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SPECIAL REPORT

Bernanke-ism: Fraud or Menace?

by Robert Blumen

Editor's Note: This speech was delivered as Ben Bernanke assumed chairmanship of the Federal Reserve. It provides a good many insights to the philosophy now driving his tenure

This talk was delivered at the Burton S. Blumert Conference on Gold, Freedom, and Peace, a benefit for LewRockwell.com.

In 2002, then-Fed Governor Benjamin Bernanke burst into our monetary consciousness with his printing press speech. His fine work earned him the honorary title "helicopter commander." While largely a background figure since then, his recent appointment to succeed Alan Greenspan as Fed chair makes this an ideal time to review Dr. Bernanke's views on monetary policy, and to speculate about what his chairmanship will bring.

Since the Fed emerged from its near-death experience in the 70s, it has largely been identified with the label "inflation fighting." Notably, Dr. Bernanke's research and speaking have dealt almost entirely with the subject of deflation. While his infamous address before the National Economists Club, titled Deflation: Making Sure "It" Doesn't Happen Here (2002) has been endlessly reported and debated, more revealing and less well known are Dr. Bernanke's many speeches on deflation between 1999 and 2004, and a series of research papers on the same subject produced by the then-Fed governor and his colleagues.

I have identified fourteen papers and speeches dealing with deflation, seven by Dr. Bernanke and seven by other Fed governors and staff economists. These materials are all available for public download on the Fed's web site. To steal a line from columnist Dave Barry, I'm not making this up. This article will cover the most important points from these articles. Since I had to read all of these, I consider myself quite fortunate that none of the speeches was by Alan Greenspan.

These writings deal with three themes: the menace of deflation, the Fed's strategy for preventing it, and their contingency plans to fight it (should their prevention efforts fail).

While Governor Bernanke is not the only member of the anti-deflation wing at the Fed, the Chair apparent has emerged as the most prominent advocate of this new agenda. His leadership merits the name "Bernankeism" for this policy program.

Upon reading the source materials, three main tenets of Bernankeism emerged. I will describe them and illustrate with examples in the Fed's own words. The three are: prevention is better than cure, learn the lessons of history, and the possibility of "unconventional measures."

The first principle of Bernankeism is that it is better to prevent deflation than to attempt a cure after the disease has set in.

The basis of the Bernanke school's thinking on deflation is the standard (mainstream) macro-economic view that consumer spending (not saving) drives economic activity, and that insufficient consumer spending is the cause of recessions. According to this view, when recession strikes, inflation is called for.

Inflation works in three ways. One, by lowering real prices when nominal prices are for some reason "stuck" at above-market-clearing levels; and two, and by threatening a continued erosion in the purchasing power of cash, inflation motivates anti-social cash hoarders to spend, thus providing the missing stimulant to economic activity. A third is through so-called "wealth effects": when asset prices inflate, people misperceive the inflation as true wealth and then increase their spending.

Deflation is so dangerous, according to Dr. Bernanke because it is a self-reinforcing process that is very difficult to reverse once it has begun. They start from the true observation that when people spend less, prices fall. They then reason that when prices fall, people become increasingly reluctant to spend because they anticipate that prices will continue to fall. People start to hoard cash, planning to buy tomorrow when things are cheaper. The less people spend, the more prices fall, and the more that people hoard. In the grip of cash hoarding, according to Bernankeism, the entire economy would spiral down as all spending ground to a halt. This is why they think that deflation is like a chronic illness.

For an example of this view, I will cite the research paper titled Monetary Policy and Price Stability (1999) (by Fed research staffers):

If economic activity is weak or contracting and interest rates hit the zero bound, a dangerous dynamic can be set in motion. Falling inflation, or even escalating deflation, would increase real rates of interest. As this depresses aggregate demand further, downward pressures on prices would raise real interest rates further: The economy would potentially face a downward deflationary spiral.

Governor Bernanke and his accomplices are obsessed with something known as "the zero bound problem." Eight of the fourteen papers and speeches that I examined deal with this problem either as their main point or in passing.

