# Monetary Misjudgments and Malfeasance

*Steve H. Hanke*

The Federal Reserve has a long history of creating aggregate demand bubbles in the United States (Niskanen 2003, 2006). In the ramp up to the Lehman Brothers' bankruptcy in September 2008, the Fed not only created a classic aggregate demand bubble, but also facilitated the spawning of many market-specific bubbles. The bubbles in the housing, equity, and commodity markets could have been easily detected by observing the price behavior in those markets, relative to changes in the more broadly based consumer price index. True to form, the Fed officials have steadfastly denied any culpability for creating the bubbles that so spectacularly burst during the Panic of 2008–09.

If all that is not enough, Fed officials, as well as other members of the money and banking establishments in the United States and elsewhere, have embraced the idea that stronger, more heavily capitalized banks are necessary to protect taxpayers from future financial storms. This embrace, which is reflected in the Bank for International Settlements' most recent capital requirement regime (Basel III) and related country-specific capital requirement mandates, represents yet another great monetary misjudgment (error). Indeed, in its stampede to make banks "safer," the establishment has paradoxically rendered the economies of the Eurozone, the United Kingdom, and the United States—among others—weaker and, therefore, less "safe" (Hanke 2011).

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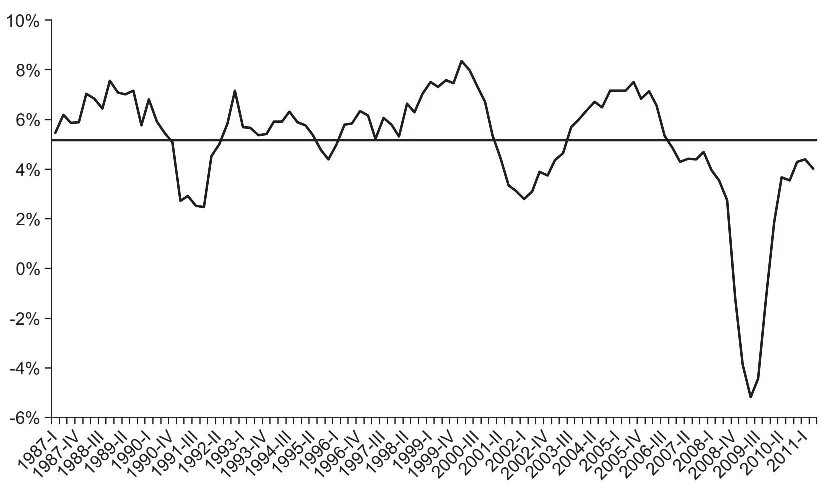
## Aggregate Demand Bubbles

Just what is an aggregate demand bubble? This type of bubble is created when the Fed's laxity allows aggregate demand to grow too rapidly. Specifically, an aggregate demand bubble occurs when nominal final sales to U.S. purchasers (GDP − exports + imports − change in inventories) exceed a trend rate of nominal growth consistent with "moderate" inflation by a significant amount.

During the 24 years of the Greenspan-Bernanke reign at the Fed, nominal final sales grew at a 5.2 percent annual trend rate. This reflects a combination of real sales growth of 3 percent and inflation of 2.2 percent (Figure 1). But, there were deviations from the trend.

The first deviation began shortly after Alan Greenspan became chairman of the Fed. In response to the October 1987 stock market crash, the Fed turned on its money pump and created an aggregate demand bubble: over the next year, final sales shot up at a 7.5 percent rate, well above the trend line. Having gone too far, the Fed then lurched back in the other direction. The ensuing Fed tightening produced a mild recession in 1991.

FIGURE 1
Final Sales to Domestic Purchasers,
1987 Q1 to 2011 Q2 (Annual Percentage Change)




Note: FSDP = GDP + Import − Export − Δ Inventory.
Source: Bureau of Economic Analysis, U.S. Department of Commerce.

