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What the chairman didn't mention

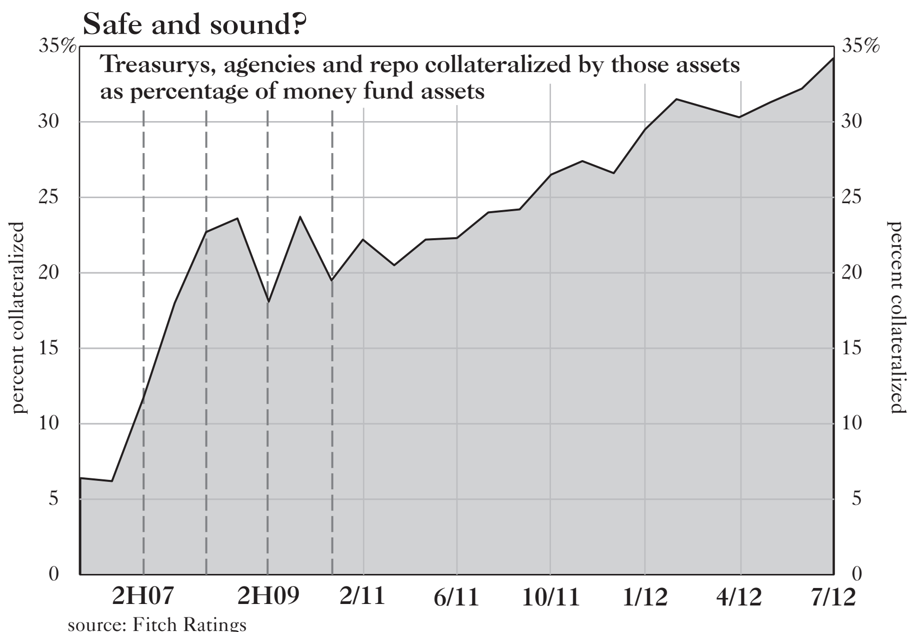
An undramatic reading of 19 pages of double-spaced text lifted stocks, bonds, commodities and non-dollar monetary assets on the Friday before Labor Day. In a few short hours, the price of gold rallied by more than the $35 per ounce at which it was officially valued between the mid-1930s and the early 1970s. The text, "Monetary Policy since the Onset of the Crisis," and the mind of the man who recited it, the chairman of the Federal Reserve Board, are the subjects at hand.

"Self-parody and self-plagiarism, neither intentional, are the bugbears of the aging author," wrote Whitney Balliett, the late, great jazz critic at *The New Yorker*. The readers of *Grant's* don't need to be told. The aging Ben Bernanke has been saying one thing, your aging editor another for a decade. We persist because he persists, and because monetary ideas have consequences. If we're right about the chairman's message, danger and opportunity are staring the holders of dollar-denominated assets right in the face. We write to try to sort out risk and reward.

It's old news, though worth repeating for emphasis, that the Jackson Hole, Wyo., address broadly hinted at a further radical monetary stroke. "The stagnation of the labor market in particular is a grave concern," warned Bernanke, "not only because of the enormous suffering and waste of human talent it entails, but also because persistently high levels of unemployment will wreak structural damage on our economy that could last for many years. Over the past five years, the Federal Reserve has acted to support economic growth and foster job creation, and it is important to achieve further progress, particularly in the labor market. Taking due account of the uncertainties and limits of its policy tools, the Federal Reserve will provide additional policy accommodation as needed to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability."

For a trade, the market seized on the phrase, "will provide additional policy accommodation as needed." For an investment, it may profitably consider the more important and revealing words, "[t]aking due account of the uncertainties and limits of its policy tools." It makes all the difference that the chairman does not, in fact, take due account of the "uncertainties and limits" of his "policy tools." He may pay them lip service, as he did in his speech. But he does not really weigh the costs and benefits of doing what no other American central banker has done before. With Bernanke, as with Adm. David Farragut, it's "[d]amn the torpedoes, full speed ahead," though Farragut's aggression, unlike Bernanke's, got quick and quantifiable results.

