First Trust
Monday Morning OUTLOOK

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Second Thoughts on Bernanke's Nobel Prize

The Nobel Prize in Economics was recently awarded to former Federal Reserve Chairman Ben Bernanke, as well as professors Douglas Diamond and Philip Dybvig, for their work on understanding the role banks play in the economy, especially during a financial crisis.

All three of them have done important work that's worthy of recognition. Banks *are* key parts of the economy that, by assessing the creditworthiness of borrowers, help channel the savings of households and companies into productive investment. Bank failures, in turn, threaten to make it tougher for an economy to direct savings to where they're most useful.

However, like many recent Nobels this award seems to ratify expansionary government policy. Bernanke's approach to the Financial Panic of 2008-09 included a massive bailout of the financial system, monetization of government spending, and a huge expansion in the Federal Reserve's balance sheet.

The Bernanke approach did *not* include fixing mark-to-market (MTM) accounting, which was the key ingredient that turned a limited financial fire into a raging inferno that almost burned down the entire US financial system.

To review, in late 2007 the Financial Accounting Standards Board (FASB) forced financial firms to use market prices to value securities, rather than models or cash flow. Within a year, the U.S. was in the middle of the worst financial panic in a hundred years. This was not a coincidence.

On the surface, MTM made sense. Markets usually provide transparent and verifiable prices, so companies couldn't just make up numbers. The problem is that market prices often deviate – sometimes substantially, but always temporarily – from underlying fundamental value. Since markets are forward looking, MTM forced financial firms to take hits to capital over something that might happen in the future but hadn't happened yet. It was like forcing homeowners to come up with more capital as a hurricane approaches because their homes *might* get destroyed.

This, in turn, created a vicious cycle as capital constraints hurt banks, undermined the economy and drove asset prices lower, and then destroyed more capital. In 2008, when markets for even prime mortgage-backed securities became illiquid, the financial crisis intensified.

Finally, in March 2009, six months after TARP and QE were put in place, the stock market was still falling. That's when Congress (specifically, Barney Frank) started to twist arms, forcing FASB to loosen up its rules and allow cash flow to be used when markets were illiquid. This seemingly small adjustment did the trick. Banks were finally able to raise new capital, the stock market surged, and the economy started a long and sustained recovery. This was no mere coincidence, but Ben Bernanke, as far as we know, has never publicly discussed it.

We find that odd because Bernanke should be familiar with the damage MTM can do. Bernanke is a student of the Great Depression and Milton Friedman won the Nobel Prize for his work on the Great Depression, as well. In addition to his focus on the money supply, Friedman also wrote about how a MTM rule in the 1930s caused many banks to fail. Not coincidently, the Roosevelt Administration suspended MTM in 1938 and, simultaneously, the Depression ended.

We, and others, including Peter Wallison, have written extensively about the economic damage done by the MTM accounting rule…especially to the financial markets. Yet, the Fed, other government agencies, and academics have ignored it. Apparently, even if you have solid evidence that TARP and QE really didn't end the 2008 Panic, you should be ignored. The only narrative allowed is that free markets caused the crisis and the government saved us.

And now, Nobel Prize or not, the bill is coming due on the "abundant reserves" monetary model that is the result of Bernanke's research. The US has its highest inflation rate in 40 years. True, this didn't happen in the aftermath of the 2008-09 crisis, because the M2 measure of money remained more stable. But government spending surged much more during COVID and Bernanke's new system monetized it.

Having some insights into the role banks play in an economy is not the same as fully understanding the economy. And dismissing the role of MTM accounting seems intellectually dishonest. We have second thoughts about anyone who does.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-17 / 8:15 am	Empire State Mfg Survey – Oct	-4.3	**-1.7**	-9.1	-1.5
10-18 / 8:15 am	Industrial Production – Sep	+0.1%	**+0.2%**		-0.2%
8:15 am	Capacity Utilization – Sep	80.0%	**80.0%**		80.0%
10-19 / 7:30 am	Housing Starts – Sep	1.470 Mil	**1.440 Mil**		1.575 Mil
10-20 / 7:30 am	Initial Claims – Oct 15	230K	**220K**		228K
7:30 am	Philly Fed Survey – Oct	-5.0	**0.2**		-9.9
9:00 am	Existing Home Sales – Sep	4.700 Mil	**4.690 Mil**		4.800 Mil