Bernanke Must Raise Benchmark 2 Points in Latest Rajan Warning

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Raghuram Rajan accurately warned central bankers in 2005 of a potential financial crisis if banks lost confidence in each other. Now the International Monetary Fund's former chief economist says the Federal Reserve should consider raising rates, even as almost 10 percent of the U.S. workforce remains unemployed.

Interest rates near zero risk fanning asset bubbles or propping up inefficient companies, say Rajan and William White, former head of the Bank for International Settlements' monetary and economic department. After Europe's debt crisis recedes, Fed Chairman Ben S. Bernanke should start increasing his benchmark rate by as much as 2 percentage points so it's no longer negative in real terms, Rajan says.

"Low rates are not a free lunch, but people are acting as though they are," said White, 67, who retired in 2008 from the Basel, Switzerland-based BIS and now chairs the Economic Development and Review Committee at the Paris-based Organization for Economic Cooperation and Development. "There will be pressure on central banks to follow an expansionary monetary policy, and I worry that one can see the benefits, but what people inadequately appreciate are the downsides."

He and Rajan will have the chance to make their case at the Fed's annual symposium in Jackson Hole, Wyoming, this week. In 2003, White told attendees central banks might need to raise rates to combat asset-price bubbles. In 2005, Rajan, 47, said risks in the banking system had increased. They were met with skepticism from then-Fed Chairman Alan Greenspan, 84, and Governor Donald Kohn, 67.

Losing Confidence

While the Fed did boost its target rate for overnight loans among banks in quarter-point steps to 5.25 percent by 2006 from

1 percent in 2004, that didn't prevent a housing bubble, which began to pop in 2006. Banks began losing confidence in August of the same year and started charging other financial institutions higher interest on loans.

A minority of policy makers are increasingly echoing Rajan and White's current worries, including Kansas City Fed President Thomas Hoenig, who is hosting the Aug. 26-28 symposium, and Andrew Sentance, one of nine members on the Bank of England's monetary-policy committee.

Hoenig has dissented from all five Fed policy decisions this year, preferring to jettison a pledge to keep rates low for an "extended period." Sentance was defeated for a third month in August in his bid to withdraw emergency stimulus by increasing the benchmark interest rate.

Few Converts

The naysayers may fail to win many converts any time soon as the recovery slows and U.S. unemployment, at 9.5 percent in July, remains near a 26-year high. The resulting extension of low rates may increase volatility of government bonds, especially in response to any stronger-than-anticipated economic data, said Marc Fovinci, head of fixed income at Ferguson Wellman Capital Management Inc.

Indications that growth will be at least 3 percent "in the coming months" would cause yields on 10-year Treasuries, which were 2.61 percent on Aug. 20, to rise to 3 percent within about a week, said Fovinci, who is based in Portland, Oregon, and helps invest $2.5 billion.

JPMorgan Chase & Co. reduced its forecast last week for growth in this quarter to an annual rate of 1.5 percent from 2.5 percent and in the last three months of 2010 to 2 percent from 3 percent.

"I'm not worried about inflation, because the economy appears to be weak," Fovinci said. At the same time, the bond market seems to be "tightly coiled up like a spring."

Rising Yields

Between June 3 and June 8, 2009, yields on 10-year Treasuries rose to 3.88 percent from 3.54 percent after the smallest drop in U.S. payrolls in eight months and European Central Bank President Jean-Claude Trichet's forecast for economic growth in 2010. Two-year Treasury yields rose to 1.4 percent from 0.91 percent in the same period.

The margin for error is "incredibly thin," said Derrick Wulf, a portfolio manager at Dwight Asset Management Co. in Burlington, Vermont, which oversees $64.3 billion. "A lot of investors have become complacent about being long" in Treasuries.

Rajan, now a professor at the University of Chicago's Booth School of Business, says near-zero interest rates are a crisis tool and economists don't know if the benefits from using them for longer periods outweigh the costs. While inflation isn't the main threat now, "you can't be totally comfortable," he said in an Aug. 18 interview. People think "there is significant unused capacity in the economy" and that assumption may be mistaken.

'Bad Incentives'

Near-zero rates create "bad incentives" for financial firms, he added.

