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On Capitalism, The Federal Reserve, and Ben Bernanke

Those held accountable for major screw-ups will say extraordinary things in an effort to get off the hook. The past couple weeks have seen two dramatic instances of this phenomena.

The first instance occurred in a December 27th CNN interview. Janet Napolitano is the Secretary of Homeland Security. When questioned regarding the situation surrounding Flight 253, she claimed that "the system worked." A known terrorist got on a commercial flight to the US and was only prevented in blowing up the plane through a combination of ineptitude on the part of the terrorist and vigilance on the part of the passengers and crew. In other words we got lucky. So for Napolitano, getting lucky counted toward 'the system working.' Obviously that was not a tenable position and she immediately retracted the statement the following day. One moral of this story - people on the hot seat will say stupid things. Which brings up to the topic of this article.

It is the second instance of a highly visible attempt to evade responsibility for a screw up that inspired this little article. In terms of being on the hot seat, the temperature of Ben Bernanke's chair has been considerably warmer than the seat of Napolitano for some time now. The collective outrage over the economic debacle has inspired both a Congressional audit of the Fed and legislation to strip the Fed of its oversight of consumer protection.

The first point to note here is the shocking discovery that the Federal Reserve had any consumer protection responsibility. The events of the past few months would have led anyone to conclude that the prime responsibility of the Federal Reserve was to protect the high fliers on Wall Street, not the denizens of Main Street.

Faced with the humiliation of a Congressional audit and the loss of major powers Bernanke appears to be trying to rewrite history in an effort to cast a more favorable light on Fed policies and actions. In a January 3rd speech to the American Economic Association, Bernanke claimed that Fed orchestrated low interest rates were not a factor in the housing bubble (!). If the Fed interest rate policy was not a factor in the housing bubble then the unstated but obvious intended conclusion of this amazing contention is that the Fed cannot be blamed for either the housing bubble or the ensuing collapse.

So what does Bernanke propose as the culprit behind the real estate bubble? He cites "the increasing use of more exotic types of mortgages and the associated decline of underwriting standards." So the cause of the largest credit bubble in the history of the world was not the unlimited supply of free and easy money from the Fed, but lax lending standards. What an utterly flabbergasting thing to say!

Why Bernanke and the Fed? We are Technicians

Why is this even an issue in a technical advisory service? Is not Fed watching is for fundamental analysts? Should we not be discussing the bullish consensus instead of Ben Bernanke? One issue I want to raise here is the wildly inflated reputation that the Fed chief has for controlling the economy. And my point will be easier made if I start with a review of the reign of Alan Greenspan.

Countless hours of painstaking analysis were focused on trying to decrypt Greenspan's extended ramblings in an effort to forecast the direction of the financial markets and the economy. The reality is that Greenspan may never have been intelligible and correct at the same time. The list of Greenspan quotations on the real estate market on the next page are unfortunately entirely typical of his forecasting skills. Under Greenspan's tutelage the Fed was blind-sided by the internet bubble - remember Greenspan's contention that the internet stock craze was not a bubble - it was the result of increased productivity. The rally in the stock market prior to 1995 can be largely attributed to the inflation of stock prices due to the collapse of the US dollar. And most analysts now agree that it was from 1995 that the rally in the stock market started forming a bubble. And despite Bernanke's protestations, the Fed under Greenspan was entirely responsible for the housing bubble. But this article is not about Greenspan. It is about a widespread misunderstanding of the cause and effect relationship between the economy and the Federal Reserve.

The Trend Makes the News

A point we emphasize whenever we see an opportunity is the old Wall Street proverb "the trend makes the news." To a casual observer it may appear like news headlines are seized on by traders and investors and price trends are thereby created. The reality, however, is the reverse. A careful observer will note that the so called 'news' is always and only bullish into all major peaks, and is only bearish at every major low. This is because it is the trend that creates the news. Furthermore, price trends in the markets do not require external events for their initiation, their continuation, or their conclusion. The dynamics of price trends are exogenous to the market. Price trends are ruled by the dynamics of herding behavior and the 'news' is only background noise.

