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Election 2012 Means the Real Bernanke Bombshells Won't Fall Until December

By Martin Hutchinson*, Global Investing Strategist, Money Morning* - October 26, 2012

If you were expecting big news from this week's Fed meeting it looks like you are going to be in for a long wait. This week's FOMC meeting was business as usual.

There was no change in interest rates, no change in the determination to keep rates low into 2015 and no change in the Fed's latest solution, otherwise known as QE infinity.

The truth is the real bombshells won't likely start until the Fed's next meeting in December. By then, the landscape could be completely changed.

With Election 2012 still at stake, it's who controls the Oval Office that matters most when it comes to Fed policy.

You'd never know that if all you did was watch the debates.

Ben Bernanke may well be the second most powerful person in the country, yet his name was never mentioned-not even once. Remarkably, monetary policy was completely absent from the debates.

Election 2012 and the Fed

That's true even though the two candidates differ substantially when it comes to the Federal Reserve.

For instance, Mitt Romney has repeatedly said he would not reappoint Ben Bernanke when the Fed chairman's current term ends in January 2014. Conversely, President Barack Obama has indicated his support for Bernanke and his easy money policies.

For that matter, Bernanke himself is in an open question. He may retire in

January 2014 no matter who wins Election 2012.

However, at the December meeting one major thing will have changed: the time horizons of both investors and policymakers.

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However, at the December meeting one major thing will have changed: the time horizons of both investors and policymakers.

By December, the political course will be set until January 2017, with only modest changes possible in November 2014. At that point people will start planning policy around that period.

In fiscal terms, that will force politicians to take the budget deficit seriously. The prospect of another $5 trillion of debt by January 2017 will simply be too awful to contemplate.

On the monetary policy front, people will care less urgently about short-term moves in the unemployment rate and more about the long-term damage caused by Bernanke's policies.

With interest rates well below the inflation rate, savers are being forced to take horrendous risks in order to preserve their capital and earn a modest real return.

That's why the country's pension funds are in such bad shape, and why Bolivia, a very poor country run by a Marxist thug, can borrow 10-year money at a mere 5% interest rate this week.

Over the medium term, Bernanke's policies are also likely to lead to rising inflation. When people's sights suddenly become set on January 2017, that medium term will quickly appear all too real.

Of course, the Fed can't raise interest rates in December - that would shoot to pieces its promise not to raise them before mid-2015 (actually it's not quite a promise if you read the fine print; as always there's some wriggle room, but not that much.)

However, there's an alternative strategy, outlined in the last month by two regional Fed presidents, Minneapolis Fed president Narayana Kocherlakota of Minneapolis and Charles Evans of Chicago.

They have both suggested using the unemployment rate and inflation rate as triggers for raising rates, rather than a specified time period. Kocherlakota has suggested rates should rise when either inflation hits 2.25% or unemployment hits 5.25%, while Evans has suggested raising rates when unemployment hits 7% or inflation hits 3%.

Kocherlakota had the idea first, but given that unemployment is currently 7.8% and core inflation 2%, Evans's targets look more balanced and realistic.

Setting Evans' targets for raising rates in December would have one important effect: on the current trajectory, with inflation trending upwards and unemployment having fallen by 1.2% in the last year, we would hit Evans' targets **not in 2015 but well before the end of 2013.**

That's a monumental something the market has not priced in. At that point, policy would depend on who was president.

Under President Obama, Bernanke would probably be replaced by a monetary "dove" like Fed vice-chairman Janet Yellen, so rates would rise only slowly, as they did in 2003-06.

Well before rates could reach the level of inflation, it's likely either inflation would have taken off or the economy would have fallen back into recession, allowing the Fed to return to zero rates.

Either way, the damage of current policies would continue, although at least extra flexibility would have been gained.

What the Romney Fed Might Look Like

Under Romney, the position is less clear.

One of his top advisors, Glenn Hubbard, has said Bernanke should be reappointed, so if he became Fed chairman he would probably continue Bernanke's policies, more or less.

Another potential Fed chairman under Romney is John B. Taylor. He invented the "Taylor rule" for setting interest rates.

The Taylor Rule is unfortunately very easy to fudge. It's based on "potential" GDP and unemployment, rather than working from hard data. Still, most variants of it would push interest rates higher than they are today.

Then there's the possibility that Romney throws the "Tea Party" a bone and appoint Ron Paul or, more likely, John Allison, the hard-money head of the Cato Institute (and former chairman of BB&T Bank.) Allison would abandon Bernanke-ism entirely and push rates up rapidly, to the great benefit of savers and the economy generally.

The ideal policy would set the federal funds target at 2% immediately, around the current level of inflation.

That would stop penalizing savers (though it wouldn't reward them much) and would lessen the upward pressure on inflation, while at the same time still being a loose policy. In real terms, money would still be free.

A sharp jump to 2% would, however, end all the speculative games played by the banks, the mortgage REITs and the rest of Wall Street.

That would cause havoc in financial markets, and would quickly kill off all the players that only exist because of Bernanke-ism. After a period of pain, the rest of the economy would benefit from their demise, because capital would be freed up.

So yes, the direction of the Federal Reserve in 2013 is still a big unknown.

But I have to tell you, the Fed's December 11-12 meeting is likely the beginning of the fireworks.