July 23, 2009, 4:00 a.m.

Bernanke Must Go

The Fed chair seems to misunderstand the current financial crisis.

By Mark A. Calabria

If his hearings this week before the House and Senate made one thing clear, it is that Fed chairman Ben Bernanke has lost the confidence of Congress, and likely also that of the American public.

Were Bernanke's only problem a loss of congressional confidence, he could overcome it. However, the erosion of public trust in the Fed has been the result of a long string of policy failures, which have overshadowed the few successes.

Foremost among these failures is the Fed's prominent role in helping to inflate the housing bubble. While Bernanke was correct in identifying the "global savings glut" and its impact on interest rates, he used it as a rationale for inaction rather than attempting to counteract the unsustainable build-up of leverage throughout our financial system.

What should have been Bernanke's greatest strength, his understanding of monetary theory and his knowledge of the Great Depression, has ended up being his greatest weakness. While correct in his analysis of the role of "debt deflation" — where deflation increases the real burden of debts and correspondingly weakens the balance sheet of both households and businesses — his obsession with slaying the Great White Whale of Deflation provided intellectual cover for the Fed's ignoring and contributing to the housing bubble. Like the proverbial general, he was fighting yesterday's battle rather than today's.

While core inflation was moderate and increasing at a slowing rate between 2001 and 2005, this measure ignores the dramatic uptick in house prices during those years. Housing makes up the single largest expense for most households — ignoring it, especially after one has already subtracted energy and food from the definition of inflation, gives a narrow and distorted picture of inflation. Even if one were to focus solely on rents, the '00s were an era of increasing housing costs.

Separate from the impact of housing prices on inflation is the role that housing plays as collateral for the primary piece of household debt: mortgages. Even were the U.S. to suffer a bout of mild deflation and the real burden of mortgages increased, this would likely have little impact on household balance sheets so long as the underlying homes were becoming more valuable.

Admittedly, Bernanke was only a "governor" and not yet chair of the Fed. However, he was the Fed's loudest voice when it came to combating deflation and arguing for lower rates. There have been zero public acknowledgments by either Bernanke or the Fed that its policy earlier this decade contributed to the housing bubble and financial crisis. Without his admitting to the occasional error, we have no way of judging whether Bernanke has learned from any of his mistakes. His role in "cushioning" the burst of the dot-com bubble by helping to inflate a housing bubble is particularly relevant as Washington looks for ways out of the current mess.

Bernanke made some attempts this week to reassure Congress and the public that the Fed "has been devoting considerable attention to issues relating to its exit strategy, and [we] are confident that we have the necessary tools to implement that strategy when appropriate." That statement, however, merely raises the question: Why didn't the Fed use those tools, and have an exit strategy after its pumping of massive liquidity into the system? The Fed always has the tools to avoid inflation. But Bernanke's ability to use them at the right time is now dubious at best.

In addition to Bernanke's role in creating the housing bubble and subsequent crisis, he starred in the bailouts of Bear Stearns and AIG and oversaw a massive expansion of the Federal Reserve's balance sheet. Despite Bernanke's claim that Lehman's failure triggered the global financial crisis (he says he only allowed it due to lack of political support for bailouts), there is little conclusive evidence to support that case. As John Taylor points out in his recent book, the market's reaction to Lehman's failure was in many ways more muted than the reaction to AIG's bailout. In fact, most market indices did not blow out until after the proposal of TARP. The best one can say is that the market data for the time between the Lehman failure and the AIG bailout is ambiguous.

What is not ambiguous is that the Fed, under Bernanke, has transcended monetary policy and bank supervision and gone into the world of fiscal policy. Over the course of the financial crisis, the Fed more than doubled the size of its balance sheet, from under $900 billion to over $2 trillion. Just as important, the Fed greatly shifted the composition of its balance sheet, from almost exclusively Treasury securities to a mix of various assets, including over $500 billion in mortgage-backed securities. Congress has over the years established a variety of lending and loan-guarantee programs, from mortgage insurance to small-business lending programs. Every one of the Fed's 14 new lending facilities could have been created by Congress and administered by an executive-branch agency. Unlike the panic-driven bailouts of AIG and Bear, these lending facilities were not created as one-off responses to fix a single crisis.

Desiring to protect the independence of monetary policy, Bernanke has pushed various regulations restricting credit in order to gain favor among congressional Democrats. The recently proposed credit-card and mortgage rules unnecessarily restrict credit and increase the litigation risk facing banks, while doing nothing to roll back some of the irresponsible lending policies that exacerbated the housing bubble.

Although it's good that Bernanke was quick to inject much-needed liquidity into the financial system after the housing bubble burst, he did so in a manner beyond the Fed's traditional monetary-policy role. His pandering to the Left on misguided "consumer protections," and the absence of any debate over the Fed's role in the housing bubble, raise serious questions as to whether Bernanke understands the causes of the current financial crisis. We cannot hope to avoid the next financial crisis without a Fed chairman who understands the current one. The time to start looking for that new chairman is now.

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