Shining through the chairman's text is the conviction that economic problems are susceptible to a monetary solution. For every monetary-policy action, Bernanke all but said out loud, there is a predictable reaction. That is, for policy A, you may bet your boots on outcome



B. For ourselves, we have come to believe—the past five years have decided us on the question—that while policy A may deliver outcome B, it may alternatively serve up outcomes J or Q or Z—or, not inconceivably, some other result too strange to be classified under a known English letter. Especially are surprises in store for the makers of "nontraditional" policy—and for the millions on the receiving end of those inventions.

Bernanke makes no bones that he is improvising. "Large scale asset purchases," a.k.a. QE, and the "maturity extension program," a.k.a. Operation Twist, are, if not absolutely novel in concept, then unprecedented in scale. "[W]e were guided by some general principles and some insightful academic work but—with the important exception of the Japanese case—limited historical experience," the chairman admitted. "As a result, central bankers in the United States, and those in other advanced economies facing similar problems, have been in the process of learning by doing."

All of us learn by doing. To learn how to ride a bicycle, we pedal. But money has been circulating for millennia, and there is a voluminous monetary record. It is there to be read. Did the chairman or his staff consult the wisdom of the ages before deciding to muscle around the yield curve, manipulate asset values, materialize dollars by the hundreds of billions and, in general, to short-circuit the price mechanism? Not on the evidence of the four-and-a-half-page bibliography appended to the Bernanke text. To judge by this reading list, the chairman consulted no authority published before 1965. He cites relatively few sources published before the onset of the 2007 financial cave-in. His favorite authors are his employees at the Federal Reserve Board.

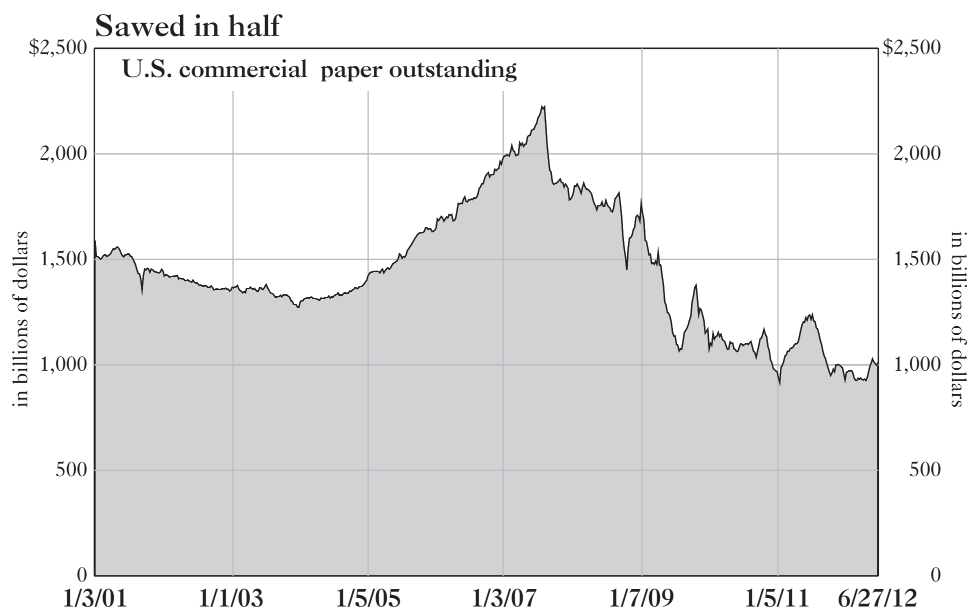
Perhaps not surprisingly, Bernanke and his authorities are in broad agreement on the post-2007 policy record of U.S. monetary policy. It is swell, they conclude. "After nearly four years of experience with large-scale asset purchases," said Bernanke, "a substantial body of empirical work on their effects has emerged. Generally, this research finds that the Federal Reserve's large-scale purchases have significantly lowered long-term Treasury yields."