The zero bound comes about as follows. The Fed commissars concern themselves largely with controlling a single rate of interest, the Fed Funds rate. This rate can be lowered only to near zero, but not to zero or below, because no one would buy a bond that had a zero or negative yield; they would hold cash instead. This poses a problem for the central banker bent on inflation: if the Fed Funds rate hit zero (or near-zero as it did with Japan), inflation cannot be accelerated by cutting the Fed Funds rate. In these circumstances, the Fed's inflation program would be frustrated.

For this reason, Bernankeism advises the central bank to avoid the zero bound problem by creating a constant state of pleasant and benign inflation of around 2--3%. This will keep the economy a safe distance away from the dangerous precipice beyond which lies deflation, and gives the Fed room to cut rates.

For an example of their thinking, I cite a speech titled An Unwelcome Fall in Inflation (2003). Dr. Bernanke states:

I hope we can agree that a substantial fall in inflation at this stage has the potential to interfere with the ongoing U.S. recovery, and that in conceivable -- though remote -- circumstances, a serious deflation could do significant economic harm. Thus, avoiding a further substantial fall in inflation should be a priority of monetary policy. To my mind, the central import of the May 6 statement is that the Fed stands ready and able to resist further declines in inflation; and -- if inflation does fall further -- to ensure that the decline does not impede the recovery in output and employment.

The second principle of Bernankeism is that central bankers must heed the lessons of history. According to the papers and speeches, the Fed's fear of deflation is based the two great 20th-century failures of central banks to inflate: America's Great Depression and the Case of Japan in the 90s.

Dr. Bernanke accepts Milton Friedman's theory of the Great Depression. In the Friedman view, a contraction of the money supply brought about by loan defaults and then bank failures turned what would have been an ordinary recession into the Great Depression. This catastrophe could have been avoided had Fed inflated sufficiently. The Friedmanites depict a Federal Reserve System ideologically paralyzed by the so-called liquidationists.

Our next Fed chair, in a speech given in the honor of Milton Friedman (2002), expressed contrition on behalf of central bankers everywhere in saying, "I would like to say to Milton and Rose: Regarding the Great Depression. You're right, we [the Fed] did it [caused the Depression]. We're very sorry. But thanks to you [Friedman], we won't do it again." The Fed has learned its lesson.

The failure of Japan's central bank to inflate its economy out of the mess following the bursting of the 1980s stock and real estate bubbles comes in a close second to the Depression in the Bernanke manual for deflation fighters. Four of the 14 Fed speeches deal mostly or entirely with Japan's attempt to inflate its way out of a series of recessions that followed their bust. Despite successive Keynesian-stimulus public-works programs (that have nearly paved the entire island of Japan into a parking lot), and several years of a near-zero short-term interest rate, and a massive program of foreign exchange intervention that has left the BOJ holding hundreds of billions of dollars worth of US Treasuries, the BOJ has been unable to generate much inflation at all.

To cite one of many examples, in a speech titled Preventing Deflation: Lessons from Japan's Experience in the 1990s (2002) (a paper by four Fed staff economists) we read:

We conclude that Japan's sustained deflationary slump was very much unanticipated by Japanese policymakers and observers alike, and that this was a key factor in the authorities' failure to provide sufficient stimulus to maintain growth and positive inflation. Once inflation turned negative and short-term interest rates approached the zero-lower-bound, it became much more difficult for monetary policy to reactivate the economy.

The term "conventional measures" figures prominently in much of the Fed's discussion. "Conventional measures" is a term from the central banker's dictionary. These measures consist of essentially two things: controlling the short-term Fed Funds rate and purchase and sale by the Fed of government securities by its so-called Open Market Committee.

The lesson of Japan, according to Bernankeism is that when the powers of a central bank are limited to "conventional measures," the central bank may not be able to prevent deflation, nor to fight it once it has taken hold. In the Fed's view, Japan tried conventional inflation measures to their utmost. However, because the deflation caught them by surprise or perhaps due to the inherent limitations of conventional measures, the BOJ's efforts were too little, too late.

The third principle of Bernankeism is the necessity of "unconventional measures."

