Wrong Way Bernanke

Federal Reserve Chairman Ben Bernanke gave an important speech in Atlanta over the weekend. He defended the Greenspan Fed, saying the policy of low rates in the early 2000s did not cause a bubble in housing.

Bernanke made three main arguments. First, the Fed might have been too loose if we use actual inflation measurements, but not if we use the Fed’s inflation forecasts for “core” inflation. Second, even if the Fed was too loose, home prices rose more than what would be expected given the historical link between monetary policy and home prices. And third, home prices increased in many countries around the world.

These are weak arguments. From 2001-2006, the Fed held interest rates substantially below both the growth rate of nominal GDP (real GDP growth plus inflation) and yields on long-term Treasury notes. So regardless of whether you use contemporaneous economic data (GDP) or expectations about the future (as seen in the yield curve), the Fed was too loose.

Second, no matter how fancy the statistics, any link between monetary policy and home prices is just a long-term average. Therefore, by definition, a bubble is abnormal. So, the Chairman is saying that the Fed can’t cause anything abnormal. But this is what the Fed said about the 1970s and oil prices. Only in retrospect, and only after every member of the Fed had passed on, has the Fed admitted the inflation of the 1970s was caused by easy money. The Fed takes 30 years to admit errors, so this claim that housing price increases had supposedly “temporary” surges in commodity prices.

The implications of this are enormous. If the Fed plans on stubbornly staying the course with zero percent interest rates in 2010, what better way to convey that inclination to investors than by defending the loose money of the 2000s?

Reading the speech – and between the lines – it was as if Bernanke were not just talking about the housing bubble, but the large rebound in commodity prices that many investors anticipate will turn into the next bubble. On cue, gold and oil prices surged on Monday and the dollar fell.

Bernanke knows full well that he will get blamed for these rising commodities. What better way to preemptively rebut this claim than by absolving the Fed of causing bubbles in the first place? At the same time, he has now explained to investors it is the Fed’s forecast of “core” inflation that matters, not supposedly “temporary” surges in commodity prices.

You can almost hear in the distance the outlines of a speech Bernanke will be making in a few years. “We didn’t cause the commodity bubble because commodity prices increased for other countries too…” It will take a totally new Fed, in 30 or 40 years time, before new young Fed staffers start writing white papers comparing the 2000s to the 1970s.