The reality is that price trends in markets are not the logical process whereby new information becomes discounted. Price trends are a collective social behavior whose dynamics generate news that expresses the mood of the market. In the upsurge of positivity and optimism that is a bull market, heroes are made so the market has a focal point that helps justify the up-beat collective mood. And in the ensuing bear market heroes must become scapegoats so the herd can justify its increasingly negative and pessimistic mood. It is no coincidence that the repuations of both Alan Greenspan and Tiger Woods soared during the bull market and then nose-dived in the ensuing bear market. The Fed looks like a genius in a bull market and like a moron in a bear market.

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Alan Greenspan Quotations on Real Estate

July 2002

"The type of underlying conditions that create bubbles are very difficult to initiate in the housing market," Greenspan said. "It is not an issue on the table on the moment."

Irrelvance of History Effect

Sep 2002

"People say, Alan Greenspan doesn't think there's a housing bubble," says Robert J. Schiller, Yale economics professor. "Well, he said there was no stock market bubble, too."

Blind Spot Effect

Feb 2003

"The notion of a bubble bursting and the whole price level (of real estate) coming down seems to me as far as a national nationwide phenomenon, is really quite unlikely. Comparisons to the stock market aren't justified since most people must live in their homes and house transaction costs inhibit speculation."

Optimism Bias

Feb 2004

"American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage."

Self Deception Effect

October 2004

"While local economies may experience significant speculative price imbalances, a national severe price distortion seems most unlikely."

Wishful Thinking Effect

Aug 2005

"an end to the housing boom could induce a significant rise in the personal saving rate, a decline in imports and a corresponding improvement in the current account deficit."

Tinkerbell Effect

Nov 2006

"It looks as though the worst is behind us" in terms of the effect of the housing slump on economic growth."

Ostrich Effect

Sep 2007

"There is no doubt about the fact that low interest rates for long-term government bonds have caused the real estate bubble in the United States"

Hindsight Effect

Damage Control Mode

Ben Bernanke is in full on damage control mode and there are three areas of smoldering wreckage that he is trying to get functional again. He is trying to repair and revive:

1. the reputation of capitalism
2. the US economy
3. the reputation of the Fed

In a bull market no Fed chief would ever think to waste his time in such an unnecessary exercise. In a bull market capitalism reigns supreme, the US economy is an unstoppable engine of wealth creation, and the Fed chief is honored as an accomplished maestro who is conducting the upward trajectory of the symphony that is the world economy. However is a primary bear market the three fold task cited above is a near impossible feat.

To place Bernanke's 3rd January speech in perspective, it is part of an on-going effort to justify the current structure, function, and powers of the Fed. During a bull market the 'Ron Pauls' of the world are a harmless annoyance. However it is in the pain of an extended bear market that the status quo is most as risk of being altered or even up-ended. In a bull market no one critiques the Federal Reserve or the Treasury department. But in a bear market the Fed becomes a lightning rod for the increasing negativity and pessimism. Before we delve into the role of the Fed in a real bear market, let us review what the Fed was chartered to do.

The Federal Reserve

The Federal Reserve was created in 1913 to prevent another financial panic like that of 1907. In the 1907 panic the New York Stock Exchange lost nearly half its value and there were numerous runs on banks and trust companies. Without the intervention of Mr. J.P. Morgan it is very possible that the entire US banking system would have imploded. The first test of the Federal Reserve was from 1929 and the grim fact is the Fed failed this test. In brief, there are four main purposes for the Federal Reserve.

1. To conduct US monetary policy and maintain credit conditions in a way that yields maximum employment, stable prices, and moderate long term interest rates.
2. To supervise and regulate the banking sector in order to
   - ensure the safety and soundness of the banks
   - protect the credit rights of consumers
3. Maintain the stability of the economy and protect it from the systemic risks of the financial markets
4. Provide financial services and payment systems for the US government and foreign banks.

