Thursday, June 23, 2011

Guest Post: Bernanke Is Either Not Very Bright or Not Very Honest. He Admits He Doesn't Know Why We Have a Weak Economy … But He's the One Who Weakened It

→ *Washington's Blog*

In "Bernanke Admits He's Clueless On Economy's Soft Patch", Forbes blogger Agustino Fontevecchia notes:

Brutally honest, Bernanke admitted that he had no clue what was actually causing the current fragility in the U.S. economic recovery. While the FOMC statement assigned blame outside of the U.S., pointing at Japan along with rising food and oil prices, Bernanke was put on the spot by a reporter who noted the inconsistency behind that explanation and a lowering of long term forecasts. Bernanke took the hit, admitting only some of the factors were temporary and that he didn't know exactly what was causing the slowdown, but that it would persist. "Growth," said Bernanke, "will return into 2012."

Specifically, Bernanke said today:

We don't have a precise read on why this slower pace of growth is persisting.

Well, it is obvious to anyone who has been paying attention what's causing the slow down, and if Mr. Bernanke doesn't know, he should be fired.

As I've repeatedly explained since 2008, all independent economists and financial experts know why the economy is weak … and *everything* the Fed has been doing has been weakening it.

High-Level Fed Officials Slam Bernanke

Fed Vice Chairman Donald Kohn conceded that the government's actions "will reduce [companies'] incentive to be careful in the future." In other words, he's admitting that the government's actions will encourage financial companies to make even *riskier* gambles in the future.

Kansas City Fed President and veteran Fed official Thomas Hoenig said:

Too big has failed….

The sequence of [the government's] actions, unfortunately, has added to market uncertainty. Investors are understandably watching to see which institutions will receive public money and survive as wards of the state…

Any financial crisis leaves a stream of losses among the various participants, and these losses must ultimately be borne by someone. To start the resolution process, management responsible for the problems must be replaced and the losses identified and taken. **Until these actions are taken, there is little chance to restore market confidence and get credit markets flowing. It is not a question of avoiding these losses, but one of how soon we will take them and get on to the process of recovery**….

Many of the [government's current policy revolves around the idea of] "too big to fail" …. History, however, may show us a different experience. When examining previous financial crises, both in other countries as well as the United States, large institutions have been allowed to fail. Banking authorities have been successful in placing new and more responsible managers and directions in charge and then reprivatizing them. **There is also evidence suggesting that countries that have tried to avoid taking such steps have been much slower to recover, and the ultimate cost to taxpayers has been larger**…

The current head of the Philadelphia fed bank, Charles Plosser, disagrees with Bernanke's strategy of the endless printing-press and ever-increasing fed balance sheet:

Plosser urged the Fed to "proceed with caution" with the new policy. Others outside the Fed are much more strident and want plans in place immediately to reverse it. They believe an inflation storm is already in train.***

Bernanke argued that focusing on the size of the balance sheet misses the point, arguing the Fed's various asset purchase programs are not easily summarized in a single number.

But Plosser said that the growth of the Fed's balance sheet was a key metric.
"It is not appropriate to ignore quantitative metrics in this new policy environment," Plosser said…
Plosser is bringing the spotlight right back to the Fed's balance sheet.
"The size of the balance sheet does offer a possible nominal anchor for monitoring the volume of our liquidity provisions," Plosser said.

The former head of the Fed's Open Market Operations says the bailout might make things worse. Specifically, the former head of the Fed's open market operation – the key Fed agency which has been loaning hundreds of billions of dollars to Wall Street companies and banks – was quoted in Bloomberg as saying:

"Every time you tinker with this delicate system even small changes can create big ripples," said Dino Kos, former head of the New York Fed's open-market operations . . . "This is the impossible situation they are in. The risks are that the government's $700 billion purchase of assets ***disturbs markets even more***."

And William Poole, who recently left his post as president of the St. Louis Fed, is essentially calling Bernanke a communist:

Poole said he was very concerned that the Fed could simply lend money to anyone, without constraint.
In the Soviet Union and Eastern Europe during the Cold War era, economies were inefficient because they had a soft-budget constraint. If a firm got into trouble, the banking system would give them more money, Poole said.
The current situation at the Fed seems eerily similar, he said.

