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Ben Bernanke's Impossible Dream

The Fed's reckless notion that it can simultaneously raise inflation and lower interest rates presumes bond buyers are fools. They aren't.

By ALAN REYNOLDS

Federal Reserve Chairman Ben Bernanke may be an excellent economist, but he is not a very good bond salesman. Since his Aug. 27 speech at an annual Fed symposium in Jackson Hole, Wyo., he's been telling us that he thinks inflation is too low and long-term interest rates are too high. In a quixotic effort to "maximize employment," he's begun purchasing up to $600 billion worth of long-term Treasury obligations to push inflation up and bond yields down.

If it worked as planned, this would flatten the yield curve, meaning it would narrow the spread between short-term and long-term interest rates. Since banks make money by borrowing short and lending long, the effect would be to discourage bank lending. That seems an unpromising way to stimulate the economy. But the whole notion of simultaneously raising inflation and lowering bond yields presumes bond buyers are docile fools.

The University of Michigan survey of expected inflation has hovered around 2.7%-3.2% since the recovery began last July, aside from two low readings of 2.2% in September 2009 and September 2010. That measure of inflation expectations has been higher than it was in November 2002, when then-Fed Governor Bernanke first began fretting about "deflation." But inflation expectations are still not high enough to please the Fed chairman.

Domestic and foreign investors have reacted to the Fed's plans by driving the dollar way down and commodity prices way up, which is consistent with higher expected inflation. So too is the gap between yields on regular Treasury bonds and the inflation-protected variety (TIPS), which has widened by more than 60 basis points since late August.

At Jackson Hole, Mr. Bernanke explained that "if inflation expectations were too low . . . an increase in inflation expectations could become a benefit."

Well, he's certainly succeeded in raising inflationary expectations. But rising commodity prices and a debased dollar have proved harmful to many businesses because inflated costs mean deflated profit margins. The headlines on two recent news reports in this paper tell the tale: "Prices Squeeze Main Street: Some Retailers Are Trapped between Rising Commodity Costs and Low Inflation" (Oct. 19) and "Dilemma over Pricing: From Cereal to Helicopters, Commodity Costs Exert Pressure" (Oct. 21).

Associated Press

Federal Reserve Chairman Ben Bernanke

Producer prices rose at an annual rate of 5.5% in September and 4.8% in August. The broad price index for GDP rose at an annual rate of 2.3% in the third quarter, up from 1.9% in the second quarter and 1% in the first.

Mr. Bernanke is unconcerned, however, because he believes (contrary to our past experience with stagflation) that inflation is no danger thanks to economic slack (high unemployment). He reasons that if people can nonetheless be persuaded to expect higher inflation, regardless of the slack, that means interest rates will appear even lower in real terms. If that worked as planned, lower real interest rates would supposedly fix our hangover from the last Fed-financed borrowing binge by encouraging more borrowing.

This whole scheme raises nagging questions. Why would domestic investors accept a lower yield on bonds if they expect higher inflation? And why would foreign investors accept a lower yield on U.S. bonds if they expect exchange rate losses on dollar-denominated securities? Why wouldn't intelligent people shift their investments toward commodities or related stocks (such as mining and related machinery) and either shun, or sell short, long-term Treasurys? And if they did that, how could it possibly help the economy?

One heavily traded exchange-traded fund (ETF) provides a sensitive market forecast of how effective this quantitative easing is expected to be in reducing long-term interest rates. Trading under the ticker symbol TBT, this ProShares ETF goes ultra-short Treasury bonds with maturities of 20 years or more, making it a highly leveraged bet on the direction of long-term interest rates. If bond yields were expected to fall because of quantitative easing, then the price of TBT should fall sharply. But that is not what has been happening.

On the day Mr. Bernanke spoke in Jackson Hole, TBT closed at 31.95, up from 30.24 on Aug. 16. The Federal Open Market Committee minutes from September became public on Oct. 12, revealing that the FOMC thought "Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment." TBT rose to 32.32 on the news, up from 31.64 the day before.

On Oct. 15, Mr. Bernanke gave another speech, at the Boston Fed, saying, "Inflation is running at rates that are too low . . . and the risk of deflation is higher than desirable." TBT rose again to 34.17, up from 33.34. On Nov. 3, when the scope of the Fed's long-term Treasury purchase plan was revealed, TBT jumped from 32.69 at 2:12 p.m. (EST), just before the news was released, to 34.99 by 3:34 p.m. (TBT closed Monday at 34.99.) If the Fed's plan really portends a sustainable reduction in long-term rates ahead, TBT should have moved in the opposite direction. When technocrats and markets disagree, it is rarely wise to bet against the markets.

There is ample evidence from commodity and foreign-exchange markets that world investors are indeed confident the Fed will raise inflation. However, the growing interest in shorting long-term Treasury bonds shows that the market does not believe higher inflation is consistent with lower long-term interest rates.

In other words, Mr. Bernanke and his FOMC allies are risking higher interest rates and inflated commodity costs in the pursuit of the contradictory objectives of higher inflation and lower bond yields, seemingly oblivious to all the evidence that they are pursuing an impossible dream.

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