Except for the decisive actions of Paul Volker the Fed must be given a failing grade in its report card. Alan Greenspan's sole concern seemed to be making sure the stock market rally was not disturbed. And it is way too early to grade Ben Bernanke. So why do we even need a Federal Reserve in the first place?

The Nature of Capitalism

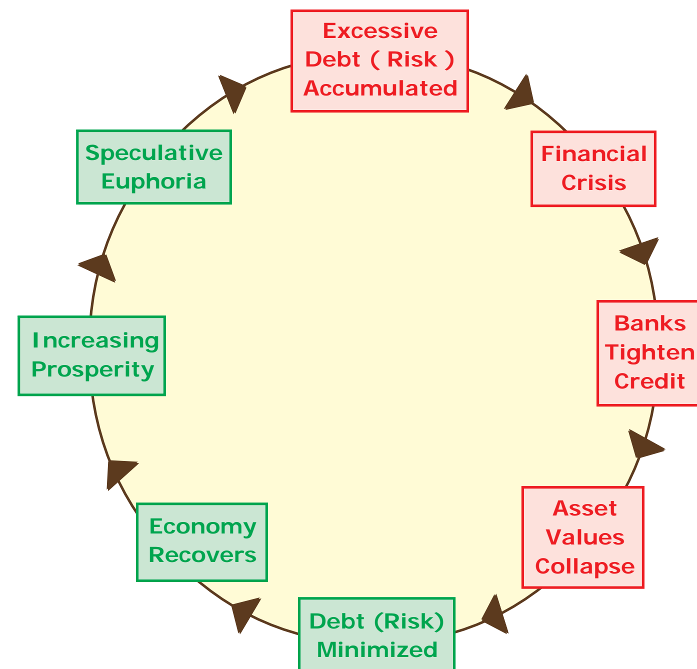
It is our contention that something like the Federal Reserve is necessary because of the nature of capitalism. It is also our contention that only two economists have really understood the true nature of capitalism. The first was an economist hired by Stalin, a Nikolai Kondratieff. The second economist was Hyman Minsky, an American economist born into a family of emigrants from Belarus. I do not want to insult Belarusians by lumping then among the Russians, but it seems rather ironic that some of the best insights into the dynamics of capitalism came from Russian origins.

The principal insight of Kondratieff was that a capitalist economy is cyclical in nature. That cycle, or long wave, consists of three main phases - an inflationary expansion, a stagnation, and then a deflationary recession. Kondratieff also argued that each of these three phases has its own distinct social mood and values. The bottom line of Kondratieff is that capitalism endures because of its cyclical nature.

The main insight of Hyman Minsky is that capitalism is not self-regenerating and self-perpetuating. It is self-destructive on a cyclical basis. He formulated his various theories into what he called the "Financial Instability Hypothesis." The core of this hypothesis is a debt cycle not unlike that of Kondratieff's long wave. In Minsky's model the rise of speculative bubbles and their ensuing collapse are not anomalies, but an integral part of the cycle of capitalism.

The Financial Instability Hypothesis

First let us outline the core structure of Minsky's model.



Minsky detailed the various phases of the economic contraction that begins in a wave of speculative euphoria and ends with a collapse in asset prices. As these dynamics relate to the role that Minsky saw for the Federal Reserve, and our current economic predicament, it is a process worth discussing in some detail.

The Financial Instability Hypothesis - the contraction

Increasing Prosperity

The problems begin as a wave of increasing prosperity creates significant excess corporate cash flow. The money not needed to meet regular expenses seeks out greater risk. Additional debts are incurred.

Speculative Euphoria

In the excess of optimism that marks the peaking phase of the economic cycle, the traditional limits on risk and debt accumulation are discarded. Asset prices roar and the fragility of the entire financial system increases.