"What is discipline – where are the hard choices – when does Fed say our resources are exhausted?" Poole asked.

But the strongest criticism may be from the former Vice President of Dallas Federal Reserve, who said that the failure of the government to provide more information about the bailout could signal corruption. As ABC writes:

Gerald O'Driscoll, a former vice president at the Federal Reserve Bank of Dallas and a senior fellow at the Cato Institute, a libertarian think tank, said he worried that the failure of the government to provide more information about its rescue spending could signal corruption.

"Nontransparency in government programs is always associated with corruption in other countries, so I don't see why it wouldn't be here," he said.

Of course, former Fed chairman Paul Volcker has also strongly criticized current Fed policies.

Global Agencies Slam Bernanke

The Bank of International Settlements (BIS) – called "the central banks' central bank" – has slammed the Fed for blowing bubbles and then "using gimmicks and palliatives" which "will only make things worse".

As the Telegraph wrote in June 2007:

The Bank for International Settlements, the world's most prestigious financial body, has warned that years of loose monetary policy has fuelled a dangerous credit bubble, leaving the global economy more vulnerable to another 1930s-style slump than generally understood…

The BIS, the ultimate bank of central bankers, pointed to a confluence a worrying signs, citing mass issuance of new-fangled credit instruments, soaring levels of household debt, extreme appetite for risk shown by investors, and entrenched imbalances in the world currency system…

The bank said it was far from clear whether the US would be able to shrug off the consequences of its latest imbalances …

"Sooner or later the credit cycle will turn and default rates will begin to rise," said the bank.

A year later, in June 2008, the Telegraph wrote:

A year ago, the Bank for International Settlements startled the financial world by warning that we might soon face challenges last seen during the onset of the Great Depression. This has proved frighteningly accurate…

[BIS economist] Dr White says the US sub-prime crisis was the "trigger", not the cause of the disaster.

Indeed, BIS slammed the Fed and other central banks for blowing the bubble, failing to regulate the shadow banking system, and then using gimmicks which will only make things worse. As the 2008 Telegraph article notes:

In a pointed attack on the US Federal Reserve, it said central banks would not find it easy to "clean up" once property bubbles have burst…

Nor does it exonerate the watchdogs. "How could such a huge shadow banking system emerge without provoking clear statements of official concern?"

"The fundamental cause of today's emerging problems was excessive and imprudent credit growth over a long period. Policy interest rates in the advanced industrial countries have been unusually low," he said.

The Fed and fellow central banks instinctively cut rates lower with each cycle to avoid facing the pain. The effect has been to put off the day of reckoning…

"Should governments feel it necessary to take direct actions to alleviate debt burdens, it is crucial that they understand one thing beforehand. If asset prices are unrealistically high, they must fall. If savings rates are unrealistically low, they must rise. If debts cannot be serviced, they must be written off.

"To deny this through the use of gimmicks and palliatives will only make things worse in the end," he said.

In other words, BIS slammed the easy credit policy of the Fed and other central banks, and the failure to regulate the shadow banking system.

More dramatically, BIS slammed "the use of gimmicks and palliatives", and said that anything other than (1) letting asset prices fall to their true market value, (2) increasing savings rates, and (3) forcing companies to write off bad debts "will only make things worse".

But Bernanke and the other central bankers (as well as Treasury and the Council of Economic Advisors and Barney Frank and Chris Dodd and the others in control of American and British and French and Japanese and German and virtually every other country's economic policy) ignored BIS' advice in 2007 and 2008, and they are *still* ignoring it today.

Instead, they are doing everything they can to (2) prop up asset prices by trying to blow a new bubble by giving banks trillions, (2) re-write accounting and reporting rules to let the big banks and other giants keep bad debts on their books (or in sivs or other "second sets of books") and to hide the fact that they *are* bad debts, and (3) encourage consumers to spend spend spend!

"The world's most prestigious financial body", "the ultimate bank of central bankers" has condemned Bernanke and all of the other G-8 central banks, and stripped bare their false claims that the crash wasn't their fault or that they are *now* doing the right thing to turn the economy around.

