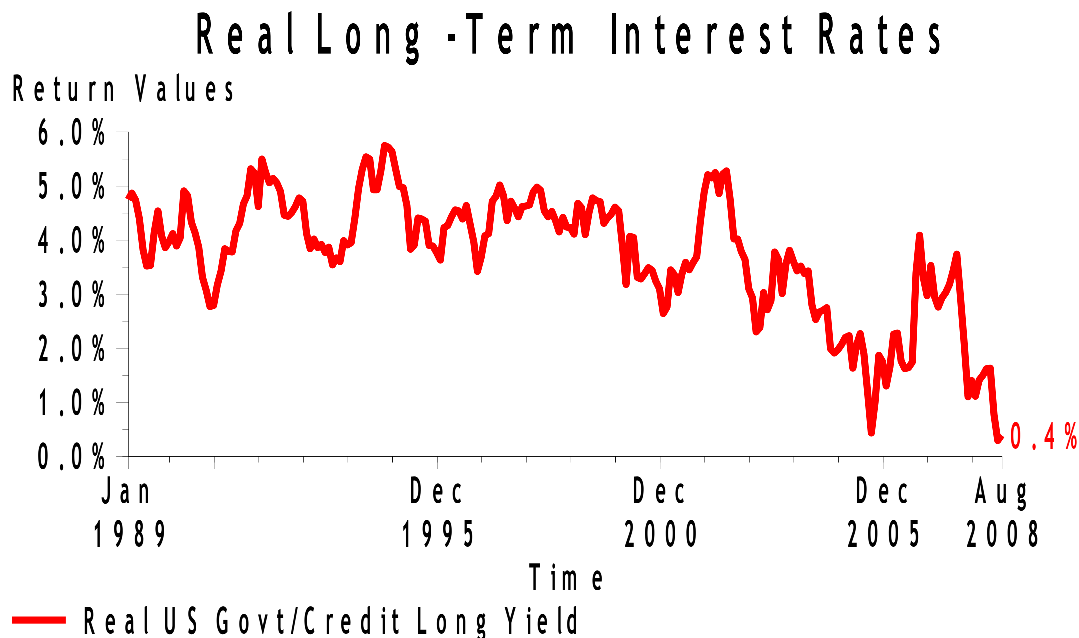
Give Bernanke a Break

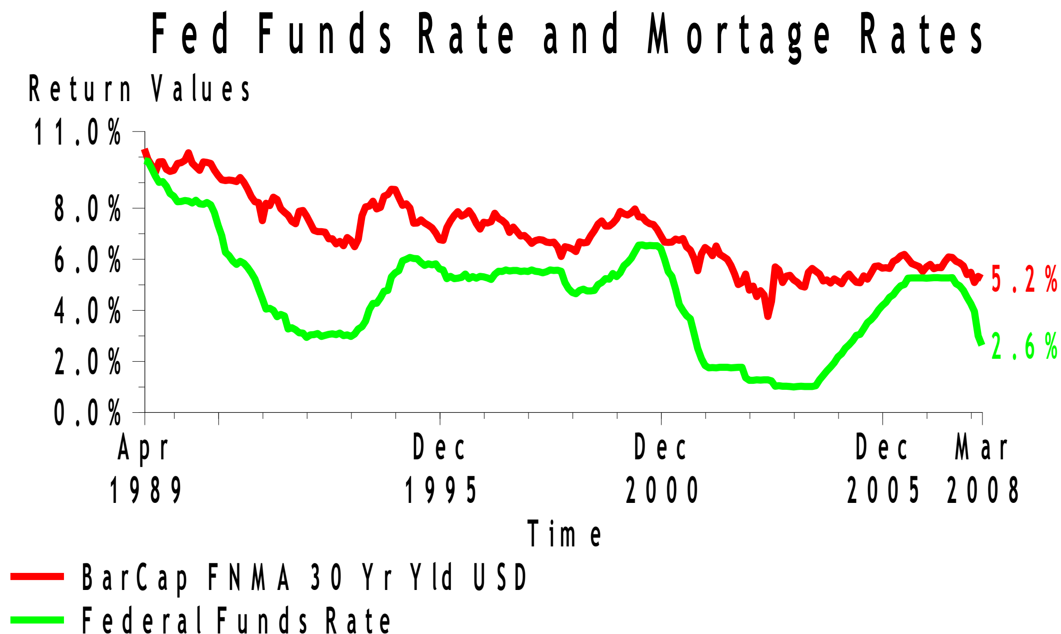
As populist politicians, long on hypocritical outrage and short on fiscal rectitude, begin the witch hunt for the parties to blame for the Great Recession, fingers are being pointed at Federal Reserve Chairman Ben Bernanke. Their criticism is that Bernanke and the Fed contributed to the housing bubble by keeping short-term interest rates too low for too long early in the decade and then not increasing them quickly enough to snuff out escalating house prices.