Excessive Debt (Risk) Accumulated

Debts are accumulated that can no longer be paid from existing cash flow. These excess debts can only be paid if asset prices continue to rise. Any cessation in the rise of asset prices will immediately cause solvency issues.

Financial Crisis

Asset prices peak out. The most aggressive borrowers can no longer make their debt payments. This pops the speculative bubble. A financial crisis ensues. Credit risk becomes the most important issue for business.

Banks Tighten Credit

The collapse of the most speculative borrowers makes it increasingly difficult for even those with perfect credit to get the loans they need. Even the most sound of investments can no longer be funded.

Asset Values Collapse

The result of the tightening of credit in an environment of excessive debt is a collapse in asset values. A deflationary economic contraction ensues and the risk is now an all out economic depression.

The 'Minsky Moment'

One of Minsky's key insights is that there are three basic classes of borrowers. Minsky called the most responsible and conservative borrowers 'hedge borrowers.' They are able to pay off their debts from the existing cash flow of the business.

Minsky described the more risky class of borrowers with the title 'speculative borrowers.' While speculative borrowers are also capable of making interest and principal payments on their debts from current cash flow, they must regularly 'roll-over' or refinance their debts. In other words speculative borrowers must continue to re-borrow in order to eventually pay off their debts.

For Minsky the third and most reckless type of borrowers are those who can only pay their debts if the assets they purchased continue to appreciate in value. Minsky called this category the 'Ponzi borrowers.' Such debts are only entered into during the euphoria of a speculative bubble. It is the 'you cannot lose' extreme of bullish sentiment that is responsible this most irresponsible class of borrowers.

The Minsky moment is the point at which the Ponzi debt load can no longer be covered by the appreciation in value of the underlying assets. If the debt load in the wider system is great enough the collapse of the Ponzi borrowers can bring down the speculative borrowers and even the hedge borrowers.

The Minsky Moment, Risk and the Role of the Fed

According to Minsky, if the larger economy is burdened with high enough debt levels the collapse of the Ponzi borrowers can quickly result in the freezing up of the credit markets and the contraction of the entire economy. In Minsky's view it is at such moments that a lender of last resort such as the Federal Reserve is the only thing preventing the economy from a complete implosion.

If Minsky's theories of the capitalist economy sound vaguely familiar then that is probably because you have been keeping up with current events. According to former Treasury Secretary Paulson and the current Fed Chief Bernanke, the recent unprecedented moves by both the Federal Reserve and the Treasury were the response to a Minsky moment that led to the freezing up of the credit markets and the risk that every major financial institution was about to fail for lack of funds.

Is the Fed at Fault?

Even assuming that the radical moves by Paulson and Bernanke saved the world from sinking back to an economic stone-age, people are starting to wonder how the economy found itself in such a predicament in the first place. And this post-mortem investigation brings the various coroners back to the collapse of the credit bubble, and then back to the formation of the credit bubble. From there the search for the ultimate cause of the debacle began to circle around Fed interest rate policy.

An Evasive Maneuver

With more and more angry investors turning up at the door of the Fed with their accusing fingers pointing at Fed interest rate policy, with irate senators pushing for a congressional audit of the Fed, and with enraged legislators trying to strip the Fed of some of its basic powers, Bernanke has evidently decided to take the evasive action of rewriting history. His speech of 3rd January was a subtle gem of mis-direction and hair-splitting in a blatant effort to repair and renovate the reputation of the Federal Reserve.

So Ben wants us to believe that lending standards were lax enough by themselves to create the largest credit bubble in the history of the world. Does he think we are all morons? Or maybe he thinks that because he is such an expert we will all turn off our minds and believe him. We suspect his real motive here is desperation. He does not want to be the Fed chief on whose watch the Federal Reserve was gutted, or even dismantled. His motive for such an egregious attempt to re-write history is a desire to escape responsibility and blame.

The central flaw in the contorted logic of his speech is that lax lending standards and exotic mortgages and Credit Default Swaps would never have arisen if money had been tight. Lending standards are lowered and excess risks are taken only because easy money was first made available. Lax lending standard are the response to easy money, not the cause of easy money.