And not only Treasury yields, he goes on. QE has tamped down mortgage rates and corporate bond yields and firmed up stock prices: "it is probably not a coincidence that the sustained recovery in U.S. equity prices began in March 2009, shortly after the [Federal Open Market Committee's] decision to greatly expand securities purchases. This effect is potentially important because stock values affect both consumption and investment decisions."

So you didn't build that, Mr. Market. The Federal Reserve got the rally rolling—and much to the advantage of the macroeconomic situation, too, Bernanke judged. Granted, the chairman told his audience, there's no telling how the economy might have fared in the absence of these improvised measures. But, "if we are willing to take as a working assumption that the effects of easier financial conditions on the economy are similar to those observed historically, then econometric models can be used to estimate the effects of [QE] on the economy." The Fed's own models rate the Fed's monetary policy a winner, the chairman again noted: "as of 2012, the first two rounds of LSAPs may have raised the level of output by almost 3% and increased private payroll employment by more then two million jobs, relative to what otherwise would have occurred."

Striking the pose of a disinterested scholar, the chairman next sought to persuade his listeners that he had considered the risks, not just the rewards, of monetary experimentation. He mentioned four potential pitfalls, of which the first was the risk that the Fed's interventions might impair the "functioning" of the securities markets. Second was the chance that QE might frighten the uninitiated into doubting the Fed's ability to normalize policy without seeding a new inflation. Third was the risk to "financial stability" presented by the temptation to reach for yield in these times of pygmy interest rates. Fourth was the possibility that the Fed might suffer a mark-to-market loss "should interest rates rise to an unexpected extent" (a slightly disingenuous point given the 2011 accounting change that shifts the burden of absorbing financial losses away from the Fed and onto the Treasury; on this little-reported innovation, so handy for an activist and leveraged central bank, the chairman was silent). All these risks the chairman discounted.

Omissions from the Bernanke checklist of unintended consequences and undesirable side effects, though they received no press, deserve the attention of every investor. He said nothing about the distortions wrought by the so-called zero-percent interest rate policy on the allocation of capital or on the analysis of investment value. Neither did he acknowledge how the whisking away of interest income has punished savers and nudged them into unsuitable risk taking. Though quick to claim credit for the decline in mortgage rates or the rise in stock prices, Bernanke was characteristically mute on the Fed's contribution to resurgent prices of commodities and farmland. We commend to the chairman the cover story in the August 18 issue of *The*



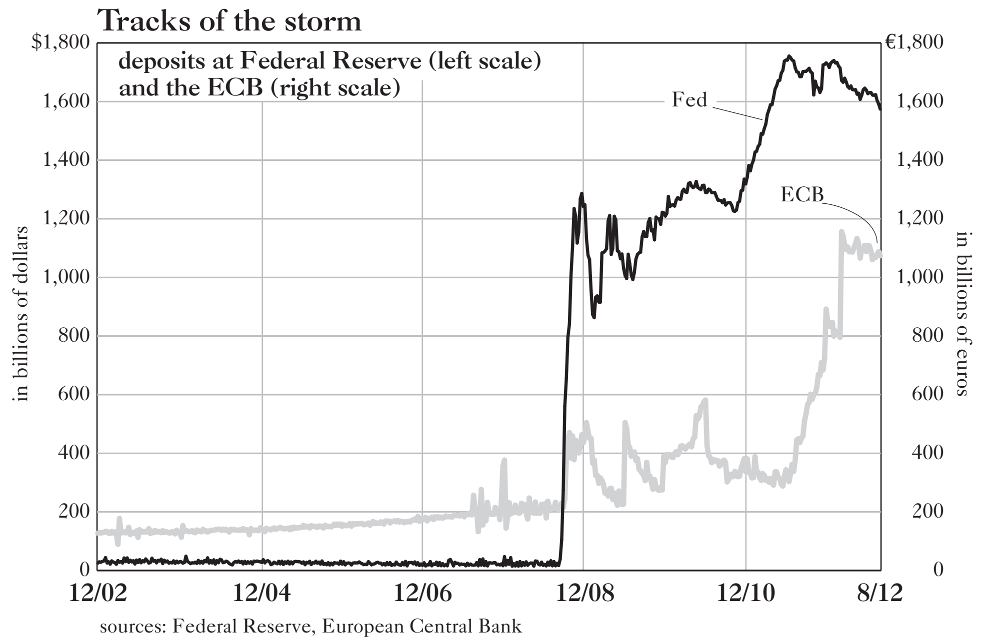
Spectator, published in London. "Hunger strikes," says the headline: "Rising food prices will mean more revolutions."

