AllianceBernstein

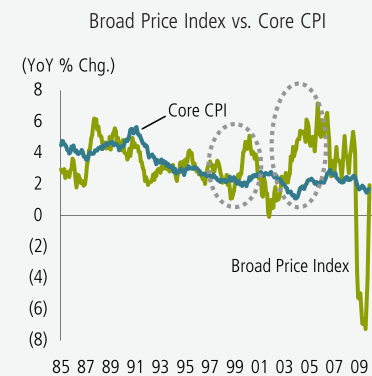
ECONOMICS: US PERSPECTIVES—DEC 11, 2009

Policymakers Need Broader Framework to Evaluate Prices and Prevent Bubbles

Joseph G. Carson
US Economist and Director—Global Economic Research, (212) 969 6886

More than a decade after Alan Greenspan asked whether asset prices should be watched more closely, the Fed still has no coherent answer to this crucial question. After two asset bubbles burst in a decade, we believe the time has come to adopt an index that extends beyond consumer prices in order to detect inflationary imbalances before they become dangerous.

Display 1
Braod Price Index Would Help Identify All Types of Inflation



Source: Bureau of Labor Statistics, Haver Analytics and AllianceBernstein

Monetary policy has reached a crossroads. In the past, monetary policymakers focused almost exclusively on consumer price inflation in setting interest rates. But after two asset price recessions in a decade, there is a growing debate over whether real and financial asset prices should play a bigger role in policy deliberations.

Historically, asset price inflation was only considered by monetary policymakers as a signal of stronger growth and more general inflation down the road. However, two important lessons have been learned over the past decade: first, inflation in asset prices can occur without significant increases in traditional CPI measures **(Display 1)**. Second, excessive inflation in asset prices can be extremely destabilizing to the real economy.

Federal Reserve Vice Chairman Donald L. Kohn put this issue high on the public agenda in a November 16 speech. "When the monetary authorities judge that important asset prices or rates of credit expansion are deviating from sustainable long-run trends," he said, "should they adjust their policy setting to damp those price and credit movements—beyond whatever actions might be called for to preserve macroeconomic stability over the usual two- to three-year planning horizon for monetary policy?"

No Answers to an Old Question

In fact, the question isn't really new at all. It was raised by Kohn's former boss, former Federal Reserve Chairman Alan Greenspan, when he coined the famous phrase "irrational exuberance" in a 1996 speech. Greenspan said at the time: "Where do we draw the line on what prices matter? Certainly prices of goods and services now being produced—our basic measure of inflation—matter. But what about futures prices or more importantly prices of claims on future goods and services, like equities, real estate and other earning assets? Are stability of these prices essential to the stability of the economy?"

Thirteen years after Greenspan asked this question, the Fed doesn't appear to have a clear answer. In last month's speech, Kohn responded to his rhetorical question by saying that he did not know enough to determine whether responding to rapid asset prices swings would outweigh the costs to the economy.

In our view, the events of the past decade provide unambiguous evidence that policymakers must respond to all types of inflation. We believe there is nothing unique about asset markets to imply that fast increases in prices of assets such as equities or real estate, which are tied to relatively low interest rates and fast credit growth, can extend indefinitely without creating costly imbalances.

On the contrary, the clear lesson of the recent downturn is that rapid asset price increases associated with an excessive buildup of private debt to finance asset purchases often has adverse macroeconomic consequences. The result may be just as bad—and possibly worse—than the recessions of the mid-1970s and early 1980s, which were driven by high traditional or consumer price inflation.

How should policymakers incorporate a view on asset prices into monetary policy decision making? It's important to clarify that we do not think it is the Fed's job to try and estimate the correct or fair value for asset prices. Monetary policymakers are not responsible for targeting any specific price in the economy for assets, commodities or specific goods or services. Instead, they should focus on broad price trends and allow the appropriate price level for specific items to be set by the free market.

Detecting Imbalances and Bubbles

However, policymakers should attempt to identify imbalances in prices and asset bubbles. We believe this mission would be significantly aided by the creation of a broad price index as a new policy tool. Such an index would include prices of currently produced goods and services (both consumer and producer prices) as well as real and financial asset prices.