During the 1992–97 period, growth in the nominal value of final sales was quite stable. But, successive collapses of certain Asian currencies, the Russian ruble, the Long-Term Capital Management hedge fund, and the Brazilian real triggered another excessive Fed liquidity injection. This monetary misjudgment resulted in a boom in nominal final sales and an aggregate demand bubble in 1999–2000. That bubble was followed by another round of Fed tightening, which coincided with the bursting of the equity bubble in 2000 and a slump in 2001.

The last big jump in nominal final sales was set off by the Fed's liquidity injection to fend off the false deflation scare in 2002 (Beckworth 2008). Fed Governor Ben S. Bernanke (now chairman) set off a warning siren that deflation was threatening the U.S. economy when he delivered a dense and noteworthy speech before the National Economists Club on November 21, 2002 (Bernanke 2002). Bernanke convinced his Fed colleagues that the deflation danger was lurking. As Greenspan put it, "We face new challenges in maintaining price stability, specifically to prevent inflation from falling too low" (Greenspan 2003). To fight the alleged deflation threat, the Fed pushed interest rates down sharply. By July 2003, the Fed funds rate was at a then-record low of 1 percent, where it stayed for a year. This easing produced the mother of all liquidity cycles and yet another massive demand bubble.

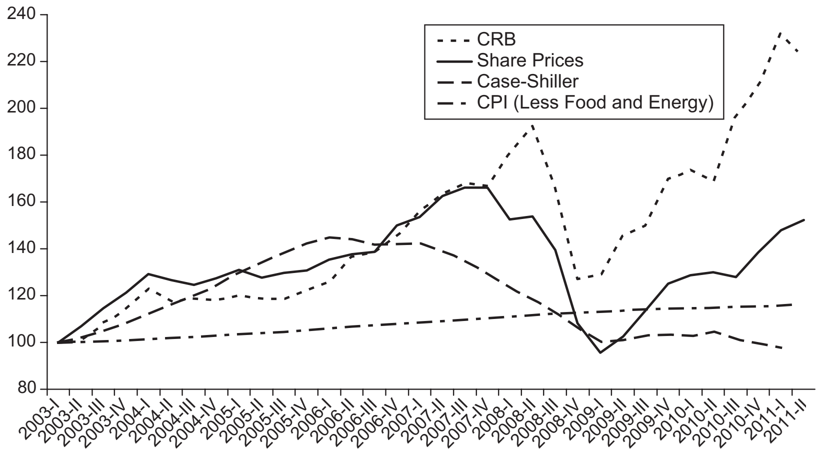
During the Greenspan-Bernanke years, and contrary to their claims, the Fed overreacted to real or perceived crises and created three demand bubbles. The last represents one bubble too many—and one that is impacting us today.

## Market-Specific Bubbles

The most recent aggregate demand bubble was not the only bubble that the Fed was facilitating. As Figure 2 shows, the Fed's favorite inflation target—the consumer price index, absent food and energy prices—was increasing at a regular, modest rate. Over the 2003–08 (Q3) period, this metric increased by 12.5 percent.

The Fed's inflation metric signaled "no problems." But, abrupt shifts in major relative prices were underfoot. Housing prices, measured by the Case-Shiller home price index, were surging, increasing by 45 percent from the first quarter in 2003 until their peak in the first quarter of 2006. Share prices were also on a tear, increasing by

FIGURE 2
Price Indexes




Sources: International Monetary Fund, *International Financial Statistics*; Federal Reserve Bank of St. Louis; Standard and Poor's; Bloomberg; and author's calculations.

66 percent from the first quarter of 2003 until they peaked in the first quarter of 2008.

The most dramatic price increases were in the commodities, however. Measured by the Commodity Research Bureau's spot index, commodity prices increased by 92 percent from the first quarter of 2003 to their pre-Lehman Brothers peak in the second quarter of 2008.