With a lot more time and a little more candor, Bernanke could have held forth for hours in this vein. The crisis-era money market alone could have afforded him all the material he needed. Zero-percent interest rates and blanket FDIC guarantees of bank deposits have reconfigured what used to be a market in short-dated IOUs of the private sector. Today's money market is increasingly a market of short-dated IOUs of the public sector.

Before the rains came in 2007, money market mutual funds earmarked just 6.2% of their assets for Treasury securities, agency obligations and repurchase obligations collateralized by the same. As of last report in July, according to an Aug. 29 bulletin from Fitch Ratings, such holdings weighed in at 34.2% of money-fund assets. Midway in 2007, $2.2 trillion of commercial paper—unsecured corporate promissory notes—was outstanding. Less than half of that amount is issued today. As Bernanke did not get around to saying in Jackson Hole, zero-percent interest rates obviate the value of credit analysis. When a given claim yields nothing, the prudent investor will roll Treasury bills or—functionally the same thing—lay up deposits at a too-big-to-fail bank.

Zero-percent interest rates may impart no credit information, but that doesn't mean they're inexpressive. "Be afraid, Mr. or Ms. Investor, because the government is afraid," is the subliminal message. It's a suggestion that the post-crisis regulatory regime powerfully reinforces. The 2010 amendments to Rule 2a-7 of the Investment Company Act of 1940, for instance, slap tough new liquidity tests on money market mutual funds. They require that 10% of the assets of a taxable fund be held in cash, U.S. Treasurys or securities that convert to cash the next business day. And they require that 30% of the assets of a taxable fund be placed in securities that mature within 60 days or that convert to cash within five business days. Pre-crisis, the money-fund managements decided such matters for themselves.

Post-crisis, the government has its knives out, and the new rules push the funds into the least remunerative spots on the nearly barren money market credit and liquidity curves. Thus, the smaller funds face starvation, the biggest funds malnutrition. Nancy Prior, president of Fidelity's Money Market Group, the nation's largest, told readers of the June issue of *Money Fund Intelligence* that "we monitor every single dollar, every hour," and that there are no fewer than 80 Fidelity money market credit analysts on the case, some of whom "can hop on a plane or a train and be in Germany, Brussels or France in an hour." It is, however, travel, overhead expense and man-hours expended in the service of delivering a 0.01% return, pretax, to the investors in Fidelity Cash Reserves.



sources: Federal Reserve, European Central Bank

That ultra-low interest rates tend to beget even lower—and more dysfunctional—rates is another side effect of zero-percent rate policy that the chairman didn't talk about. He could have cited the example of the European Central Bank, which in July shaved the rate it pays on bank deposits to zero percent from 25 basis points. By this adjustment, Mario Draghi, president of the ECB, presumably expected to drive money out of his vaults and into the receding European economy. But the funds have stayed put while other yields have actually turned negative. It stands to reason that repurchase rates on the highest quality collateral would be quoted at less than zero if that collateral itself—short-dated notes issued by the governments of Germany, Denmark and Switzerland, for instance—yields zero percent or less. As optimism has a life of its own, so does pessimism, and the central bankers are having a hard time cheering up the glum and broken-spirited survivors of the panic of 2008. They'll have an even harder time of it after the €1.1 trillion European money-market industry starts passing along negative interest rates to its hapless investors, as FT.com is reporting the funds are preparing to do.

