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## Simple Ben

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Fred Sheehan's book, *Panderer to Power: The Untold Story of How Alan Greenspan Enriched Wall Street and Left a Legacy of Recession*, will be published by McGraw-Hill in November 2009.

Federal Reserve chairman Ben S. Bernanke lives in a simple world where exchanges of opinion don't exist. This, from a man who often reminds his audiences that he wrote a textbook, and a macroeconomic textbook at that. The Investopedia.com website explains that "[m]acroeconomics is focused on the movement and trends in the economy as a whole." Yet, Ben Bernanke didn't understand that the level of debt produced during the recent, mortgage-driven financial economy could never be paid back by the real (non-financial) economy. Today, his money printing segregates these two economies to an even greater degree than before the Fed imposed his MIT thesis on the world.

His macroeconomics, at least in his *Essays on the Great Depression*, is statistical. He inputs his chosen variables and outputs his solution to prevent another great depression: print more money. Bernanke doesn't consider that a future (or current) depression may take another form than Great Depression I. He appears to think that falling prices (he would

call this "deflation") is synonymous with an economic depression. Bernanke knows that debt became a greater burden as income fell in the 1930s, but his book doesn't consider, other than in side comments and footnotes, the possibility that the enormous growth of debt in the 1920s was the reason these loans couldn't be paid back in the 1930s. He is convinced that falling prices — even the *possibility* of falling prices — are the enemy and can be defeated by printing more money.

His *Essays* gives the impression of a man devoid of curiosity. A telling comment on page 6 of the book: "I am a macroeconomist rather than a historian, my focus will be on economic issues rather than details." The former head of the Princeton University economics department mentions 139 names in his *Essays* — 135 of whom are economists, mostly macroeconomists, and most having written after 1980. He never mentions or cites Robbins, Hayek, Mises or Roepke — economists who wrote in the 1930s that the cause of the debt bust in the thirties was the debt boom of the twenties. From

what I am told, this is ignorance rather than wilful exclusion — he has probably never read from these authors. Most of what he has read was produced by like-minded economists on other campuses who likewise have mostly read each others' papers and textbooks.

He writes about money, but not much about banking. He mentions only one US bank in the book, but gets its name wrong. It was the Bank of United States, not the Bank of *the* United States. A small error, but it persists in the paperback edition. (To give him his due, Bernanke noted his lack of interest in historical details.)

His input-output, money-printing theory has failed. His equations treat the banking system as a perpetual, never-varying conveyor belt. He seemed (and seems) not to understand that undercapitalised banks don't lend. Confusing banks with robots, he doesn't grasp the connection between a healthy banking system and a healthy economy. (Even odder for someone who studies the "economy as a whole", he doesn't seem to notice how finance has come to dominate

the American economy.) He expresses reverence for his mathematical findings even though his explanation of inputs leaves this non-economist wondering how he can be so sure of his conclusions. (From page 102 of his *Essays*: “[I]t is possible an additional factor such as debt deflation should be considered.”)

In Bernanke’s simple world, more numbers solve our ills. From page 5 of his *Essays*: “[B]y ... expanding ‘the data set,’ there is ‘the potential to bring the profession into agreement on the causes of the Depression.’” His essays give the impression that his real objective is to suffocate disagreement with him and his fellow apparatchiks. Bernanke’s essays cross-reference essays by Frederic Mishkin, Christina Romer, and Janet Yellen; those who dominate academia and government bureaucracies.

This lack of oxygen in economic discussion isn’t lost on an elder statesman of the field. Paul Samuelson, President Kennedy’s primary economic adviser, author of the textbook *Economics* (now in its 19th edition), and retired MIT professor, was recently interviewed by *The Atlantic*: “The 1980s trained macroeconomics — like ... Ben Bernanke and so forth — became a very complacent group, very ill adapted to meet with a completely unpredictable and new situation, such as we’ve had.... I looked up Bernanke’s PhD thesis [written when Bernanke was a student at MIT — *author’s note*], which was on the Great Depression, and I realized that when you’re writing in the 1980s, and there’s a mindset that’s almost universal, you miss a lot of the nuances of what actually happened during the depression.” (This shows why the argument of whether Bernanke should be reappointed as Fed chairman isn’t too important. A replacement would be another economist trained in the 1980s, such as Paul Samuelson’s nephew, Larry Summers.)

