

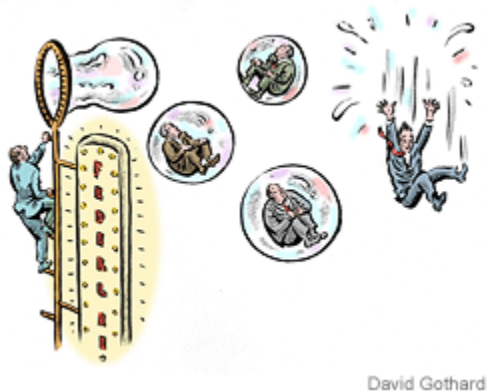
August 10, 2007

COMMENTARY

Our Subprime Fed

 By **GERALD P. O'DRISCOLL, JR.**
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In recent years, monetary policy has created an expectation that the Federal Reserve will bail out investors when asset bubbles deflate. The recent crisis in the subprime mortgage market is at least partly the outcome of this new approach to monetary policy. That crisis has already had widespread ramifications for homeowners and investors.



David Gothard

In February 2007, the popular press discovered subprime mortgage loans when two major originators of such loans, HSBC Holdings PLC and New Century Financial, disclosed increased loan loss provisions. HSBC is a globally diversified financial company. While it was a large lender in the


market, the aggregate amount of its subprime loans was not a significant portion of its total portfolio.

New Century Financial fared much less well because of the concentration of its lending in this risky category. Its stock price collapsed after problems surfaced on Feb. 8, 2007 and the company eventually declared bankruptcy.

Other lenders in the subprime market experienced difficulties. Fears of a housing collapse and even an economic recession grew as investors gauged the size and extent of the problem in the mortgage market.

The crisis was foreseen -- for more than a year before the bust, bankers, analysts, and even regulators knew they had a mess in the making. And once the mess became clear, it wasn't hard to see what was wrong. Lending practices in the subprime market were "shoddy and absurd," said John Makin of the American Enterprise Institute in March of this year. Lewis Ranieri, former chairman of Salomon Brothers, echoed those comments in this newspaper when he observed: "We're not really sure what the guy's income is and . . . we're not sure what the house is worth. So

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you can understand why some of us become a little nervous." Mr. Ranieri helped pioneer the bundling of mortgages into marketable securities ("securitization"), so he should know!

The collapse of the subprime mortgage market is the latest in a series of financial bubbles whose existence reflects, at least in part, moral hazard in financial markets. At one time, deposit insurance was a major culprit. For example, in an October 2002 speech to economists in New York, then Fed Governor Ben Bernanke described the savings and loans crisis of the 1980s as "a situation . . . in which institutions can directly or indirectly take speculative positions using funds protected by the deposit insurance safety net -- the classic 'heads I win, tails you lose' situation." After an intellectual and political battle of more than a decade, the deposit insurance loophole was sealed.

Today, monetary policy is fostering moral hazard. Monetary policy can generate moral hazard if it is conducted so as to bail investors out of risky and otherwise ill-advised financial commitments. If investors come to expect that the policy will persist, then they will deliberately take on additional risk without demanding commensurately higher returns. In effect, they will lend at the risk-free interest rate on risky projects, or at least at a lower rate than would otherwise be the case. Too much risky lending and investment will take place, and capital will be misallocated.

The new moral hazard in financial markets has its source in what can be best described as the Greenspan Doctrine. The doctrine was clearly enunciated by Alan Greenspan in his December 19, 2002 speech. Mr. Greenspan argued that asset bubbles cannot be detected and monetary policy ought not to in any case be used to offset them. The collapse of bubbles can be detected, however, and monetary policy ought to be used to offset the fallout.

Two months earlier, Mr. Bernanke endorsed the Greenspan Doctrine, arguing against the use of monetary policy to prevent asset bubbles: "First, the Fed cannot reliably identify bubbles in asset prices. Second, even if it could identify bubbles, monetary policy is far too blunt a tool for effective use against them." Since Mr. Bernanke is now Fed chairman, it is reasonable for market participants to assume that the Greenspan Doctrine still governs current Fed policy.