The dramatic jump in commodity prices was due, in large part, to the fact that a weak dollar accompanied the mother of all liquidity cycles. Measured by the Federal Reserve's Trade Weighted Exchange Index for major currencies, the greenback fell in value by 30.5 percent from 2003 to mid-July 2008. As every commodity trader knows, all commodities, to varying degrees, trade off changes in the value of the dollar. When the value of the dollar falls, the nominal dollar prices of internationally traded commodities—like gold, rice, corn, and oil—must increase because more dollars are required to purchase the same quantity of any commodity.

Indeed, in my July 2008 testimony before the House Budget Committee on "Rising Food Prices: Budget Challenges," I estimated that the weak dollar was the major contributor to what then, only a few months before the collapse of Lehman Brothers, was viewed as the world's most urgent economic problem: world-record commodity prices. My estimates of the depreciating dollar's contribution to surging commodity prices over the 2002–July 2008 period was 51 percent for crude oil and 55.5 percent for rough rice, two commodities that set record-high prices (nominal) in July 2008 (Hanke 2008).

Before leaving the market-specific bubbles, two points merit mention. First, the relative increase in housing prices was clearly signaling a bubble in which prices were diverging from housing's fundamentals. A simple "back-of-the-envelope" calculation confirms a bubble. The so-called demographic "demand" for housing in the U.S. during the first decade of the 21st century was about 1.5 million units per year. This includes purchases of first homes by newly formed families, purchases of second homes, and the replacement of about 300,000 units per year that have been lost to fire, floods, widening of highways, and so forth (Aliber 2010). During the bubble years 2002–06, housing starts were two million per year. In consequence, an "excess supply" of about 500,000 units, or 25 percent of the annual new starts, was being created each year. These data suggest that housing prices in the 2002–06 period should have been very weak, or declining. Instead, they increased by 45 percent. The Fed, even according to the minutes of the Federal Open Market Committee of June 2005, failed to spot what was an all-too obvious housing bubble (Harding 2011).

A second point worth mentioning is that, while operating under a regime of inflation targeting and a floating U.S. dollar exchange rate, Chairman Bernanke has seen fit to ignore fluctuations in the value of the dollar. Indeed, changes in the dollar's exchange value do not appear as one of the six metrics on "Bernanke's Dashboard"—the one the chairman uses to gauge the appropriateness of monetary policy (Wessel 2009: 271). Perhaps this explains why Bernanke has been dismissive of questions suggesting that changes in the dollar's exchange value influence either commodity prices or more broad gauges of inflation (McKinnon 2010, Reddy and Blackstone 2011).

It is remarkable that the steep decline in the dollar during the 2002–July 2008 period and associated surge in commodity prices, the subsequent surge in the dollar's value after Lehman Brothers collapsed and associated plunge in commodity prices, and the renewed decline in the dollar's exchange rate after the first quarter of 2009 and associated new surge in the CRB spot index (Figure 2) has left

Fed officials in denial. Indeed, they continue to be stubbornly blind to the fact that there is a link between the dollar's exchange value and commodity prices (Reddy and Blackstone 2011).

## Malfeasance

For most masters of money, it is all about an inflation target. As long as they hit a target, or come close to it, they are defended from all sides by members of the establishment (Blinder 2010, Mankiw 2011). It is as if nothing else matters. The deputy governor of the world's first central bank (Sweden's Riksbank) and a well-known pioneer of inflation targeting made clear what all the inflation-targeting central bankers have in mind:

> My view is that the crisis was largely caused by factors that had very little to do with monetary policy. And my main conclusion for money policy is that flexible inflation targeting—applied in the right way and in particular using all the information about financial conditions that is relevant for the forecast of inflation and resource utilization at any horizon—remains the best-practice monetary policy before, during, and after the financial crisis [Svensson 2010: 1].

For central bankers, the "name of the game" is to blame someone else for the world's economic and financial troubles (Bernanke 2010, Greenspan 2010). How can this be, particularly when money is at the center?