On February 20, 2004, Bernanke gave a speech that should have disabused any notion that he could think of the “economy as a whole”. “The Great Moderation” was the title

of his address. Bernanke offered interpretations of the “remarkable decline in the variability of both output and inflation” over the past two decades. He left no doubt that “*improved performance of macroeconomic policies, particularly monetary policy*”, should receive the Nobel Prize. [Bernanke’s italics.]

Bernanke’s “great moderation” has since exploded. He was ignorant of the financial mayhem that accompanied his economic moderation. In 2008, researchers at the IMF identified 124 international banking crises since 1970. Four were in the 1970s; 39 were in the 1980s; 74 in the 1990s; and seven this decade. The current worldwide banking crisis isn’t included. It would be premature to quantify it. Bernanke seemed — and seems — blind to how the banking system, lurching towards meltdown, had absorbed the instability that was missing from his remarkable macroeconomic data.

That speech came before his chairmanship. (He relieved Alan Greenspan on February 1, 2006.) Greenspan handed Bernanke a banking system that was possibly beyond saving. Notable though is how the excesses of the banks and brokers accelerated after Bernanke’s accession.

The nominal value of derivative contracts held by US *commercial* banks (over which the Fed has regulatory authority) leapt from \$33 trillion at the end of 1998 to \$101 trillion at the end of 2005, about the time Greenspan left office. This was roughly a 17% annual increase. By June 30, 2007, 17 months into Bernanke’s chairmanship, the nominal value had risen another 50% — to \$153 trillion.

The problems with supersonic derivatives were evident. CDO (collateralised-debt obligation) indexes were collapsing. By the end of March 2007, some of the largest vacuums that sucked in borrowers had left the mortgage business or entered bankruptcy: HSBC Mortgage Services, Ameriquest, ACC Wholesale, New Century, Wachovia Mortgage. New Century alone had made over \$60 billion in mortgage loans during 2006.

Bernanke, still living on his own planet, couldn’t see how such a turn of events might slow an economy that was driven by an increasing growth of mortgage debt. (Home mortgage debt rose by \$380 billion in 2000. In 2005, it increased by \$1.1 trillion.) On May 17, 2007, he thought all was well: “[W]e believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system.” Northern Trust economist Asha Bangalore had calculated that 43% of the rise in private payrolls between 2001 and early 2005 were housing-related jobs. Car dealers also knew better than the Fed chairman: when New Century went under, all the Lamborghini dealers in Orange County flew their flags at half-mast.

The macroeconomist (Bernanke loves referring to himself as that) not only missed the macro mortgage data; he also didn’t understand how overdrawn were those who held the mortgages. He rationalised chaos with such abstractions as the “global savings glut” while, in the same speech, he stated: “Increases in home values, together with a stock-market recovery that began in 2003, have [aided] ... [t]he expansion of U.S. housing wealth, much of it easily accessible to households through cash-out refinancing and home-equity lines of credit.” That speech was delivered in March 2005. His lesson in home economics was no more enlightened a month later: “[T]he recent capital inflow into the developed world has shown up in higher rates of home construction and in higher home prices. Higher home prices in turn have encouraged households to increase their consumption. Of course, increased rates of homeownership and household consumption are both good things.”

An adroit attendee at a November 2006 Bernanke speech would have known the banking system was a short sale: “[T]he expansion of subprime lending has

contributed importantly to the substantial increase in the overall use of mortgage credit. From 1995 to 2004, the share of households with mortgage debt increased 17 percent, and in the lowest income quintile, the share of households with mortgage debt rose 53 percent.” This was good news in Bernanke’s view, although he did advise “greater financial literacy” for “borrowers with lower incomes and education levels”.

The lowest quintile was the last group that needed a financial lesson. It was already neck deep in the muck. ACNielsen had recently published a report that described Americans as “among the world’s most cash-strapped people”. With 22% of Americans having no money left after they paid for essential living expenses, the US ranked number one among 42 countries for “saving futility”.

The rise of mortgage debt among the poorly educated was not, in itself, a reason to rein in the bankers, but Bernanke was surrounded by disturbing trends. For the period ending June 30, 2006, the Federal Deposit Insurance Commission (FDIC) reported 32% of US commercial bank assets were construction loans, land development loans, and direct mortgages. Another 11% of bank assets were mortgage securities. And who were they lending to? By July 2005, 42% of first-time home buyers were putting no money down.

