

## **Bernanke Has Been Anything But Loose**

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Contrary to those who criticize Federal Reserve Chairman Bernanke for following an easy money policy, nothing could be further from the truth.

In fact, "Helicopter" Ben, as Wall Street calls him for his comment one time that the Fed could always drop money on the economy from a helicopter if things got really bad, has been more like "Tightwad" Ben.

A month after Bernanke became Fed chairman on Feb. 1, 2006, completions of new single-family homes peaked near an annualized unit rate of 2 million. By February of this year, the rate had been more than halved to 903,000 units and a further decline is expected.

In addition, housing prices and household balance sheets are in deflation, the financial system is de-leveraging, Bear Stearns is no longer a stand-alone entity and the economy is in recession, at least unofficially.

Nothing in this grim picture reflects easy money.

Some ask what about the falling value of the dollar and sky-high gold and oil prices? China broke the dollar peg in July 2005, and the dollar's price already was under pressure in anticipation of that break. That was a decision made by the Chinese, not the Fed.

As a result, allocations in global portfolios were adjusted to reflect the revaluing of the Chinese currency by selling dollar assets. Hedge funds no doubt piled on and have exacerbated the trend. But changing allocations in global portfolios shouldn't be mistaken for an easy money policy.

Others say look at the collapse in the federal funds rate. Surely that must reflect the Fed flooding the market with liquidity. No. A simple example illustrates why the funds rate is declining.

Say someone has a monopoly on apple production. Apple prices hold steady, but then start to fall. The apple producer is perplexed until he picks up a paper and reads that apples are harmful to your health. Prices fell due to a lack of demand, not more production.

Instead of producing apples, the Fed produces money, the price of which is the federal funds rate. Like the apples, it's falling in large part due to lack of demand: The U.S. is in a recession, so the Fed doesn't need to add much liquidity to induce the funds rate to fall.

The Fed essentially chased the falloff in demand from the get-go. The economy fell off a cliff, and the funds rate chased it from 5.25% in September 2007 to 2.25% now.

Meanwhile Fed permanent additions to the money supply have been stingy over the past year — an after-inflation increase of 2% in the sweep-adjusted monetary base adjusted for changes in velocity. That's lower than the 2.75% average over the past 20 years.

The Fed has provided substantial sums of temporary liquidity to act as a backstop for financial entities that needed dollars. But that's a wash as far as inflation goes, because the dollars eventually return to the Fed.

To investors, Fed actions in this credit crunch should not be surprising. Bernanke essentially told the markets his plans in an Aug. 21 speech in Jackson Hole, Wyo. The Fed, he said then, "stands ready to take additional actions as needed to provide liquidity and promote the orderly functioning of markets. It is not the responsibility of the Federal Reserve — nor would it be appropriate — to protect lenders and investors from the consequences of their financial decisions."

The downside of anemic growth in money was Bear Stearns and the \$30 billion in mortgage-backed securities the Fed/taxpayers guaranteed. So the cost of months of not adding more permanent liquidity showed up at the Fed's door in the form of \$30 billion.

Fed officials may yet need to add sizable amounts of permanent liquidity should one of the major commercial banks encounter issues. That's very unlikely at this stage. But should that situation arise, temporary liquidity would be inadequate. Large permanent additions would be needed, which means the Fed would need to temporarily stop using the funds rate as its operating target and switch to a quantity target.

Since last fall, credit markets have told us that the Fed wasn't doing much in the way of permanent injections of liquidity. The Fed would make an announcement on the funds rate and almost immediately the futures market would price in another steep cut. There was no indication from the credit markets that the Fed was ever out in front. Message: The Fed needed to pay more attention to the credit markets.

It is beginning to look like Bernanke may have expected the outlines of something like the current economic and financial meltdown and had decided, probably well before his August 2007 speech, not to bail out investors and lenders. He just used that occasion to announce it.

The housing market that broke just after he became chairman was a bubble waiting to pop. Some pundits seem to think the Fed has acted to put a floor under investors and financial entities on the downside of the blowout. But there probably was little choice but to guarantee the \$30 billion of mortgage-backed securities at the end as the Fed needed to ensure functioning of the financial system.

A number of leading indicators suggest that real interest rates are low enough to juice the economy and that U.S. economic growth should resume in the second half of this year. For example, the inverted yield curve in the latter half of 2006 and the first part of 2007 did a good job of signaling difficulties in the housing and credit markets. Today's positive-sloping yield curve also is signaling growth ahead.

A useful confirmation of the yield curve signal comes from the freight transportation services index, which turned up about the time the yield curve did.

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