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Can the Fed Identify Bubbles Before They Happen?

By Donald L. Luskin

President Barack Obama proposed last month that the Fed act as an overall "systemic risk" regulator, with consolidated supervisory responsibility over "large, interconnected firms whose failure could threaten the stability of the system." Now William C. Dudley, the ex-Goldman Sachs economist just appointed president of the New York Federal Reserve, has upped the ante. He thinks the Fed should be responsible for identifying and preventing asset-price bubbles. Considering that the Fed's track record reveals more skill at causing bubbles than preventing them, this is a very dangerous idea.

In a speech in late June in Switzerland, Mr. Dudley said, "I think that this crisis has demonstrated that the cost of waiting to clean up asset bubbles after they burst can be very high. That suggests we should explore how to respond earlier." Mr. Dudley claims that "Asset bubbles may not be that hard to identify—especially large ones" and suggests "additional policy instruments"—that is, new regulatory powers for the Fed to "more directly influence risk premia." Because risk premia are a key element in determining asset prices, Mr. Dudley is effectively asking for the power to control asset prices.

Fed Chairman Ben Bernanke and former Chairman Alan Greenspan both disagree. Mr. Greenspan once said that he doubted "that bubbles, even if identified early, could be pre-empted short of the central bank inducing a substantial contraction in economic activity—the very outcome we would be seeking to avoid." According to Mr. Bernanke, even if the Fed "could identify bubbles, monetary policy is far too blunt a tool for effective use against them." For these experienced central bankers, policy is a matter of risk-management under uncertainty; they don't imagine that they are wise enough to detect every problem and solve it.

Mr. Dudley seems surer of himself. He notes confidently, by way of example, that "the housing bubble in the United States had been identified by many by 2005." Well, that's true. But it is only true in retrospect. It offers no justification for a leap toward government control of asset prices.

If the housing bubble hadn't burst, the "many" who identified it in 2005 would have been wrong. The reality is that at all times in markets there are multiple opinions. There can be no assurance that those who hold the correct ones about what is or is not a bubble will end up at the Fed, where they can make prescient policy decisions.

Consider Mr. Dudley himself. In a 2006 speech at a conference of the National Bureau of Economic Research, when he was still with Goldman Sachs, Mr. Dudley listed "five bubbles that one could reasonably have identified in real time." He said that he'd "tried to speculate against three of the five bubbles" but confessed his speculations met only "with limited success."

Second, Mr. Dudley's claim that the housing bubble had been identified in 2005 is a red herring, because by then the bubble was already well advanced (the peak in home prices came in May 2006). To do any good, the Fed would have to identify bubbles before they even happen.

But by 2005, Alan Greenspan had already begun gradually raising interest rates a year earlier, referring to "signs of froth in some local markets." Mr. Dudley is asking for new regulatory powers based on faulting the Fed for not having or acting on insights that it, in fact, did have and did act on. He has not adduced an example of a bubble that could have been identified and prevented before it happened.

More broadly, there's little reason to expect the Fed can deal effectively even with a bubble identified well before the fact, or that it might not do more harm than good trying. While John Maynard Keynes and Milton Friedman didn't agree on much, they did agree that the Great Depression was caused less by the stock market crash of 1929 than by the Fed's tight-money policies aimed at curbing stock speculation (which those policies failed to do).

It seems unproductive, as we try to extract lessons from the present recession, to go back to the regulatory policies that caused the Great Depression—and to put them on steroids with "additional policy instruments."

In the end all these concerns, however urgent, are merely pragmatic. The overarching philosophical concern is whether we ought to empower the Federal Reserve to determine asset prices. If so, then on what basis?

In the case of oil, many argue that its price is too high because of speculation. Yet many also say it's too low, because markets aren't pricing the negative externalities of carbon emissions.

Which bubble should the Fed prevent—with arbitrary leverage restrictions, position limits, transaction taxes, and who knows what else—the speculation bubble or the carbon bubble?

And if we don't want the Fed controlling asset prices, then how do we tell the central bank where to stop once we've given it a new mandate (on top of the many it already has) to prevent asset bubbles? If the Fed is to determine the price of the overall housing market, or stock market, or oil market, how is that different in principle from having it determine the price of every individual item at Wal-Mart, or the salary of every individual who works there?

This brings us back to politics. The issues involved with bubbles are of more than merely philosophical concern.

Mr. Bernanke's term as Fed chairman expires in January. Based on his track record, he's likely a shoo-in for reappointment. But in politics, the winner is often the candidate who makes the biggest promises. So perhaps we'll be hearing more about preventing bubbles from Mr. Dudley.

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