Policymakers would be able to use this index to help distinguish between relative and absolute price movements, while also linking broad price increases to money and credit expansion. Imbalances would be detected through large, persistent increases in the broad price index which are not attributable to any temporary or special factors and exhibit changes well above the historical average. Only cases like these would warrant a tighter monetary policy.

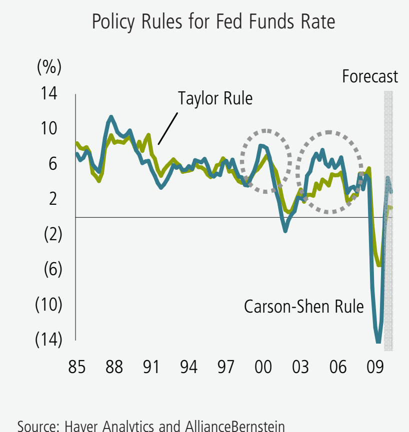
Building a Broad Price Index

How would this work in practice? As an example, we charted the widely referenced Taylor rule, a guidepost for the official level of interest rates based on the standard consumer price measure, alongside the Carson-Shen rule, an alternative measure of official rates that we have constructed based on our proprietary broad price index **(Display 2)**.

In the past two decades there have been two periods in which reliance on the historical links between monetary policy and standard price measures was misleading. In each instance—the late 1990s and between 2004 and 2007—the result was that official rates were set too low in relation to the trends in the real estate and financial asset markets. Our research suggests that official rates should have been set 100 to 150 basis points higher during these periods in order to damp the excessive price increases in the asset markets.

Display 2

Higher Policy Rates Would Be Required During Fast Asset Price Cycles



Source: Haver Analytics and AllianceBernstein

Of course, the problem is deeper and much more complex than simply identifying the most appropriate price measure. But it's clear that the analytical framework used to assess the appropriate monetary policy stance was too narrow and inflexible to evaluate developments in key asset markets properly and quickly. Even with a broad price index, policymakers will always need to carefully consider how to use their formidable regulatory and supervisory powers to deal with various types of potentially destabilizing price inflation. Without a broad price index, however, they will almost certainly fail to prevent the next price bubble from developing, and bursting, with catastrophic effects on markets and the economy.

Dennis Shen, an AllianceBernstein research associate, contributed to the construction of the new policy rule and to this report.

This document reflects the views of AllianceBernstein and sources believed by AllianceBernstein L.P. to be reliable as of the dates cited. No representation or warranty is made concerning the accuracy of cited data. Nor is there any guarantee that any projection, forecast or opinion will be realized. The views expressed may change at any time. References to stocks, securities or investments should not be considered recommendations to buy or sell. The value of investments, and the income from them, can fall as well as rise and you may not get back the original amount invested. Past performance is not a guide to future performance. The value of overseas securities will be subject to exchange-rate fluctuations. Under no circumstances should this information be construed as investment advice. Nor should it be construed as sales or marketing material for any financial instrument, product or service sponsored or provided by AllianceBernstein or its affiliates or agents.

Note to Canadian Readers:
AllianceBernstein provides its investment management services in Canada through its affiliates, Sanford C. Bernstein & Co., LLC, and AllianceBernstein Canada, Inc.

Note to UK Readers:
UK readers should note that this document has been issued by AllianceBernstein Limited, which is authorised and regulated in the UK by the Financial Services Authority. The registered office of the firm is: Devonshire House, One Mayfair Place, London W1J 8AJ.

Note to Taiwan Readers:
This information is provided by AllianceBernstein funds Taiwan Master Agent, AllianceBernstein Taiwan Limited. SFB operating license No.: (97) FSC SICE no. 049. Address: 57F-1, 7 Xin Yi Road, Sec. 5, Taipei 110, Taiwan R.O.C. Telephone: 02-8758-3888. AllianceBernstein Taiwan Limited is a separate entity and an independently operated business.

Note to Singapore Readers:
This document has been issued by AllianceBernstein (Singapore) Ltd. (Company Registration No. 199703364C.) The Company is a holder of a Capital Markets Services Licence issued by the Monetary Authority of Singapore to conduct regulated activity in fund management.

Note to Hong Kong Readers:
This contributor is not licensed by the Hong Kong SFC and does not intend to provide investment advice in Hong Kong. For Financial Representatives General Information only and shall not be regarded as provision of investment advice.