In June 2011, Jamie Dimon put a question to Bernanke at a banking conference in Atlanta. The CEO of JPMorgan Chase & Co. asked the chairman if the regulatory and market response to the financial crisis might not be hurting recovery rather than helping it. Regulators are tougher, credit committees are tougher and examiners are tougher, Dimon observed. "Has anyone bothered to study the cumulative effect of all these things?" he posed.

Bernanke replied that he, for one, was gratified by how thoroughly the government had scoured the system. As to Dimon's question, he answered that no one had attempted to study the cumulative effect of so much rule and policy making and that, in truth, "it's just too complicated, we don't really have the quantitative tools to do that." And the chairman had a most revealing afterthought. He had a "pet peeve," he said, about people insisting that "the single cause of the crisis was 'x.' There was not a single cause of the crisis," Bernanke went on. "There were many, many different causes, and they interacted in a way that was in many ways unpredictable, and led to the disaster that we experienced."

So, after all, the chairman was prepared to concede that outcomes are unpredictable, that financial systems are complex and that policies implemented for one purpose can wind up serving another. Yet the very same Bernanke, speaking at Jackson Hole, talked up the new federal crisis-prevention bureau, the Financial Stability Oversight Council, as if it had powers of divination never before available to the federal bureaucracy. "We have seen little evidence thus far of unsafe buildups of risk or leverage," he said, "but we will continue both our careful oversight and the implementation of financial regulatory reforms aimed at reducing systemic risk."

Market economies excel at identifying and repricing error. Regimented economies, in contrast, are ill suited to making mid-course corrections, as the only thing the Dear Leader despises more than error is the messenger who tells him about it.

America's Dear Leaders are the functionaries who are busily substituting bureaucracy for the price mechanism. Nowadays, when things go pear-shaped, Chairman Bernanke is front and center with broad hints to print enough money or suppress enough prices or inflate enough assets to make us forget our troubles. Don't worry that QE or Twist or ZIRP will end in inflationary tears, Bernanke counseled at Jackson Hole: "The FOMC has spent considerable effort planning and testing our exit strategy and will act decisively to execute it at the appropriate time."

But, of course, Mr. Market doesn't hand out wristwatches. It isn't the Fed's efforts or good intentions one doubts, but its judgment. As for our judgment, as fallible as anyone's, we expect that our drugged bond markets will give no helpful signal that the central banks of the world have over-cranked the printing presses. The radical monetary experiments of 2012 will strike posterity as the most obvious setup to a virulent inflation there ever was, except that our monetary mandarins had no clue it was happening.

In 1921, O.M.W. Sprague, author of "History of Crises under the National Banking System," contributed an essay on the Federal Reserve, then just seven years young, to *The American Economic Review*. In it, Sprague, a Harvard professor, warned against the temptation to print one's way out of cyclical trouble. The Fed had hugely expanded the nation's money and credit to help the Treasury finance America's participation in World War I. There had been a rip-roaring inflation. And now came the time to undo the inflationary damage. What, if anything, could the new central bank do to smooth the process of adjustment?

"If we insist upon using such power as a means of temporary relief and stimulation," wrote Sprague, "ultimate disaster is the certain consequence. Past experience shows that it is dangerous for governments to issue paper money. There is a constant temptation to overissue when confronted by real or imaginary emergencies. The same danger arises in the case of the [R]eserve system—that public opinion and perhaps legislative action will compel the employment of its resources in a vain endeavor to cure evils which are mainly due to credit already granted in excess."

Now comes Chairman Bernanke, a Harvard man himself, doing exactly what Sprague warned against, and with the support of the 21st-century economics establishment. *Grant's* is betting on a new inflation with a flight of investable funds from the assets that are today deemed safe (notably, sovereign debt) to assets deemed infra dig or permanently impaired (for instance, precious metals and equities). Anyway, "nontraditional" central banking is a short sale.