In every category, bank lending was diving off the precipice. Bernanke’s banks were closing leveraged syndicated deals at an accelerating pace: from \$220 billion in 2005 to \$360 billion in 2006 to \$570 billion in the *first half* of 2007. Please note again how recklessness skyrocketed after Bernanke replaced Greenspan. Maybe the trend would have been no different, but to leave Bernanke in charge of the banking system today is a sign of senile leadership.

There was practically no spread (profit) on these leveraged deals. (Leveraged loans are made to companies with heavy debt burdens. The growing leverage in private-

equity deals needed the rising quantity of bank loans.) A novice could see the buyout binge was loading companies with unsupportable debt, since many novices lost their jobs as the companies entered bankruptcy. A non-novice, Steven Rattner, managing principal of Quadrangle Group LLC, was quoted by *Reuters* in April 2007: “Of all the bubbles, the bubble in the credit market today is one of the greatest — it is beyond any rational measure.” Did Bernanke read the newspapers?

To clarify the Fed’s authority: it has direct supervisory authority over US bank holding companies. The Fed cannot direct the banks where to lend (although, who knows what additional authority it has usurped in the past 24 hours), but, as regulator, it has the ability to halt dangerous excesses. The Fed had restricted bank credit used for acquisitions in 1980. It would have been worth the trouble to do so again. Banks wrote off \$3.8 billion of leveraged loans in 2007 and another \$54.4 billion in 2008... It is a good bet the rise of write downs from 2007 through 2011 will approximate the trajectory of new syndicated deals from 2005 through the first half of 2007.

On it went. Bernanke saw clear skies in a June 5, 2007 speech: “[W]e have not seen major spillovers from housing onto other sectors of the economy.” In October 2007, asked about collapsing derivatives (CDOs), Bernanke admitted: “I’d like to know what those damn things are worth.” This seemed a promising evolution in the chairman’s mind, yet, in the same month Bernanke told a group of central bankers and economists he didn’t know if there had been a housing bubble. (This was mentioned in a profile of Bernanke in the December 1, 2008, issue of the *New Yorker*, in which the macroeconomist’s strength appears to be administration.)

Bernanke has shown similar weaknesses when addressing some elementary economic concepts. In November 2007, Congressman Ron Paul berated Bernanke. The Fed’s loose money policy was devaluing the

dollar and causing consumer prices to rise. According to the Fed chairman, this wasn’t the case: “If somebody has their wealth in dollars, and they’re going to buy consumer goods in dollars, for the typical American, then the deval-, the decline in the dollar, the only effect it has on their buying power is it makes foreign goods more expensive.” What wasn’t a foreign good other than ham and eggs? Even these prices were rising from the energy consumed in their production and transportation, energy that was being repriced by higher economic activity in China and India. Simple Ben sounded like a theoretical physicist who doesn’t know that water boils but writes textbooks on the eighth dimension.

Bernanke threw in the towel on money. At a conference in November 2006, he told his audience: “It would be fair to say that monetary and credit aggregates have not played a central role in the formulation of U.S. monetary policy since [1982], although policymakers continue to use monetary data as a source of information about the state of the economy.” After he spoke, the former college professor sat at the other end of a lecture. Lucas Papademos, vice president of the European Central Bank, questioned Bernanke: “Is it really possible for a policy described as ‘monetary’ to be formulated and implemented without money playing a central role in it? Indeed, the suggestion that monetary policy can be conducted without assigning a prominent role to money seems like an oxymoron — a statement containing apparently contradictory terms, if not worse: for the literal meaning of the Greek word ‘oxymoron’ is ‘pointedly foolish.’”

Foolish has been the Federal Reserve System’s ballooning balance sheet — from around \$800 billion of assets in December 2007 to \$2 trillion today. The Fed’s balance sheet is what stands behind the dollar, a reason its assets were (until 2008) predominantly US Treasury securities. The rise in Fed assets was accomplished by machinations, including the sale of Treasury securities to buy dubious bonds and

derivatives from financial institutions that are probably insolvent. Many of these securities are probably worthless. At least, that is the strong suspicion and will remain so as long as the Fed resists the Congressional initiative to audit the Federal Reserve.

Bernanke's Great Depression theory was a flop, but he may not recognise his failure. He has spent his career following a single train-of-thought. That will persist: a debt-deflation can be prevented by printing money, ever-increasing mountains of money, if the incidence

of mortgage defaults, consumer loans, and leveraged loans continues to rise. We can expect Simple Ben to boost the Fed's balance sheet from \$2 trillion to \$4 trillion, and, if given the time, to \$10 trillion. Maybe 100% inflation will solve the mortgage problem.

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