ECONOMICS: US PERSPECTIVES

IRRATIONAL EXUBERANCE 20 YEARS LATER

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In 1996, Federal Reserve Chairman Alan Greenspan raised an important question concerning asset prices: was the stability of these prices essential to the performance of the economy and the conduct of monetary policy? Nearly 20 years later, no one has yet answered that question or even determined how to define stability in asset prices. Yet the changing framework of business cycles—with rapid and volatile asset inflation and stable consumer prices—requires an answer and policy choices.

Irrational Exuberance

On December 5, 1996, Greenspan delivered a speech at the American Enterprise Institute for Public Policy Research titled "The Challenge of Central Banking in a Democratic Society." The speech is noteworthy for having raised the issue of "irrational exuberance in financial markets." Greenspan said one of the challenges that the central bank will face in the 21st century is "the notion of what constitutes a stable general price level."

He argued that when the economy was basically a goods economy (largely tied to industrial production), the traditional price measures captured underlying price patterns—with minimal measurement problems. But as the economy grew more complex—adding a variety of services and introducing new devices—price measurement became more ambiguous and less precise.

Present and Future Goods and Services

In that speech, Greenspan also raised two key issues on inflation that have largely been ignored or overlooked for the past 20 years. First, he argued that we need to develop new techniques of price measurement, because inflation can and will destabilize an economy even if the "faulty price indexes fail to reveal it." Second, he questioned, "where do we draw the line on what prices matter?" He admitted that the prices of currently produced goods and services will always matter, but he then raised the issue that prices of claims on future goods and services—like equities, real estate and other earnings-generating assets—could also matter for the general stability and performance of the economy.

In 1996, there was little evidence in the US that the negative feedback from an abrupt and sharp decline in asset markets would affect the general economy in a substantial manner. Greenspan noted that the 1987 stock crash had produced "few negative consequences for the economy," but nevertheless "we should not underestimate or become complacent about the complexity of the interactions of asset markets and the economy."

His warnings proved to be prescient as the US economy experienced two recessions shortly thereafter—in 2000 and again in 2008–09. Both economic corrections were triggered by a sharp and abrupt correction in asset prices.

Business Cycles and Price Patterns

Policymakers spent decades trying to achieve relative price stability in the traditional price measures…and for good reason. Large and volatile inflation cycles hurt household and business decision making, resulting in poor macroeconomic performance. Then, as policymakers used interest rates to tame or remove the excess price inflation, it invariably resulted in an economic recession.

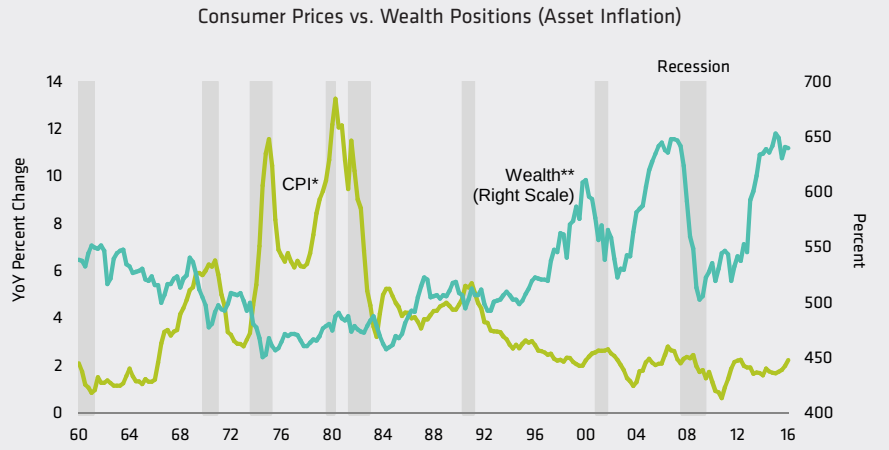
For many years, price stability was often defined as a rate of price change so low that it does not influence the economic and financial decision making of households and businesses. In recent years, policymakers have defined price stability as a rate of inflation in the traditional consumer price measures of roughly 2%. That doesn't mean a consistent rate each

and every month, but over the intermediate term (2–3 years), policymakers are targeting a general price increase rate around this mark.

Certainly, policymakers have struggled for decades to achieve general consumer price stability and spent years debating whether a numerical measurement was needed to convince the general public and the financial markets of their commitment to price stability. But during all that time, there has been no discussion (to our knowledge) on how to define stability in asset prices. Should stability in asset prices be linked in some formal way to general price trends? How should stability in house prices be measured: against the growth in income or rents? How about equity prices: should they be viewed in the context of current earnings (however defined) or future earnings?

Display 1

On Monetary Policy, Where Do We Draw the Line on Which Prices Matter?



* ex energy ** net worth as a percent of disposable income
Through March 31, 2016
Source: Haver Analytics, US Bureau of Labor Statistics and US Federal Reserve Board

Answers to these questions are not merely academic. Indeed, a fundamental shift in price patterns has occurred in business cycles (*Display 1*). Large and variable swings in consumer prices have been absent from business cycles over the past 25 years. What's emerged instead are large and variable swings in asset prices—both real and financial.

Thus, the challenges for central banks that Greenspan discussed 20 years ago are front and center today. In the Monetary Policy Report submitted by the Federal Reserve to Congress on June 21 (as part of the semiannual testimony of the Federal Reserve chair), the Fed staff stated, "Financial vulnerabilities in the United States remain at a moderate level." However, nowhere in the report does the Fed staff define what a moderate level is and what should be done to reduce the risk to a low level. Policymakers seem to be making the same mistakes as in the past. Namely, they're not recognizing the price imbalances that are forming in the economy and that those imbalances are directly related to the Fed's low rate policies. As Greenspan noted 20 years ago, just because inflation doesn't appear in a specific price gauge, that doesn't mean it's not real and that it can't eventually destabilize the economy. ■