To understand why the Fed's fantastic claims and denials are rarely subjected to the indignity of empirical verification, we have to look no further than the late Nobelist Milton Friedman. In a 1975 book of essays in honor of Friedman, *Capitalism and Freedom: Problems and Prospects*, Gordon Tullock (1975: 39–40) wrote:

> It should be pointed out that a very large part of the information available on most government issues originates within the government. On several occasions in my hearing (I don't know whether it is in his writing or not but I have heard him say this a number of times) Milton Friedman has pointed out that one of the basic reasons for the good press the Federal Reserve Board has had for many years has been that the Federal Reserve Board is the source of 98 percent of all writing on the

> Federal Reserve Board. Most government agencies have this characteristic.

Friedman's assertion has subsequently been supported by Lawrence H. White's research. In 2002, 74 percent of the articles on monetary policy published by U.S. economists in U.S.-edited journals appeared in Fed-sponsored publications, or were authored (or co-authored) by Fed staff economists (White 2005, Grim 2009).

For powerful and uncompromising dissidents, the establishment can impose what it deems to be severe penalties. For example, after the distinguished monetarist and one of the founders of the Shadow Open Market Committee Karl Brunner was perceived as a credible threat, he was banned from entering the premises of the Federal Reserve headquarters in Washington, D.C. Security guards were instructed to never allow Brunner to enter the building. This all backfired. Indeed, the great Brunner confided to Bill Barnett that the ban had done wonders for his career (Barnett 2006: xiii). Alas, most money and banking professionals would, unlike Brunner, find a Fed ban to be a burden they could not bear.

## Misjudgments, Again

As part of the money and banking establishment's blame game, the accusatory finger has been pointed at commercial bankers. The establishment asserts that banks are too risky and dangerous because they are "undercapitalized." It is, therefore, not surprising that the Bank for International Settlements, located in Basel, Switzerland, has issued new Basel III capital rules. These will bump banks' capital requirements up from 4 percent to 7 percent of their risk-weighted assets. And if that is not enough, the Basel Committee agreed in late June to add a 2.5 percent surcharge on top of the 7 percent requirement for banks that are deemed too-big-to-fail. For some, even these hurdles aren't high enough. The Swiss National Bank wants to impose an ultra-high 19 percent requirement on Switzerland's two largest banks, UBS and Credit Suisse. In June, the upper chamber of the Swiss Parliament approved that rate. In the United States, officials from the Fed and the Federal Deposit Insurance Corporation are also advocating capital surcharges for "big" banks (Braithwaite and Simonian 2011).

The oracles of money and banking have demanded higher capital-asset ratios for banks—and that is exactly what they have received.

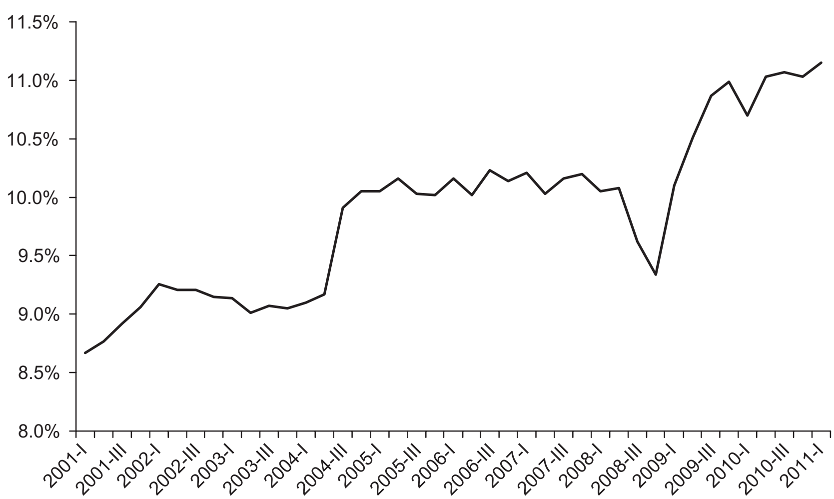
Just look at what has happened in the United States. Since the onset of the Panic of 2008–09, U.S. banks have, under political pressure and in anticipation of Basel III, increased their capital-asset ratios (Figure 3).

