Emerging signs of stronger economic activity and the Federal Open Market Committee (FOMC)’s second round of quantitative easing (QE2) have raised concern among some analysts that expansionary policy might be causing bubbles in financial and commodity markets—bubbles that might harm the economy if they burst. Prices for bonds, equities, and commodities have increased sharply since late August: The Reuters Jefferies/CRB weekly futures commodity price index increased by 22 percent (in U.S. dollars) through the week of November 9 (but fell sharply the following week), oil prices by 22 percent, the Economist food-price index by 20 percent, the Russell 2000 Index by 22 percent, and the broader S&P 500 Index by 15 percent. Given these increases, the concern over bubbles is reasonable, but it is difficult to distinguish beforehand the line between aggressive (“just right”) monetary policy and overly aggressive (“too hot”) monetary policy that generates bubbles.

Rapid increases in commodity and financial market prices by themselves, however, are not reliable indicators of potential bubbles because such increases also occur as part of normal monetary policy. How exactly does policy operate in normal times when the federal funds rate is well above zero? The path begins with a reduction in the target rate, in normal times when the federal funds rate is well above normal monetary policy. Whether bubbles have been generated remains to be seen.

Commodity price movements are more complex and involve several factors. One factor is the potential success of expansionary monetary policy: If economic activity expands, demand for commodities likely will increase, pushing futures prices upward, which, in turn, tends to increase current-period prices. Further, some analysts have suggested the expansion of hedge funds and similar investments over the past decade may have increased the speed and volatility of commodity price changes. A second factor is the decreased foreign exchange value of the dollar as a result of aggressive monetary policy. Because most commodities are freely traded in international markets, commodity prices in U.S. dollars tend to increase as the dollar’s value against other currencies falls. As James Hamilton discussed in his blog on November 10, 2010, recent data show that changes in the U.S. dollar price of oil closely approximate changes in the dollar’s exchange value against our trading partners.

As long as the FOMC’s pursuit of highly expansionary policy continues, households and businesses remain pessimistic, and demand is sluggish, the potential exists for asset prices to deviate from their long-run levels by large amounts and for long periods. Such increases per se are not bubbles but a commonplace reaction of the monetary transmission mechanism. Yet, monitoring of prices is essential lest future adjustments be misunderstood by the public as part of the dynamics of aggressive monetary policy. Whether bubbles have been generated remains to be seen.

—Richard G. Anderson

Views expressed do not necessarily reflect official positions of the Federal Reserve System.