

## Bernanke's Impossible Dilemma

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Imagine the challenge Ben Bernanke faces.

His goal is to provide full employment and price stability. Yet he faces a slowly growing economy, unemployment close to 10%, consumers deleveraging and spending frugally, renewed fears of banking system instability, and the threat of an asset bubble is growing somewhere in the markets. Monetary and fiscal policy options have been seemingly exhausted, and the public is losing confidence in all aspects of government.

How Bernanke might address those challenges was the focus of a keynote address by David Wessel at last week's Financial Planning Association conference in Denver. Wessel is the economics editor of *The Wall Street Journal* and the author of *In Fed We Trust*, a study of Bernanke's handling of the recent crisis.

Wessel considers Bernanke a hero for his handling of the crisis, but he offered few words of optimism when discussing how the Fed chairman might tackle the problems now confronting him. I'll review Wessel's assessment of the likely path of Fed policy, but first let's look what earned Bernanke the "hero" accolade.

### Bernanke's handling of the crisis

When Milton Friedman turned ninety years old, Wessel said, there was a birthday party for him at the University of Chicago. Bernanke, who was then a governor at the Federal Reserve, spoke to Friedman. "You're right," the current chairman is said to have told the great economist. "The Great Depression was our fault. Because of you, we won't do it again."

That conviction to avoid a repeat of the 1930s explains many of Bernanke's actions in the current crisis.

Bernanke served as George W. Bush's Chairman of the Council of Economic Advisors, eventually succeeding Alan Greenspan as Fed chair. Bernanke's expertise on the Depressions was a non-factor in his selection for the post, according to Wessel. Bush wanted a safe choice that would easily win approval, having just failed in his nomination of Harriet Miers to the Supreme Court.





After a largely uneventful first year as Fed Chairman, Bernanke and Treasury Secretary Henry Paulson entered a stage that Wessel called “the great denial.” “They didn’t understand what was happening to the economy and to the housing market, particularly at the end of 2007,” Wessel said. “They had, what you might call, a failure of imagination.” That failure was, of course, their ignorance of the bet being made across global financial markets that housing prices would never go down.

By the end of 2007, markets had unraveled, and Bernanke realized his error. He moved quickly and effectively, according to Wessel, by cutting interest rates and providing the liquidity necessary to keep markets operating.

Next came the failure of Bear Stearns, which Bernanke decided the markets could not handle, Wessel said. Using powers given to the Fed during the Depression to lend under unusual and exigent circumstances, Bernanke deftly orchestrated the purchase of Bear Stearns by J.P. Morgan.

In the following months, Wessel said Bernanke was remiss in not taking advantage of the “pause in the chaos” to prepare for what happened in the fall of 2008 – the merger of Merrill Lynch with Bank of America and the failure of Lehman Brothers.

Wessel said Lehman’s failure was a mistake to which Bernanke wouldn’t admit. The key reason Bernanke allowed Lehman to fail, according to Wessel, was his belief that he lacked the legal authority to rescue it, but a couple of days later the Fed found justification to bail out AIG, in part, Wessel said, because Bernanke was afraid to let another large financial institution go under.

Wessel said we are lucky the Fed was the “first responder.” Despite several big mistakes, he added, “they got most of the big decisions right.”

TARP, for which Bernanke lobbied, was never used for its original intended purpose of buying troubled assets, but, Wessel said, it stabilized the system. Bernanke was an outspoken advocate of the stimulus and the bank stress tests, which Wessel said were important in maintaining stability and public confidence.

“In my book,” Wessel said, “Bernanke is something of a hero here. “ Most Americans wrongly believe Bernanke bailed out Wall Street, according to Wessel, but in reality he acted to save Main Street – which was the essence of his work on the Great Depression.

Unfortunately, Wessel said, most Americans don’t comprehend or believe that Bernanke’s decisions were made with them in mind.

### **Confronting today’s problems**



That disbelief leads us to the situation today. Wessel said the public is unsurprisingly and justifiably angry. Public confidence in the Fed and other government institutions has rapidly diminished, Wessel said. He cited a Gallup poll that found that more people believe the IRS does a good job than the Fed.

