Fed urged to control future asset bubbles

By Krishna Guha in Washington
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The Federal Reserve should use regulatory powers aggressively and pro-actively to limit the threat from future asset price bubbles, Frederic Mishkin, one of the Fed's governors, said yesterday.

Mr Mishkin, a top academic economist who is intellectually close to Fed chairman Ben Bernanke, said "it falls to regulatory policies and supervisory policies to help strengthen the financial system and reduce its vulnerability to both booms and busts in asset prices".

Such policies "could be made a standard part of the regulatory system and would be operational at all times". But he also proposed using regulations dynamically to deal with bubbles as they emerge.

"Future bubbles will almost certainly create unanticipated difficulties, and as a result, adjustments to our policy stance to limit the market failure contributing to the bubble could be very beneficial if identified and implemented at the appropriate time," he said.

His comments in a speech come as the US central bank is reconsidering its traditionally hands-off approach to asset bubbles after two bubbles - housing and the earlier dotcom bubble - in the space of a decade.

Mr Bernanke is re-evaluating all the evidence, including the use of interest rates to tackle bubbles, but is inclined to favour using regulation more aggressively as Mr Mishkin proposed yesterday.

Mr Mishkin argued in general against putting the burden of fighting bubbles on monetary policy, which he said was "already challenged by the task of managing both price stability and maximum sustainable employment".

However, he did not explicitly rule out the notion that a central bank might "lean against the wind" with interest rates in some circumstances to reduce the risk that a bubble could swell then burst, pushing inflation too low at some point beyond the normal two or three year forecast horizon.

Mr Mishkin said the policy response to bubbles should recognise that "not all asset bubbles are alike". Those linked to credit booms present particular challenges, he said, "because their bursting can lead to episodes of financial instability that have damaging effects on the economy". Fortunately, he argued, these bubbles may also be easier to identify.

Mr Mishkin said the approach to regulation should "favour policies that will help prevent future feedback loops between asset bubbles and credit supply." He said the central bank and other authorities should design regulations "with an eye towards fixing market failures" of the kind that fuelled subprime mortgage lending in the US in the early 2000s. He said it may also be necessary to adopt counter-cyclical capital requirements - which would force banks to hold more capital in good times than in bad - to avoid a situation in which booming asset values spur additional lending, while the eventual bust results in a credit squeeze.

Mr Mishkin also said that regulators may need to go beyond traditional assessments of the soundness of individual financial institutions, and think more broadly about "the resilience of both individual institutions and the financial system as a whole" in the face of potential shocks.

The Treasury proposes giving the Fed additional powers to do this, which experts term "macro-prudential" rather than "microprudential" because they look at the risks to the system not just individual firms.

Bernanke calls on US banks to press ahead with capital-raising efforts

Ben Bernanke, chairman of the Federal Reserve, yesterday urged US banks to continue raising capital, saying this could pave the way for an improvement in economic conditions.

At a conference organised by the Chicago Fed, Mr Bernanke said he had been "encouraged by the recently demonstrated ability of many financial institutions, large and small, to raise capital from diverse sources".

But he said banks should remain "pro-active" in their efforts. "Capital-raising and balance sheet repair allow for the extension of new credit, which supports economic expansion," the Fed chairman said.

Some of the largest US commercial and investment banks have been forced to raise capital from sovereign wealth funds and other investors over the past nine months in order to offset the billions of dollars in writedowns caused by the decline in value of the banks' mortgage assets. These capital infusions have been encouraged both by the Fed and the US Treasury.

Mr Bernanke's speech highlights the continued concern among policymakers regarding the health of financial services groups, in spite of the recent, more stable, conditions in the credit markets.

This week Mr Bernanke said he welcomed "some improvement in financing markets" but warned that "conditions in financial markets are still far from normal".

He said the Fed stood ready to increase its credit auctions beyond the current level of $150bn (€97bn, £76.5bn) a month, if required, to combat stress in the money markets.

In his remarks yesterday, Mr Bernanke traced the origins of the crisis to problems that "occurred at each step of the credit extension chain", starting with subprime mortgages.

He added: "The turmoil in the credit markets underscores some important principles for bank risk management, including the value of proper risk identification and measurement, the need for robust and objective valuation methods, the importance of preparing for liquidity disruptions and the critical role of strong oversight by senior managers."

Asked about the risk to banks from their exposure to troubled bond insurers, Mr Bernanke said the exposure was "moderate and manageable relative to the capital of these banks".

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