"Blow the system up, we'll come back and reward you with very low interest rates that allow you to build up capital, and then you could try it again next time around," Rajan said.

The Fed also may be "prolonging pain" by propping up the housing market and keeping home prices from falling, he said.

Companies are sending mixed signals.

"Demand is very low across the country" for houses, Richard Dugas, chief executive officer of Bloomfield Hills, Michigan-based Pulte Group Inc., said Aug. 20 on Bloomberg Television's "In the Loop with Betty Liu." Meanwhile, Caterpillar Inc., the world's largest maker of construction equipment, may add as many as 9,000 workers worldwide this year, Doug Oberhelman, chief executive officer of the Peoria, Illinois-based company, said Aug. 19.

Another Bubble

White, a Bank of Canada deputy governor from 1988 to 1994, says the benefits of low rates may already be waning "in a world with so much debt, especially household debt," which in the U.S. totaled a near-record $11.7 trillion at the end of June. There's also a danger they might create another bubble, he said.

Another risk is that near-zero rates allow companies to roll over nonviable loans, a practice known as "evergreening"
that can create so-called zombie businesses, which happened in Japan, he added.

Rajan and White's arguments aren't winning over Keith Hembre, chief economist at U.S. Bancorp's FAF Advisors Inc. in Minneapolis, where he helps oversee $86 billion.

"There's little evidence that the very low rates today are inflicting any harm," said Hembre, a former Fed researcher.
While he has "some longer-term sympathy with the argument,"
it's "just off-base today, given the evidence available from both real-time and market indicators."

Bernanke, 56, and the majority of Fed officials show little inclination to change course. The Fed lowered its benchmark rate to a range of zero to 0.25 percent in

December 2008 and said after each policy meeting since March 2009 it will likely stay very low for an "extended period."

Emergency Measures

The ECB has kept its main refinancing rate at 1 percent since May 2009, and the Bank of England's key rate has been 0.5 percent since March 2009. Axel Weber, an ECB council member, said in an Aug. 19 Bloomberg Television interview that policy makers should keep emergency liquidity measures in place at least through the end of the year, beyond Trichet's October guarantee. Bernanke and Trichet will speak at the Fed symposium Aug. 27.

White and Rajan have ruffled central-bank feathers before at Jackson Hole, where policy makers, academics, analysts and money managers from dozens of countries mix hiking and rafting in Grand Teton National Park with debate over monetary policy and bank regulation.

In 2003, White and then-colleague Claudio Borio, who was head of BIS research and policy analysis, told central bankers they might need to raise interest rates to "lean against" asset-price bubbles.

'Cannot Work'

"The one thing I am sure about is that a mild calibration of monetary policy to address asset-price bubbles does not and cannot work," Greenspan, who retired in 2006, responded at the conference.

Bernanke, then a Fed governor, told attendees that Japan raised rates in 1989 to prick a bubble, and as a result, "asset prices collapsed and they had a 14-year depression."

In 2005, Rajan warned that if banks lost confidence in each other, "the interbank market could freeze up, and one could well have a full-blown financial crisis."

Kohn disagreed in a speech after Rajan's presentation.

"As a consequence of greater diversification of risks and of sources of funds, problems in the financial sector are less likely to intensify shocks hitting the economy and financial market," he said.

More Open

Bernanke has since become more open to White's view. While low interest rates didn't cause the U.S. housing bubble, he said in a January speech, if the next wave of regulation proves "insufficient to prevent dangerous buildups of financial risks, we must remain open to using monetary policy as a supplementary tool for addressing those risks."

Kohn, the Fed's vice chairman from 2006 through June, said in a March speech that "serious deficiencies" with securitization of loans "exposed the banking system to risks that neither participants in financial markets nor regulators fully appreciated."

Spyros Andreopoulos, a London-based global economist at Morgan Stanley, says he worries about the inflationary implications of extreme monetary accommodation beyond the next two to three years, with policy makers likely to lean toward low rates because of the fear of deflation.

"Imagine a car that's stuck in the mud," he said. "When you press on the gas, the car doesn't emerge smoothly; it jumps up. My fear is when economies pick up after the stimulus, you'll see inflation faster than was expected."