what Mr Greenspan called a "conundrum". But that just raises another question: why did long-term rates not go up when the fed funds rate did?

One possible explanation is that markets had faith in the Fed's ability to rein in inflation in the long term, even though policy was on the loose side. However, financial globalisation may have counted for more. America borrows from abroad on a grand scale: last year its current-account deficit soared to over 6% of GDP. And the rest of the world—especially emerging Asian economies and oil exporters—was more than happy to save and lend.

In 2005, when he was a Fed governor during Mr Greenspan's chairmanship, Mr Bernanke dubbed this a "saving glut". Desired saving in emerging economies had gone up, he suggested, for three reasons. After the Asian crisis of 1997-98 emerging economies had become determined to accumulate foreign reserves and resist exchange-rate appreciation. Rising crude oil prices had filled oil exporters' coffers and Chinese saving rates rose even faster than investment.

This extra desired saving in emerging economies had to be accommodated somehow, because in the world as a whole saving and investment must balance. That implied lower saving relative to investment in developed countries, and lower real interest rates. In effect, oil exporters and Asian savers were pushing down American mortgage rates.

These credit-cheapening forces helped subprime borrowers to join the housing party, as did the speed with which house prices climbed. The poor by and large find it much harder to borrow than the rich because lenders are less sure about their ability to repay. But lenders look more kindly on borrowers who offer collateral, such as a house. The more valuable the collateral, the more willing they are to lend. Developments in the financial industry also made lenders more willing to extend risky credit. As prices soared and interest rates stayed low, delinquency rates remained low too. Subprime debt looked an excellent investment.

A bad time to buy

With everyone sure of a winner, standards slipped—a common failing in a craze. Some lenders did not look closely enough at their borrowers. Many borrowers had no idea of how much they might be asked to pay once interest rates picked up and their introductory teaser rates ran out.

The unravelling of all this is proving painful. Housing construction once helped drive the American economy along. Now it has been a big drag for more than a year and is likely to remain so for a while yet.

Had the Fed acted differently, would the boom and bust have been less marked? At Jackson Hole Mr Taylor said it would. He reckons that the Fed's policy explains housing starts fairly well until mid-2004, when interest rates started to rise; by then, the boom had its own momentum. Under the Taylor rule, starts would have peaked sooner—around two years earlier than happened in real life—and at a much lower level.

Mr Taylor's argument, in essence, is that the Fed fuelled the housing boom by taking its eye off inflation. Some economists, however, believe that even when inflation is low, there is a danger that asset prices will get out of hand. Low inflation could even help to set them off.

In a paper last year Claudio Borio, an economist at the Bank for International Settlements, mused on a puzzle. Despite the remarkably strong growth in monetary and credit aggregates, inflation around the world has been subdued. That could be taken as confirmation that central banks have mastered the secrets of the world economy. But Mr Borio and his colleagues at the BIS (not to mention a few central bankers) are not so sure.

He suggests that financial liberalisation, credible anti-inflationary monetary policies and globalisation have changed the way the world economy works in ways that no one quite understands. They are all good things, separately or together, but may require central bankers to refine their policies—and specifically to pay more attention to financial imbalances and the risk of asset-price bubbles.

Financial liberalisation has meant that more people have easier access to credit. This has allowed resources to be better allocated. But there are also fewer constraints on the forces that can cause booms to feed on

themselves. For example, rising asset prices can generate more demand, not less. Investors see little risk when markets are near their peak. And yet, in hindsight, that is precisely when the risks of something going awry are at their greatest.

It is well known, says Mr Borio, that high inflation can disrupt economies and cause financial instability. But financial imbalances can also build up when inflation is low—as it was in America in the late 1920s or Japan in the 1980s. A technological advance, say, can set off investment booms. Awkwardly for central banks, if they have done a good job of anchoring inflation expectations at a low level, wages and prices might not rise to hold down demand. Mr Borio and Philip Lowe, now at the Reserve Bank of Australia, have called this behaviour a "paradox of credibility". If inflation stays low, then central banks will have no need to tighten rates and hence may allow financial imbalances to build up.

Leaning machines

Meanwhile, globalisation can set off a boom, in much the same way that a technological innovation can. By pushing down inflation for a while, it may reinforce the credibility of monetary policy. If it causes inflation to dip below a central bank's target, it may even prompt a cut in interest rates, making a credit and asset-price boom more likely.

All this implies that it is not enough for central banks to focus on controlling inflation in the near term; it would also be desirable for them to lean against credit and asset-price booms that appear unsustainable, as a form of insurance against a bust further down the road. The idea has a pedigree: BIS economists, in particular, have been arguing along these lines for years, finding more sympathetic ears among central bankers than among academics.

Mr Taylor's conclusions are therefore oddly reassuring for those of orthodox mind. If over the past few years the Fed had simply stuck to its usual policy, carefully watching out for inflationary pressures, the housing boom would have been much milder. Yet this summer's turmoil has dropped asset-price worries on to central bankers' desks with a thud. What should they do about them?

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