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Federal Reserve Bank of Cleveland

# Too Much Risk?

**by Joseph G. Haubrich and Ben Craig**

*Some participants believed that the prolonged period of policy accommodation had generated a significant degree of liquidity that might be contributing to signs of potentially excessive risk-taking in financial markets.*

—FOMC Minutes, December 14, 2004

Despite low inflation, there remains a concern with rapidly rising prices—of assets, not goods and services. Though many people are happy to see their portfolios grow and their houses appreciate, others worry that this signals the start of a boom and bust cycle that presages another recession. In this *Commentary*, we examine those concerns and the evidence behind them, paying special attention to what effect, if any, asset booms and busts should have on monetary policy.

The policy question is clear in principle, even if the answer is not. Should the FOMC react to asset prices? The question really has two parts. Few people disagree that the FOMC can use asset prices as predictors of inflation, and to the extent that some asset prices (long-term Treasury bonds, Treasury Inflation-Protected Securities, CPI futures) help forecast inflation, it makes sense for the FOMC to use them. The second part of the question elicits more disagreement, however. Should the FOMC react to other asset prices that may signal excessive risk taking or the start of an unsustainable boom–bust cycle?

Proponents of using asset prices take to heart the proverb "a stitch in time saves nine." They argue that a small action early on can prevent the asset boom from getting out of control, avoiding (or at least reducing) a costly crash later. Opponents downplay the ability of policymakers to detect a boom and distinguish excess risk from a strong economy. They believe that standard monetary policy, focusing on the inflation rate and economic conditions, will accommodate asset price increases stemming from higher profits and increased productivity. In those cases where asset prices rise because of excessive risk taking or unwarranted speculation, they argue, asset prices will also show through to aggregate demand and be offset by standard monetary policy.

We will take a more detailed look at the arguments for and against giving asset prices a prominent role in monetary policy, but first it makes sense to look at evidence for and against excessive risk taking in the current financial environment.

**Are asset prices climbing too far too fast? Do they signal the approach of an unsustainable boom that the FOMC should step in and stop before it gathers speed? Bubbles are notoriously hard to spot beforehand, and even if we were better at it, no one is sure what the best monetary policy response would be.**

## ■ Evidence: Building the Case?

There's not too much controversy about the fact that the FOMC has provided a large amount of liquidity over the past several years; the drop in the target federal funds rates from 6.5 percent to 1 percent between 2001 and 2003 is generally taken as a good indication of the stance of policy. A trickier task, given the richness and depth of American financial markets, is picking out asset prices that (allegedly) signal excessive risk. We can delegate that task to the FOMC, though; its December 14 minutes record the asset prices that concern several committee members. They note:

*"…narrow credit spreads, a pickup in initial public offerings, an upturn in mergers and acquisition activity, and anecdotal reports that speculative demands were becoming apparent in the markets for single-family homes and condominiums."*

At first, it seems strange to worry about narrow credit spreads. They are usually a good thing—a small difference between the yield on risky corporate bonds and safe Treasury bonds should signal a low probability of default, less risk, less uncertainty about corporate profits, and a generally strong economy with a reduced chance of a recession. Some people, however, start to worry when these numbers look "unnaturally" low, too low for the risk actually out there. That's when low spreads might signal excessive speculation.

Certainly, a variety of credit spreads are low, abnormally or not. One commonly used risk spread, between the yields on Moody's Baa-rated Bond Index and 10-year Treasury notes, stands at 102 basis points (1.82 percent). Granted, this is down from 379 basis points in October 2002 and well below the average (since 1982) of 205 basis points.

A shorter-term credit spread, the spread between 90-day commercial paper and three-month T-bills, now (April 2004) stands at only 21 basis points. This falls short of the average over the past several decades, 32 basis points. Short-term spreads have been lower, of course, even going negative in the early 1980s, but the persistently low spreads since early 2001 certainly stand out.

Do these spreads count as excessively low? Perhaps not; there are reasons to believe that the underlying credit risks are also at low levels. For example, the default rate on the riskiest, speculative-grade bonds in the U.S. has dropped dramatically over the past several years. The default rate dropped to 2.7 percent in

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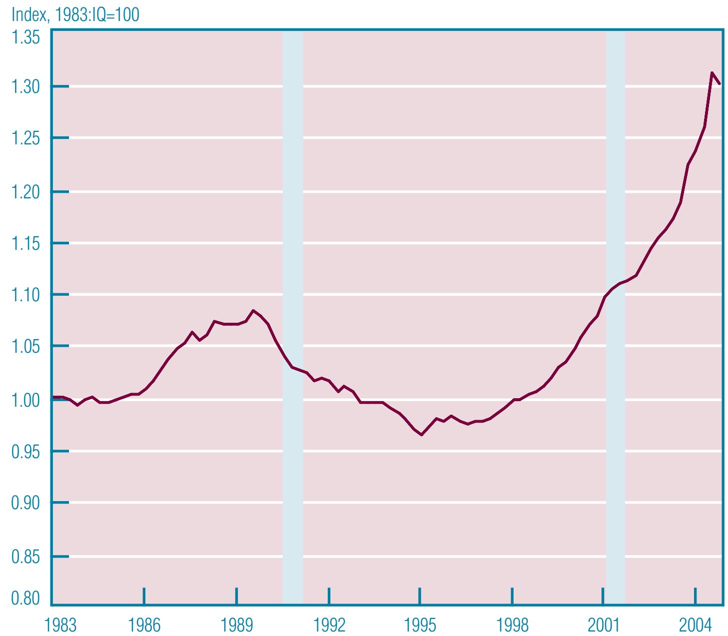
**FIGURE 1 OFHEO HOUSE-PRICE-TO-RENT INDEX**




NOTES: The Office of Federal Housing Enterprise Oversight Index is not adjusted for changes to physical characteristics of homes. The shaded bars represent recessions.