In a recent speech, Bernanke pointed out that it was low real long-term rates (i.e. nominal rates less inflation) determined in the bond market that were a major contributor to the housing bubble, not the short-term interest rates engineered by the Fed.

The facts support Bernanke. As depicted in the following graph, real long-term rates trended downwards for much of this decade, hitting bottom just before Lehman's failure in September 2008. Even the Fed tightening in 2004 and 2005 failed to push real rates up to the levels of the 1990's. Long-term real rates were just too low and consumers got the message – instead of saving, they spent.



As depicted in the following graph, this view is also supported by the failure of long-term mortgage rates (in red) to respond to the increase in the fed funds rate (in green) in 2005-2006 as they had in previous tightening cycles.



In 1994-95 and 1999-2000, long-term mortgage rates were 2.0% or so higher than the fed funds rate as they peaked, while in 2006 the spread was in the 1.0% range. Monetary policy was less effective at driving up mortgage rates than previous cycles.

The real culprit in keeping long-term real interest rates low was the global savings glut that was in large part created by the recycling of U.S. dollars by China and other Asian countries. The chronically undervalued currencies of those countries have created a permanent trade imbalance and yawning current account deficit in the United States. In fact, Bernanke himself coined the phrase "global savings glut" in a speech that he made in March 2005. At that point, he warned that low real interest rates seemed to reflect an imbalance between global savings and investment – too much money chasing too few investments around the world.

Viewed from this vantage point, the seeds of the recent crisis were sown when China was allowed to join the World Trade Organization in 2001 in the absence of adequate safeguards to curb its policy of promoting exports through currency manipulation. The Great Recession is an unwelcome consequence of the structural faults that were allowed to develop in the world economic system.

Although China and other Asian exporters play leading roles, asset bubbles typically manifest themselves through the disparate actions of a cast of characters so there are many players to point fingers at. Blame the U.S. home buyer for thinking house prices always grow to the sky. Blame the bankers who sold collateralized mortgage securities to every Tom, Dick and Harry and, worse yet, kept some of this dreadful paper on their own books creating systemic risk for the entire financial system. An especially large share of the blame must go to the credit rating agencies who gave their AAA blessing to so much of this flawed paper. Blame also the mortgage brokers who turned “liars’ loans” into the raw material of defective investments as well as the financial engineers who mispriced the risk in a host of derivatives simply because they had never read a history book on the Great Depression. And finally politicians should look in the mirror – they consistently supported housing policies and programs that made housing accessible to buyers who couldn’t afford a down-payment let alone a house.

Instead of pointing fingers at Bernanke, his critics should lead a round of applause for his leadership of the Fed in initiating the dramatic increase in monetary expansion in March 2009 that was clearly the catalyst for the recovery in the stock market and the turn-around of the U.S. economy, however tenuous and fragile it may be. In addition, given the immense challenge faced by the Fed in unwinding its massive monetary stimuli, Bernanke’s second term should be confirmed by the Senate and he and his colleagues should be allowed to concentrate on steering the economy to terra firma.

This is vital. The recession and stock market collapse of 1937-38 that occurred after the initial recovery from the Great Depression was in part triggered by the Federal Reserve’s increase in bank reserve requirements. We cannot afford Bernanke and the Fed to get it wrong this time around.

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