As Spiegel wrote in July 2009:

White and his team of experts observed the real estate bubble developing in the United States. They criticized the increasingly impenetrable securitization business, vehemently pointed out the perils of risky loans and provided evidence of the lack of credibility of the rating agencies. In their view, the reason for the lack of restraint in the financial markets was that there was simply too much cheap money available on the market…

As far back as 2003, White implored central bankers to rethink their strategies, noting that instability in the financial markets had triggered inflation, the "villain" in the global economy…

In the restrained world of central bankers, it would have been difficult for White to express himself more clearly…

It was probably the biggest failure of the world's central bankers since the founding of the BIS in 1930. They knew everything and did nothing. Their gigantic machinery of analysis kept spitting out new scenarios of doom, but they might as well have been transmitted directly into space…

In their report, the BIS experts derisively described the techniques of rating agencies like Moody's and Standard & Poor's as "relatively crude" and noted that "some caution is in order in relation to the reliability of the results."…

In January 2005, the BIS's Committee on the Global Financial System sounded the alarm once again, noting that the risks associated with structured financial products were not being "fully appreciated by market participants." Extreme market events, the experts argued, could "have unanticipated systemic consequences."

They also cautioned against putting too much faith in the rating agencies, which suffered from a fatal flaw. Because the rating agencies were being paid by the companies they rated, the committee argued, there was a risk that they might rate some companies too highly and be reluctant to lower the ratings of others that should have been downgraded.

These comments show that **the central bankers knew exactly what was going on, a full two-and-a-half years before the big bang. All the ingredients of the looming disaster had been neatly laid out on the table in front of them: defective rating agencies, loans repackaged to the point of being unrecognizable, dubious practices of American mortgage lenders, the risks of low-interest policies. But no action was taken. Meanwhile, the Fed continued to raise interest rates in nothing more than tiny increments…**

The Fed chairman was not even impressed by a letter the Mortgage Insurance Companies of America (MICA), a trade association of US mortgage providers, sent to the Fed on Sept. 23, 2005. In the letter, MICA warned that it was "very concerned" about some of the risky lending practices being applied in the US real estate market. The experts even speculated that the Fed might be operating on the basis of incorrect data. Despite a sharp increase in mortgages being approved for low-income borrowers, most banks were reporting to the Fed that they had not lowered their lending standards. According to a study MICA cited entitled "This Powder Keg Is Going to Blow," there was no secondary market for these "nuclear mortgages."…

William White and his Basel team were dumbstruck. **The central bankers were simply ignoring their warnings. Didn't they understand what they were being told? Or was it that they simply didn't want to understand?**

The head of the World Bank also says:

Central banks [including the Fed] failed to address risks building in the new economy. They seemingly mastered product price inflation in the 1980s, but most **decided that asset price bubbles were difficult to identify and to restrain with monetary policy**. They **argued that damage to the 'real economy'** of jobs, production, savings, and consumption **could be contained once bubbles burst, through aggressive easing of interest rates**. They turned out to be wrong.

A study of 124 banking crises by the International Monetary Fund found that propping banks which are only pretending to be solvent hurts the economy:

Existing empirical research has shown that providing assistance to banks and their borrowers can be **counterproductive**, resulting in increased losses to banks, which often *abuse forbearance to take unproductive risks at government expense*. The typical result of forbearance is a deeper hole in the net worth of banks, **crippling tax burdens to finance bank bailouts, and even more severe credit supply contraction and economic decline than would have occurred in the absence of forbearance.**

Cross-country analysis to date also shows that accommodative policy measures (such as substantial liquidity support, explicit government guarantee on financial institutions' liabilities and forbearance from prudential regulations) tend to be **fiscally costly** and that these particular policies do not necessarily accelerate the speed of economic recovery.

***

All too often, central banks privilege stability over cost in the heat of the containment phase: if so, they may **too liberally extend loans to an illiquid bank which is almost certain to prove insolvent anyway**. Also, closure of a nonviable bank is often delayed for too long, even when there are clear signs of insolvency (Lindgren, 2003). Since bank closures face many obstacles, there is a tendency to rely instead on blanket government guarantees which, if the government's fiscal and political position makes them credible, can work albeit at the **cost of placing the burden on the budget**, typically squeezing future provision of needed public services.

By failing to break up the giant banks, governments are forced to take counter-productive emergency measures (see this and this) to try to cover up their insolvency. Those measures drain the life blood out of the *real* economy … destroying national economies.