Our Top Ten Main Points

1. The ultra low interest rate - easy money policy of the Fed created a monster pile of credit looking for a return.
2. The low interest rates made the traditional, conservative investments untenable. Credit was forced to search for risk.
3. The Fed low interest rate policy made holding US Dollars a non-starter.
4. The result was that all the newly created credit went looking for assets to buy. A bull market in assets was born.
5. The principle assets affected were real estate, foreign equities, and commodities.
6. Credit is not actual money. It is debt. The resultimng bull market in the physical assets was debt driven.
7. The proliferation of exotic mortgages and the lowering of lending standards was a response to the bubble markets created by the easy money Fed.
8. When the various asset bubbles burst, investors became acutely aware that, instead of being wealthy, but were deeply mired in a mountain of debt.
9. There was then an urgent need to sell off assets to pay down debts to avoid foreclosures and bankruptcy.
10. Economic cycles may be inevitable, but each new generation has the free will to take measures so make the cycles more benign and less destructive.

The choice of the Fed: Incite Bubbles or Prevent Them

The last topic that we want to cover is from point #10 at left. And the first statement that needs to be made in this regard is that the claim of certain economists that bubbles can only be identified after they have burst is absolute nonsense. Such ludicrous assertions are typically made by those in positions of power at the time of the bubble - those who had the power to minimize the bubble and its destructive aftermath. And it is a claim typically made by apologists for the efficient market hypothesis who would prefer that the financial markets remain as unregulated as possible. But it is truly a false claim. There are a whole array of fundamental and technical tools that can be employed to locate bubble markets well in advance of their collapse.

One of the founding purposes of the Fed was to protect the economy from the systemic risks of the financial markets. I am absolutely certain that waiting for bubbles to pop and then trying to pick up the pieces are not what the founders of the Federal Reserve had in mind as a method of protecting the economy.

Low interest rates are like steroids to financial bubbles. A Fed chief who is afraid to raise interest rates while asset prices are inflating - for fear of a negative impact on the stock market, such a Fed chief should be removed from office. And a Fed chief who tries to dismiss the role of easy money in bubble inflation cannot be trusted on to prevent future bubbles.

Interest Rates and Free Markets

With regard to capitalism, the Federal Reserve, and interest rates, one thing has been on my mind for several years now. The United States is supposedly the bastion of free market capitalism. Our foundational theory is that a free market will create the most efficient pricing and distribution for a scarce or limited commodity. We trust the free market to set prices for real estate, for stocks and bonds, for commodities, for consumer goods… for all types of goods and services. However there is one key area in which the United Sates does not trust the pricing skill of a free market - that area is interest rates.

Here in the US we have a separate, independent kingdom that selects the basic interest rate like a king determining the destiny of serfs. This separate and independent kingdom is the Federal Reserve. If we really trust the free market to price everything dear and important to us, then why can we not trust the free market to set basic interest rates? Either we believe in free markets or we do not. If free markets cannot be trusted with interest rates then why not give the Fed price setting power over key commodities?

Perhaps we should strip the Fed of all interest rate policy decisions and restrict the Fed to the role of the lender of last resort in financial crises. We suspect that the market would make interest rates much more responsive to the risk of financial bubbles then the Fed ever was, or likely ever will be.

If interest rates are too important to be left to the market then what else that is now in the hands of the market should not be? Some might argue that the Fed Fund rate is simply moved in response to market setting interest rates. That may well be the case. But then why do we even need the Fed to have any say over interest rates?

The low interest rate policy of the Fed has been instrumental in the birth and inflation of the internet bubble into 2001, the real estate bubble into 2005, the stock market bubble into 2007, and the commodity bubble into 2008. Is this what capitalism evolves into - an unending sequence of disastrous bubbles? Or is this the result of the Federal Reserve mucking up the machinery of free market capitalism?