SOURCE: The Office of Federal Housing Enterprise Oversight.

December 2004, down from 5.4 percent in January 2004 and well below the recent peak of 11.6 percent in January 2002. Defaults are only one part of the loss equation. The other is recoveries, or how much creditors get back in case of default—what they get when the assets of the firm are sold off. Recoveries have been increasing lately; they came in at 42 percent for 2003, up from 34 percent in 2001, further indicating that the risks associated with the reduced spread are lower now.

The pick-up in IPOs (initial public offerings) also would usually be greeted as good news. An increase in new, innovative firms that have become successful enough to issue public equity surely is a sign of a healthy, growing economy. An excessive number of IPOs, though, may signal overvalued stocks and investors who have surrendered their natural skepticism. The IPO market of 2004 was hardly frothy, however. True, IPOs nearly tripled from their 2003 level, surging to 188 from a mere 67, but that was well off 2000’s pace of 397 and far from 1986’s record pace of nearly a thousand (953). Once again, the evidence does not seem to point to excessive risk taking.

The upturn in mergers and acquisition (M&A) activity has a similar paradoxical aspect. Normally a growing economy should see more M&As, and as firms restructure, finding the most efficient scale and scope for their industry, mergers unlock firm value for shareholders. But some see the activity as firms exploiting their overpriced stocks to acquire assets while they can. It is the case that merger activity is high, although 2004 saw few really big deals, so the dollar value of mergers and acquisition was not particularly large: The $464 billion for 2004 exceeded the $319 for 2003 but fell well below the trillion-dollar years of the late 1990s. Furthermore, the percentage of M&As financed with stock has fallen and that financed by cash has risen, perhaps indicating that firms aren’t cashing in on overvalued stock—though one might question why they have so much cash on hand!

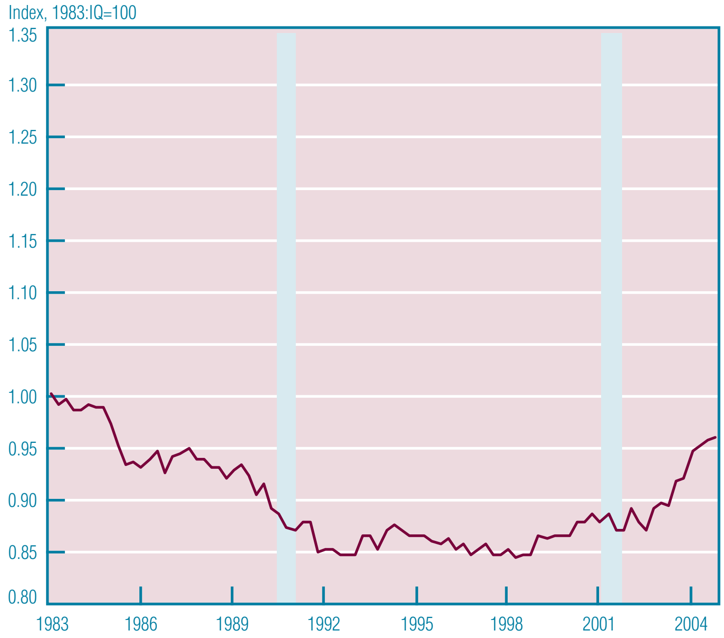
The last asset mentioned in the minutes, and the one most often mentioned in connection with unsustainable booms or bubbles, is housing prices. It is not simply that housing prices are rising; with real incomes up, it’s not surprising that higher demand leads to increased prices, particularly in areas without a lot of room to expand, such as Manhattan or San Francisco. But the fear is that house prices are rising at an unjustifiable rate. If it was just the economic recovery increasing demand, rents in those areas would be increasing as well. Instead, in the U.S. the ratio of house prices to rents has increased by nearly 30 percent in the past five years, rising particularly fast since the end of the 2001 recession (see figure 1). This price-to-rent ratio is a bit like a P/E or price-to-earnings ratio for stocks and can serve to signal when the price is too high and the asset is overvalued. After all, if prices rise because demand is high, rents should also rise, which is less likely if people buy houses for the price appreciation and not the space. Some of the price increase can be attributed to low interest rates, but that only raises fears that prices will fall as interest rates rise.