The two men were surely asking and answering the wrong question. They were implicitly treating bubbles as solely the consequences of real shocks or disturbances. (An example of a real shock is a technological innovation leading to productivity gains and higher future expected profits in a sector.) They asked whether monetary policy should be used to offset the effects of real shocks, and concluded that it should not. The latter is the correct answer to the question they each posed.

A different question would be to ask whether monetary policy should be conducted so as to create or exacerbate asset bubbles. The answer to that question is surely "no." Consider Mr. Bernanke's apt characterization of moral hazard in the context of the deposit insurance crisis: "When this moral hazard is present, credit flows rapidly into inelastically supplied assets, such as real estate. Rapid appreciation is the result, until the inevitable albeit belated regulatory crackdown stops the flow of credit and leads to an asset-price crash."

He could have been talking about the subprime mortgage market. The Fed pre-announced that it will take no action against bubbles, but will act aggressively to offset the consequences of their collapse. In effect, the central bank is promising at least a partial bailout of bad investments. The logic of the old deposit insurance system is at work: Policymakers should protect investors against losses, no matter their folly. Or, in Mr. Greenspan's own words: Monetary policy should "mitigate the fallout [of an asset bubble] when it occurs and, hopefully, ease the transition to the next

expansion."

In the present context, the "next expansion" could also be rendered as "the next asset bubble." If the Fed *promises* to "mitigate the fallout" from "irrational exuberance," then it is rational for investors to be exuberant. Investors may be at risk for some loss, as with a deductible on a conventional insurance policy, but losses are still being mitigated.

The Bernanke Fed has confused matters for investors by not yet cutting interest rates in the face of the recent crisis. There are two possible (not mutually exclusive) reasons for its not doing so. First, it may not view the current crisis as serious enough. Second, current price inflation is above its comfort zone, and the Fed may feel it has no room to maneuver. Time will only tell which is at work.

The Fed cut the Fed Funds rate sharply after the bursting of the stock market bubble in March 2000. In the eyes of many, the Fed cut rates too far and held them down too long, fueling not only a vigorous economic expansion but also the housing bubble. In his December 2002 speech, Mr. Greenspan was at pains to deflect any argument that the Fed was inflating a housing bubble. "To be sure," he acknowledged, mortgage debt was high relative to household income (remember the date) by historical norms. But "*low interest rates*" were keeping the servicing requirements of the mortgage debt manageable (emphasis added). "Moreover, owing to continued large gains in residential real estate values, equity in homes has continued to rise despite very large debt-financed extractions."

How wrong the Fed chairman was! If Mr. Greenspan was not worried about interest rates resetting, however, why should mortgage bankers and homeowners worry? It would have been reasonable to read into the chairman's musings an implicit guarantee of continued low rates. A homeowner is certainly entitled to bet his home on the come if he wants. Should the central bank encourage such behavior, however?

A monetary policy of substantial stimulus will have a number of real consequences, including asset bubbles. These asset bubbles have real costs and involve misallocations of capital. For example, by the peak of the tech and telecom boom in March 2000, too much capital had been invested in high-tech companies and too little in "old economy firms." Too much fiber-optic cable was laid and too few miles of railroad track were laid.

By 2002, worried about the possibility of price deflation, the Fed introduced a strong anti-deflationary bias. A tilt to stimulus was understandable at the time. A continued bias against deflation at any cost, however, will produce a continued bias upward in price inflation. With the bursting of each asset bubble and the fear of deflationary pressure, Fed policy must ease. The Greenspan Doctrine prescribes a stimulative overkill that begins the cycle anew. The Greenspan-era gains against inflation will then prove to be only temporary. His doctrine will be the death of his legacy, a legacy that already includes a housing bubble and its aftermath.

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