Inflation is always the answer (according to these thinkers), but, they are afraid that it may nearly be impossible to bring it about when they most need it. Suppose that the Fed found itself fighting a stubborn deflation. If conventional measures had been tried and failed, and with the US on the brink of following Japan down the road to a long and painful deflationary morass, what would be the alternative?

I quote Dr. Bernanke himself from a paper titled Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment (2004). When the economy is at the zero bound, "a central bank can no longer stimulate aggregate demand by further interest-rate reductions and must rely on 'non-standard' policy alternatives." What does he mean by "non-standard"? This is what passes for "thinking outside of the box" among central bankers.

The reader of the Fed's papers and speeches will find a series of increasingly exotic plans for the dollar. From beginning to end, these methods range from the merely unsound to the bizarre and terrifying.

The paper titled Monetary Policy and Price Stability (1999) introduces some of the more mild of the so-called alternatives. The first of these tools is to expand the menu of assets that the Fed could purchase through its open market operations. The Fed's current structure limits its activities to the purchase of short-term US Treasury bonds. When the Fed can no longer lower short-term interest rates, long-term rates are the next obvious target. Among their options for lowering long bond yields are: the purchase of long-term US Treasury Bonds, writing interest rate option contracts, purchasing foreign exchange reserves (in an attempt to lower the exchange rate of the dollar), and purchasing private sector securities like stocks and bonds. The measures described in this paper would involve massive Fed intervention in US financial markets.

If the above methods were not sufficient to "simulate aggregate demand," the Fed could loan money into existence, accepting as collateral almost any private sector asset whatever. In the paper titled Monetary Policy and Price Stability, we find:

A central bank can also attempt to spur private aggregate demand by extending loans to depositories, other financial intermediaries, or firms and households. By making the loan, the central bank turns an asset that may be illiquid for the lender into a liquid asset. This may be particularly helpful in spurring aggregate demand should the financial sector be under stress and in need of liquefying its assets.

In the United States, the Federal Reserve currently lends only to depository institutions. But in contrast to the limited type of securities the Federal Reserve can purchase, it can accept as the security for a loan virtually

any security that the Federal Reserve Banks themselves deem acceptable. And in fact, the Federal Reserve accepts mortgages covering one- to four-family residences; state and local government securities; and business, consumer, and other notes. These notes can be open market securities such as corporate bonds and commercial paper or can be commercial and industrial loans extended by banks, for example.

The measures described so far rely on loaning money into existence in order to generate inflation. This channel depends on the willingness of borrowers to borrow the cheap money that the Fed prints. But what if borrowers won't borrow? Don't worry, say the Bernankeists, we will print the money and distribute it.

From the paper titled Monetary Policy When the Nominal Short-Term Interest Rate is Zero (2005), in a section with the ludicrous title Wealth Creation, we find:

In ordinary circumstances, monetary policy exerts its stimulative impact in part through increasing the financial wealth of the public -- such as producing capital gains in bond and equity markets. If, at the zero bound, the Federal Reserve had already taken what actions it could to raise bond and equity prices, it might look to other tools it has to increase the public's wealth. One tool commonly attributed to the Federal Reserve, at least in theory if not by the Federal Reserve Act, is that of conducting "money rains."

Money rains are a clean way to study theoretically the effects of increases in the supply of money. In practice, it seems a bit difficult to envision how the Federal Reserve could literally implement a money rain -- that is give money away either through directly disbursing currency to the public or by disbursing it through the banking system. The political difficulties that are likely to arise from the Federal Reserve determining the distribution of this new wealth would be daunting.

The above plan aims to decrease the value of each dollar by increasing the quantity in circulation. But what if the Fed prints but people are unwilling to spend? The next weapon in their arsenal is to make money pay a negative rate of interest. While that sounds difficult, in the paper titled Monetary Policy in a Zero-Interest-Rate Economy (2003), two Fed economists explain how:

No one would be willing to hold any asset that pays a negative nominal rate, as long as zero-interest money is available as a store of value. The strategy for eliminating the zero bound, therefore, is to make money pay a negative nominal interest rate, by imposing some type of "carry tax" on currency and deposits.