The oracles have erupted in cheers at the increased capital-asset ratios. They assert that more capital has made the banks stronger and safer. While at first glance that might strike one as a reasonable conclusion, it is not (Dowd, Hutchinson, and Hinchliffe 2011).

For a bank, its assets (cash, loans, and securities) must equal its liabilities (capital, bonds, and liabilities which the bank owes to its shareholders and customers). In most countries, the bulk of a bank's liabilities (roughly 90 percent) are deposits. Since deposits can be used to make payments, they are "money." Accordingly, most bank liabilities are money.

To increase their capital-asset ratios, banks can either boost capital or shrink assets. If banks shrink their assets, their deposit liabilities will decline. In consequence, money balances will be destroyed. So, paradoxically, the drive to deleverage banks and to shrink their balance sheets, in the name of making banks safer, destroys money balances. This, in turn, dents company liquidity and asset prices. It

FIGURE 3
U.S. Banks' Capital-Asset Ratios




Note: A bank's capital-asset ratio is its total equity relative to its total assets.
Source: Federal Reserve Bank of St. Louis.

also reduces spending relative to where it would have been without higher capital-asset ratios.

The other way to increase a bank's capital-asset ratio is by raising new capital. This, too, destroys money. When an investor purchases newly issued bank equity, the investor exchanges funds from a bank deposit for new shares. This reduces deposit liabilities in the banking system and wipes out money.

By pushing banks to increase their capital-asset ratios to allegedly make banks stronger, the oracles have made their economies (and perhaps their banks) weaker.

UK economist Tim Congdon convincingly demonstrates in *Central Banking in a Free Society* (2009) that the ratcheting up of banks' capital-asset ratios ratchets down the growth in broad measures of the money supply. And, since money dominates, it follows that economic growth will take a hit, if banks are forced to increase their capital-asset ratios.

The capital-raising mania in the United States and its consequences are clear. While the high-powered base money (M0) has exploded since the Panic of 2008–09, broad money (M3) has taken a different, and worrying, course (Figure 4).

FIGURE 4
U.S. Broad Money (M3)
(Annual Growth Rate)


Source: Shadow Government Statistics.

The oracles' embrace of higher capital-asset ratios for banks in the middle of the most severe slump since the Great Depression has been a great blunder. While it might have made banks temporarily "stronger," it has contributed mightily to plunging money supply metrics and very weak economic growth. Until the oracles come to their senses and reverse course on their demands for ever-increasing capital-asset ratios, we can expect continued weak (or contracting) money growth, economic weakness, increasing debt problems, continued market volatility, and a deteriorating state of confidence.

## Conclusion

Monetary misjudgments and malfeasance have characterized U.S. policy. Even though there were numerous signs that the financial systems in Europe and the United States were enduring severe stresses and strains in 2007, the money and banking oracles failed to anticipate and prepare for the major financial and economic turmoil that visited them in 2008–09. Indeed, the oracles' ad hoc reactions turned the turmoil into a panic. Since then, members of the money and banking establishment have been busy dissembling. They have hung out "not culpable" signs and pointed their powerful accusatory fingers at others.

The Fed has a propensity to create aggregate demand bubbles. These bubbles carry with them market-specific bubbles that distort relative prices and the structure of production. Contrary to the assertions of the stabilizers who embrace inflation targeting, these relative price distortions are potentially dangerous and disruptive.

If that was not enough, policymakers have latched onto a new mantra: to make banks "safe," higher capital requirements are absolutely essential. The banks have obliged and increased their capital-asset ratios. In consequence, the banks' loan books that are subject to higher capital-to-asset mandates have shrunk. With that, broad money (M3) growth rates have remained submerged and a typical post-slump economic rebound has failed to materialize.

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