There is good reason to suspect that this increase in the price-to-rent ratio is exaggerated, however. The home-price index usually used is put out by the Office of Federal Housing Enterprise Oversight (OFHEO) and measures repeat sales of homes. This has an advantage: By tracking repeat sales, it avoids problems of mixing the prices of new homes (which tend to be higher) with those of older homes. This means, however, that it is far from a “constant quality” home-price index because it ignores renovations, add-ons, and other improvements to the property. The rental index, on the other hand, is a “constant quality” index, and so part of the increase arises because the housing-price index rises as homes improve while the rent component stays constant; this imparts an upward bias to the ratio.

Is this bias important? One way to get a handle on the question is to look at another home price index, this one produced by the Census Bureau. The Census people produce a constant-quality index of new home prices; although its exact usefulness is subject to some debate, it delivers a very different price-to-rent ratio (see figure 2).

Using the Census number, the price-to-rent ratio is lower than it was in 1983. Instead of the 19 percent increase since (March) 2001 using OFHEO data, it shows only a 7 percent increase. This apples-to-apples comparison suggests that much of the increase in home prices comes from higher quality, not speculative excess.

**FIGURE 2 CENSUS BUREAU CONSTANT-QUALITY INDEX OF NEW HOME PRICES TO RENTS**




NOTES: The constant-quality index accounts for the physical and locational characteristics of homes. The shaded bars represent recessions.

SOURCE: U.S. Department of Commerce, Bureau of the Census.

## What's the Policy?

So a closer look at the numbers makes it seem less likely that we're at the start of an asset price boom–bust cycle. Still, outcomes are rarely certain in forecasting, so no discussion would be complete without considering the appropriate monetary policy for booms and busts. As mentioned in the introduction, the discussion revolves around whether—and how much—monetary policy should react to asset prices. Proponents of reacting hope to tame the boom and avoid the bust. Opponents tend to downplay the benefits and emphasize the costs.

The argument takes place on several levels. At the basic level is the question of whether we can recognize an asset boom when it starts and distinguish booms that policy should respond to from those that it should not. Most analysts agree that restraining a speculative bubble is a good idea, but it's not easy to differentiate a bubble from strong fundamentals. Three hundred and fifty years after the famous tulipmania episode in Holland, economists still debate whether that event was a bubble. (Admittedly, this may tell you more about economists than tulips.) At a somewhat higher level is the question of whether it's possible to pick up the pieces after the crash. The major concern is that the asset price crash could bring the rest of the economy down with it. The canonical examples are the stock boom of the 1920s, leading to the Wall Street Crash and Great Depression, and the Japan bubble of the 1980s.

In both these cases, however, monetary policy did little to help the situation. In discussing the Depression, Milton Friedman and Anna J. Schwartz, in their magisterial *A Monetary History of the United States, 1867–1960* ask, "Why Was Monetary Policy So Inept?" On Japan, Roger Ferguson, vice-chairman of the Federal Reserve's Board of Governors remarks that "Despite steps toward an expansionary policy, the monetary easing of the early 1990s was insufficient to mitigate the underlying weakness…" Indeed, Ferguson (among others) argues that the United States faced a much less severe recession after the 2001 stock market crash, in part because of the quick reaction of monetary policy. Coupled with a strong banking and financial sector (which were missing both in the 1930s United States and in Japan), the asset price bust had less-than-catastrophic effects, even assuming it was a cause of the recession.

The two sides also disagree about the costs of trying to restrain asset price booms. It's a bit like buying insurance—sure, it would be nice, but after you calculate the premium and the deductible, is it still worth it? Here the discussion is a bit more subjective, as participants weigh the costs of slowing the current economy against the benefits of softening a future crash. Any decision must not only balance the chances of correctly distinguishing a speculative boom from strong fundamentals, but also gauge the policy's effect on output and employment.

Making monetary policy, it seems, doesn't leave much time to rest on one's laurels: Get goods inflation under control and there are calls to halt asset price inflation. How to do so looks like a trickier problem, with scant evidence of speculative bubbles and controversy about what to do even if you found one. It is safe to say that no consensus has emerged, though more economists probably favor the "benign neglect" approach.

## Recommended Reading

*On the housing bubble or lack thereof:*


"Are Home Prices the Next 'Bubble'?" Jonathan McCarthy and Richard W. Peach, Federal Reserve Bank of New York *Economic Policy Review*, December 2004, pp. 1–17.


*On whether monetary policy should respond to asset prices:*


"Should Central Banks Respond to Movements in Asset Prices?" 2001. Ben S. Bernanke and Mark Gertler, *American Economic Review*, Papers and Proceedings, pp. 253–57.

"Is 'Benign Neglect' the Right Response to Asset Price Booms?: Interview with Bordo and Jeanne," *International Monetary Fund Survey*, 2003 (March 31), pp. 86–88.


*The quotations on monetary policy are from*


*A Monetary History of the United States, 1867–1960.* Milton Friedman and Anna J. Schwartz, NBER, Princeton, N.J.: Princeton University Press, 1963, p. 407.

"Recessions and Recoveries Associated with Asset-Price Movements: What Do We Know?" Roger W. Ferguson, Jr., speech at the Stanford Institute for Economic Policy Research, Stanford, Calif., January 12, 2005.

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