It's easy to envision such a system with regard to deposits at the Federal Reserve or transactions deposits at banks; for the most part, the technology to implement such a system is already in place. A tax or fee on Reserve deposits of 1 percent per month, for example, would mean that those deposits, in effect, pay a nominal interest rate of roughly minus 12 percent.

The technological difficulty lies mainly in imposing such a tax on currency. In the 1930s, Irving Fisher of Yale University, one of the greatest [sic] American economists,proposed such a system, in which currency had to be periodically 'stamped', for a fee, in order to retain its status as legal tender. The stamp fee could be calibrated to generate any negative nominal interest rate that the central bank desired.

If "aggregate demand" has not been sufficiently stimulated by the above measures, the Bernanke Fed stands ready to play its final card: the direct monetization of goods and services. From the same paper, under the heading The Goods and Services Solution, we read:

Why not have the Fed just conduct an open market purchase of real goods and services? Even more so than exchange rate intervention, this strategy would represent a direct stimulus to aggregate demand.

As posed, though, the strategy has a major drawback: it violates the Federal Reserve Act. The Fed isn't authorized to purchase goods and services, apart from those needed for the operation of the Federal Reserve System.

The strategy can be implemented, however, by coordination with fiscal policy-makers. The Federal government, for example, could purchase goods and services and finance the purchase with new debt, which the Fed in turn would buy -- in technical terminology, the Fed would 'monetize' the resulting debt.

By coordinating with fiscal policy, the Fed could even implement what is essentially the classic textbook policy of dropping freshly printed money from a helicopter.

My final example is from a story that ran in The Financial Times (March 25, 2002). The paper reported:

The US Federal Reserve in January considered a variety of "unconventional" emergency measures to be taken if cutting short-term interest rates failed to arrest a US recession and prevent Japanese-style deflation. One of those steps may have been a plan to buy US stocks.

According to the reporter, an unnamed source was quoted as follows:

the Fed "could theoretically buy anything to pump money into the system" including "state and local debt, real estate and gold mines -- any asset."

These "unconventional measures" all have two things in common: one, that they are more inflationary than the conventional central bank policies; two, that they are among the most absurd, bizarre, and preposterous monetary crank schemes ever proposed by anyone calling themselves an economist. Not to mention that some of these plans are illegal (according to existing Fed regulations), though who doubts that in a crisis, this would be ignored?

Setting that aside, the question remains: Do they really mean it? Or is this just a lot of musings by academic economists with time on their hands? Too many boys with toys? Is Bernankeism a serious plan? Or is it an orchestrated propaganda campaign?

In attempting to answer that question, we must not forget that everything the Fed says must be looked at as propaganda. In the realm of media relations there is surely no body on the planet whose utterances are more scrutinized than the Fed. The mere possibility of the removal of the word "measured" from the statements accompanying recent rate increases has spawned an entire body of analysis and commentary. A Google search on "removal of the word measured" yields over 500 hits.

The Fed is well aware of this and it can only be assumed that calculation plays a large part in their artifice. Every statement by a Fed governor is without doubt carefully crafted and vetted as a part of its overall message. The Fed's management of the media, dubbed by some the "Open-Mouth Committee," is a key part of the manipulation of public opinion that preserves the Fed mystique.

Even the Fed itself is not secretive about their use of opinion management. One of Bernanke's papers, Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment enumerates "using communications policies to shape public expectations about the future course of interest rates" as one of the three main types of non-standard policies. And in Central Bank Talk and Monetary Policy, we read:

Although effective communication by the central bank is always important, it becomes especially important when the rates are near zero. Indeed, when the proximity of the zero bound prevents further rate cuts to stimulate the economy, talking about future policy actions may be one of the few tools at the central bank's disposal by which to influence conditions in financial markets.

However, because something is propaganda does not mean that it is a deliberate untruth. As Rothbard wrote:

To achieve a regime of big government and government control, power elites cannot achieve their goal of privilege through statism without the vital legitimizing support of the supposedly disinterested experts and the professoriat. To achieve the Leviathan State, interests seeking special privilege, and intellectuals offering scholarship and ideology, must work hand in hand.