The Fed and most economists are now forecasting unemployment above and inflation below the Fed's targets. Bernanke has kept interest rates at zero and, Wessel said, is well aware of the potential for unintended consequences. "When people can borrow money for nothing, and they can get a yield somewhere else, they tend to do that whether the something else makes a lot of sense" or not, he said.

Bernanke can buy more assets above and beyond the \$1.7 trillion of mortgage-backed securities and Treasury bonds the Fed has already purchased. Bernanke, according to Wessel, knows that the effects of doing so are very uncertain, given that Bernanke doesn't really know how much long-term rates were pushed down by the first round of quantitative easing.

One option is to raise inflation expectations, which would depress real yields and incent investors to move into riskier assets. But, Wessel said, that "scares the bejesus" out of Bernanke, presumably because he fears that could ignite runaway inflation. He doesn't think Bernanke will choose that course.

Bernanke knows there is \$1.8 trillion of cash on corporate balance sheets, more percentage-wise than at any time since 1963. Neither that nor the banks' cash on the Fed's balance sheet has entered the commercial sphere, and, Wessel said, Bernanke realizes that if zero interest rates were going to do the trick, they would have done so already.

The net effect of the Fed's experimentation in policy measures has been a loss of confidence in the people who run our economy, Wessel said.

Few fiscal policy options are available, he said. Americans want more benefits than they are willing to pay for in taxes, "and the politicians are unable to deal with that contradiction."

Indeed, it is the political environment that poses the greatest challenges. Here's what Wessel said:

When the pendulum swings one way, the crowd that is in charge misinterprets what they got as a mandate for their platform. People voted for Barack Obama and the Democrats because they wanted change, not because they moved to the left. A lot of them are going to vote for the Republicans this fall, not because they buy the Republican agenda, whether it is the Tea Party agenda or the mainstream Republican agenda, but



because they want change. I suspect the Republicans will make the same mistake and misinterpret that as a mandate for their agenda, if you can figure out what it is.

Some among a committee of Bernanke's 19 closest advisors, which includes the seven governors of the Federal Reserve system, are arguing for less aggressive policies, but Wessel said Bernanke is siding with the other camp, who are clearly on the side of doing more, even if it is "bigger doses of the same medicine" (i.e., more quantitative easing). One of the reasons Bernanke is going to get aggressive, Wessel said, is because he's nervous the politicians can't deliver.

Wessel noted a poignant piece of irony: Two years ago, he said, nobody would have expected that Obama would turn out to be great at legislative tactics and getting things through Congress but lousy at communicating. "But that is kind of where we are," he said.

Ultimately, Wessel said, the "secret" plan to restart the economy is to cheapen the dollar to drive exports. In theory, he said, it will work, as it did for emerging markets. In practice, though, it faces enormous hurdles, as the Chinese and Japanese will be unwilling to let their currencies appreciate.

In the short term, Wessel said, Bernanke will buy more Treasury bonds. That plan will be implemented gradually, in increments of \$75 to \$100 billion per month for the next six months, after which the Fed will reevaluate it. That approach may prove risky, Wessel said, because expectations may be for a more aggressive plan.

Wessel said the Bush tax cuts will be extended for two years, at least for those earning less than \$250,000 per year, and that some form of tax relief for small businesses will pass. But he doesn't expect any progress on the far more serious issue of budget deficits, except perhaps a promise from the deficit commission to deal with Social Security in the next six to nine months.

### **A dim outlook**

Wessel said, plainly and clearly, that the economy is not healthy. Most people thought that we would have clarity by now, consumer spending would have picked up, government support would be waning, and businesses would be hiring.

None of that happened.

Nor is this a great time to have gridlock in Washington. "We are not going to fix the deficit by a whole bunch of people disagreeing for the next six years," Wessel said.



Most will acknowledge that we need to do something with taxes and entitlements, Wessel said, but nobody can say how to get from this “irrefutable fact” to any action from our leadership.

“The problem is lack of national will in a weak economy – one that can't compete with the Chinese in combination with borrowing a lot of money from them.”

“We’re in a very treacherous situation in a very delicate moment,” Wessel concluded.

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