Indeed, instead of directly helping the American people, the government threw trillions at the giant banks (including foreign banks; and see this) . The big banks have – in turn – used a lot of that money to speculate in commodities, including food and other items which are now driving up the price of consumer necessities [as well as stocks]. Instead of using the money to hire Americans, they're hiring abroad (and getting tax refunds from the government).

Economists Slam Bernanke

Stephen Roach (former chief economist for Morgan Stanley, and now director of Morgan Stanley Asia) is one of the most influential and respected American economists. Roach told Charlie Rose recently that we have had terrible Federal Reserve policy for the past 12 years under Greenspan and Bernanke, that they concocted hair-brained theories (for example, that we should let the boom and bust cycle occur, but then "clean up the mess" once things fall apart), and that we really need to reform the Fed.

Specifically, here's the must-read portion of the interview:

STEPHEN ROACH: And what's missing in the debate that drives me nuts is going back to the very function of central banking that's at the core of our financial system. Do we have the right model for the Fed to go forward? And, you know, I think we've minimized

the role that the custodians, the stewards of our financial
system, the Federal Reserve, played in leading to this crisis and in making sure that we will never have this again. I think we've had horrible central banking in the United States for the past dozen of years. I mean, we elevate our central bankers, we probably .

CHARLIE ROSE: From Greenspan to Bernanke.

STEPHEN ROACH: Yeah.

CHARLIE ROSE: Both.

STEPHEN ROACH: We call them maestro, and, you know, we make them sound larger than life. And, you know, and the fact is, they condoned policies that took us from one bubble to another. They failed to live up to their regulatory responsibility granted them by law. They concocted new theories to explain why these things could go on forever, and they harbored the belief, mistakenly in my view, that monetary policy is too big and blunt an instrument, and so you just bring it in to clean up the mess afterwards rather than prevent a mess ahead of time. Well, look at the mess we're in right now. We need a different approach here. We really do.

Leading economist Anna Schwartz, co-author of the leading book on the Great Depression with Milton Friedman, told the Wall Street journal that **the Fed's entire strategy in dealing with the financial crisis is wrong**. Specifically, the Fed is treating it as a *liquidity* problem, when it is really an *insolvency* crisis.

Moreover, prominent Wall Street economist Henry Kaufman says that the Federal Reserve is primarily to blame for the financial crisis:

"I am convinced that the misbehavior of some would have been much rarer — and far less damaging to our economy — if the Federal Reserve and, to a lesser extent, other supervisory authorities, had measured up to their responsibilities …

Kaufman directly criticized former Federal Reserve Chairman Alan Greenspan for not using his position to dissuade big banks and others from taking big risks.

"Alan Greenspan spoke about irrational exuberance only as a theoretical concept, not as a warning to the market to curb excessive behavior," Kaufman said. "It is difficult to believe that recourse to moral suasion by a Fed chairman would be ineffective."

Partly because the Fed did not strongly oppose the repeal in 1999 of the Depression-era Glass-Steagall Act, more large financial conglomerates that were "too big to fail" have formed, Kaufman said, citing a factor that has made the global credit crisis especially acute.

"Financial conglomerates have become more and more opaque, especially about their massive off-balance-sheet activities," he said. "The Fed failed to rein in the problem."…

"Much of the recent extreme financial behavior is rooted in faulty monetary policies," he said. "Poor policies encourage excessive risk taking."

Economist Marc Faber says that central bankers are money printers who create bubbles, and that the system would be much better now if the Fed hadn't intervened. Specifically, Faber says that – if the Fed hadn't intervened – the system would be cleaned out, the system would be healthier because debt load and burden on taxpayers would be reduced.

Economist Jane D'Arista has shown that the Fed has failed miserably at its main task: providing a "counter-cyclical" influence (that is, taking the punch bowl away before the party gets too wild).

The Fed has also failed miserably in its role as regulator of banks and their affiliates. As well-known economist James Galbraith says:

The Federal Reserve has never been an effective regulator for the straightforward reason that it is dominated by economists and bankers and not by dedicated skeptics who make bank regulation a full-time profession.

Unemployment

The Federal Reserve is mandated by law to maximize employment. The relevant statute states:

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of *maximum employment*, stable prices, and moderate long-term interest rates.

