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May 20, 2011

Bernanke's Economic Time Bomb

By Chuck Rogér
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Ben Bernanke's Federal Reserve has laid the charges, connected the leads, and now stands ready at the detonator. America waits.

We wait for the economic effects of "quantitative easing" (QE). In QE, a nation's central bank buys financial instruments, such as Treasury bonds, with money decreed into existence through electronic transactions. The objective is to "stimulate" economic activity by injecting additional currency into circulation and bank reserves. Plusher reserves would theoretically encourage lenders to lend, which would kick-start business activity and home purchases. QE derives from the Keynesian economic hypothesis that government spending helps end recessions. But reality refuses to comply with theory.

For instance, in the current recession, the National Center for Policy Analysis calculates that the $800 billion stimulus passed by Democrats and signed by Obama in 2009 will generate a paltry 5 percent boost in Gross Domestic Product. Furthermore, each government dollar injected between 1947 and 2007, via deficit spending, stimulated only forty-six cents of additional GDP. Negative returns and higher debt make for crummy investment karma. But a miserable track record doesn't deter Keynesians, including Fed Chief Ben Bernanke.

In slow or shrinking economies, a Keynesian-minded Fed normally tries to impact short-term interest rates by buying up short-term Treasury bonds or T-bills. However by late 2008, short-term rates were already very low. "Normal" was off the table. Instead, using electronically-created dollars, Bernanke relieved financial institutions of $1.75 trillion in mortgage-backed securities heavy in high-risk loans. The move, referred to as QE1, almost tripled the monetary base (currency plus bank reserves) between December 2008 and March 2010. Hillsdale College economist Ivan Pongracic explains the mess created by Bernanke's Fed and Obama's regulators.

> ...rather than stimulating the economy through increased lending, much of [the injected] money has remained idle, locked up in vaults as banks have been unwilling and often unable to lend. (Regulators in the past two years have considerably tightened lending standards, making it much more difficult to qualify for a loan, especially in these uncertain times.) Moreover, the Fed started to pay banks interest on their reserves held at the Fed. This is why the massive increase in the monetary base has not brought about much increase in the active money supply (currency plus deposits), which is necessary to stimulate the economy. This is also why the official inflation rate has continued to stay so low.

After QE1 added $1.75 trillion to federal debt with little positive impact, the Fed might have chosen to abandon quantitative easing. But in November 2010, Bernanke began injecting another $600 billion into the economy-QE2.

Still underway, QE2 involves buying up *long*-term Treasuries in order to depress long-term interest rates that key off Treasuries. The tactic could stimulate lending, but will boost inflation, which, due to the Fed's money injections, is already poised to continue climbing. Bernanke actually *wants* higher inflation. Pongracic notes that the Fed Chief judges inflation "too low to be consistent with a robust rate of growth."

According to Cato Institute's Mark Calabria, Bernanke thinks that Americans "need not worry about inflation because we will see it coming, and then the Fed will do something about it." There indeed is a 0.93 correlation (1.00 being perfect) between actual inflation and certain "inflation expectations" on which Bernanke relies. But expectations predict only the direction, not the magnitude, of inflation. Bernanke is probably underestimating how high prices will rise.

The Fed Chief is inclined to give in to the insanity reflex: expecting repeatedly-failed tactics to succeed. Oddly, there may be a brief period in which Bernanke appears to be a genius. At some point, cash will emerge from bank reserves and flow faster and faster into a larger and larger economy. Private-sector money will change hands more rapidly. Hiring will rise. Banks will lend. Loans will be cheap. Lots of people will buy houses.

Then Bernanke's strategy will ram into reality. His tactics will create conditions like those which caused the Great Recession in the first place. Worse still, to compound the conditions that existed when the subprime mortgage gravy train derailed, today we have $2.35 trillion from QE1 and QE2 ready to flood the economy. After initial good times, Americans may face a return of Carter-era stagflation (zero growth + high inflation). For now, GDP growth is still modest to low, not zero. Most of Bernanke's extra trillions are not circulating. The Fed's house of cards stands.

Bernanke must carefully remove each card in order to facilitate an orderly demolition of his failed Great Recession "fixes." To avoid runaway inflation, which would naturally occur if QE's trillions circulate in a near-zero interest-rate environment, the Fed will have to apply economic brakes. Fed Chief Paul Volcker gave braking lessons during the first Reagan administration.

To duplicate Volcker's success, interest rates will have to rise in order to yank QE1's and QE2's trillions out of the economy. As an added defense against inflation, tax rates must not fall until after the trillions are substantially drained. It's a matter of record that President Reagan made the right decision, at Volcker's urging, to delay any push for lower tax rates until inflation was tamed. In today's predicament, when enough of the Fed's injected money gets drained and inflation is calmed, tax rates can be reduced. At that point, letting people keep more of their own money to invest and spend will be just the ticket to spur a Reaganesque economic boom.

In twenty years or so, Americans will almost surely take another economic roller coaster ride enabled by another Keynesian Fed Chief as well as another Keynesian President and Congress elected by voters as dismissive of economic reality as the Fed Chief, President, and Congress. By that time, I plan on doing lots of fishing.

A writer, physicist, and former high tech executive, Chuck Rogér invites you to sign up to receive his "Clear Thinking" blog posts by email at www.chuckroger.com. Contact Chuck at swampcactus@chuckroger.com.

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