Austrian economist Joseph Salerno has written that modern macro-economics is a "fiat profession," a manufactured discipline whose purpose is to legitimize inflation, and whose development has been funded by the same state that benefits from inflation.

Seventy years after Keynes, macro-economic inflationism has become so entrenched in the economics profession that all university-trained economists were taught this. When false ideologies have been sufficiently entrenched, propaganda no longer depends on deliberate lies. Sincerely held beliefs by properly trained experts are sufficient. Dr. Bernanke is most probably a true believer. Unlike Alan Greenspan, who got his start as a forecaster and consultant before becoming a government employee, Dr. Bernanke is a leading figure in the fiat macro profession, and his eminence in this academic field pre-dates his appointment to the Fed.

I have no doubt that the authors of these papers would like to implement their plans, if the conditions played out the way that their theories describe. But how likely is this to happen? Not very. When the Fed first started talking about deflation, interest rates were at generational lows and the economy was in the midst of a post-bubble recession.

While the media and much of the financial markets fell for what can now be seen clearly in retrospect as a deflation scare, there was no deflation. A few Austrians and assorted contrary thinkers have pointed out that the Greenspan era been one of rampant inflation. The inflation of our time has produced asset bubbles, rather than rising consumer prices. Even at the time of the 2002 deflation scare, the housing bubble was well underway. A recent Wall Street Journal series Awash in Cash: Cheap Money, Growing Risks, documents the inflation of nearly all asset classes around the world. The second article in the series explains how timberland, formerly an obscure and uncorrelated asset class, has doubled or in some cases quadrupled over the last few years.

The economic problem that has resulted from serial asset bubbles is that the relative prices of financial assets, compared to final goods, are unsustainably high. This is Greenspan's "conundrum" of low long-term interest rates. One way or another, there must be a normalization of relative prices between credit-sensitive assets and final goods. I will call this normalization a "financial asset deflation."

There are two ways that a financial asset deflation could occur: one, a deflationary crash in financial assets that would take down stocks, housing, and blow the whole fiat money fractional reserve banking system to smithereens; the other: an accelerating consumer price inflation (or even hyperinflation), in which everything we buy gets more expensive, allowing the prices of end goods to catch up with the elevated prices of financial assets.

Some within the Fed know that they must continue to inflate or face a collapse. And when conventional measures no longer work, they must be ready to print money and buy the assets. No one knows the score better than Alan himself, who has staved off the collapse several times during his tenure by flooding the markets with liquidity when the system threatened to unravel.

Greenspan's admission of the possibility of a financial collapse was first revealed by Lawrence Parks in his book What Does Alan Greenspan Really Think? Greenspan's knowledge is also proved by the release, after the five-year sliding wall, of late 90s Fed meeting minutes. FOMC transcripts from the 1996 meetings show that, contrary to Greenspan's statements at the time to the effect that a bubble cannot be identified until it has burst, the Greenspan Fed was aware that the stock market was in a bubble.

Greenspan for years publicly denied that there could even be such a thing as a housing bubble, relying on the reasoning that housing is illiquid and all housing markets are local in nature. A recent New York Times story titled Fed Debates Pricking Housing Bubble, reports that some Fed governors have publicly dropped oblique hints that they know that the recent speculative blow-off in housing is driven by the Fed's own low interest rates.

I believe that the anti-deflation wing headed by Bernanke is telling part of the truth, but with an element of misdirection. Yes, they are worried about deflation, but relevant comparison is to Argentina, not Japan. Yes, they must stand ready to monetize anything and everything, but they are far more worried about collapsing asset bubbles than slowly falling goods and services prices. There has already been speculation that anomalously large bond purchases from Caribbean sources that have shown up in this year's flow of funds data from the Fed are a cover for Fed purchases of treasury debt.

Yet they cannot openly state that they are playing this game without risking a run on the dollar and a collapsing bond market. The fear of deflation enables them to keep the game going, at least for a while. And who better to do this than Chairman Bernanke.

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