But the Fed has apparently decided to fight inflation instead of unemployment.

No wonder we're suffering depression-level unemployment.

Leverage

The Fed *says* that we should reduce leverage, but is doing everything in its power to *increase* leverage.

Specifically, the New York Federal published a report in 2009 entitled "The Shadow Banking System: Implications for Financial Regulation".

One of the main conclusions of the report is that leverage undermines financial stability:

Securitization was intended as a way to transfer credit risk to those better able to absorb losses, but instead it increased the fragility of the entire financial system by allowing banks and other intermediaries to "leverage up" by buying one another's securities. In the new, post-crisis financial system, the role of securitization will likely be held in check by more stringent financial regulation and by the recognition that it is important to prevent excessive leverage and maturity mismatch, both of which can undermine financial stability.

And as a former economist at the New York Fed, Richard Alford, wrote recently:

On Friday, William Dudley, President of FRBNY, gave an excellent presentation on the financial crisis. The speech was a logically-structured, tightly-reasoned, and succinct retrospective of the crisis. It took one step back from the details and proved a very useful financial sector-wide perspective. The speech should be read by everyone with an interest in the crisis. It highlights the often overlooked role of leverage and maturity mismatches even as its stated purpose was examining the role of liquidity.

While most analysts attributed the crisis to either specific instruments, or elements of the de-regulation, or policy action, **Dudley correctly identified the causes of the crisis as the excessive use of leverage** and maturity mismatches embedded in financial activities carried out off the balance sheets of the traditional banking system. The body of the speech opens with: "..**this crisis was caused by the rapid growth of the so-called shadow banking system** over the past few decades and its remarkable collapse over the past two years."

In fact, every independent economist has said that too much leverage was one of the main causes of the current economic crisis.

Federal Reserve Bank of San Francisco President Janet Yellen said recently that it's "far from clear" whether the Fed should use interest rates to stem a surge in financial leverage, and urged further research into the issue."Higher rates than called for based on purely macroeconomic conditions may help forestall a potentially damaging buildup of leverage and an asset-price boom".

And yet, the Fed has been and continues to be one the *biggest enablers* for increased leverage. As anyone who has looked at Mr. Bernanke and Geithner's actions will tell you, many of the government's programs are aimed at trying to re-start securitization and the "shadow banking system", and to prop up asset prices for highly-leveraged financial products.

Indeed, Mr. Bernanke said in February 2009:

In an effort to restart securitization markets to support the extension of credit to consumers and small businesses, we joined with the Treasury to announce the Term Asset-Backed Securities Loan Facility (TALF).

And he said it again in September 2009:

The Term Asset-Backed Securities Loan Facility, or TALF … has helped restart the securitization markets for various types of consumer and small business credit. Securitization markets are an important source of credit, and their virtual shutdown during the crisis has reduced credit availability for many borrowers.

As I noted in 2009, the economy is not getting better because government's policies are strengthening the parasite and killing the patient.

Fraud

Two fundamental causes of the Great Depression, and of our current economic problems, are fraud and inequality.

Fraud was one of the main causes of the Great Depression and of our current economic problems, but the Federal Reserve has done ***nothing*** to rein in fraud today.

Indeed, despite the Fed's responsibility to prevent certain types of fraud, it adopted a "see no evil" policy and winked at it. (Bernanke's predecessor as Fed chair, Alan Greenspan, adopted the non-sensical position that fraud could *never* happen, so the Fed shouldn't police for it).

The New York Federal Reserve Bank – then run by current Treasury Secretary Tim Geithner – also helped to cover up fraud. As senior S&L prosecutor and professor of economics and law William Black points out:

Mr. Geithner, as President of the Federal Reserve Bank of New York since October 2003, was one of those senior regulators who failed to take any effective regulatory action to prevent the crisis, but instead covered up its depth.

Inequality

Inequality was another major cause of the 1930s Depression and today's lousy economy, but the Fed has done nothing to even things out. Indeed, inequality is currently ***worse*** than during the Depression.

Indeed, the Fed has given trillions to the biggest banks, and virtually nothing to main street. This has gone to Wall Street bonuses and made the big banks' executives richer, but the rest of us poorer (and it hasn't help the economy).