Bernanke's Bad Bet

The Fed sacrifices Main Street's wealth to Wall Street.

By Charles Hugh Smith

WOULD YOU CALL sacrificing $6 trillion of America's household wealth to inflate the stock market by $2 trillion a good deal? Few would, but the Federal Reserve obviously thinks it's a bargain, for this tradeoff is the explicit result of the central bank's latest round of quantitative easing, the grandly named QE2.

From the time Fed officials began outlining QE2 in June—a plan to buy $600 billion in U.S. Treasury bonds and inject that stupendous sum into the banking sector—the U.S. dollar plummeted by 15 percent. (It has since recovered a little.)

The mainstream financial media studiously ignored the downside of this beggaring of the dollar. The $43 trillion worth of non-stock assets held by U.S. households—real estate, bonds, cash deposits—are denominated in dollars, so a 15 percent depreciation in the currency knocked about $6 trillion off the purchasing power of those assets.

Given that the Fed's zero-interest rate policy (ZIRP) has lowered the yield on cash to almost zero—earn a big 1/10th of 1 percent on your cash—the predictable result of the latest easing was a mad rush into risk assets such as precious metals, commodities, and stocks, which jumped 19 percent from June to early November.

That was the intent, as Fed Chairman Ben Bernanke recently made clear: "Higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending [that] will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

In other words, the Fed threw the dollar into the shredder in an attempt to create a stock-market wealth effect that assumes consumers who see their portfolios rising will borrow and spend more, igniting the moribund U.S. economy.

What QE2 has already sparked is not growth but skyrocketing agricultural commodities prices. Though Chairman Bernanke has claimed QE2 won't cause inflation, the average bloke can see that a 70 percent increase in the cost of wheat will end up raising the price of bread. Paying more for essentials while household incomes stagnate is a recipe for impoverishment, not growth.

There is a more than a whiff of desperation in this stock market wealth-effect gambit, and that says volumes about the fundamental flaws in the Fed's policies. Why would the Federal Reserve make such a risky bet? Is making such bets really the central bank's job?

The Federal Reserve's mandate is limited to "maintaining monetary and credit aggregates commensurate with the economy's potential to increase production, so as to promote the goals of maximum employment, stable prices, and moderate long-term interest rates." In plain English, the Fed is supposed to manage the nation's supply of money and credit, not its economy or stock market. Yet the latter is precisely what the Fed is trying to do by boosting the stock market to engineer a wealth effect.

There are two fatal errors in this policy: one is a fundamental misunderstanding of capitalism, and the other is a misunderstanding of the stock market.

In a capitalist business cycle, "animal spirits" reach euphoric heights in a strongly expanding economy, and eventually people borrow a lot of money to speculate on future growth: betting, in effect, that trees will grow to the sky.

At the peak, too much credit is extended, too much money is borrowed, too much capacity is built, and too many speculative bets are placed. In the inevitable cooling of the economy that follows rapid expansion, the overleveraged find they cannot service their debt or roll it over into new loans, and an overhang of buildings and capacity cannot be rented or sold for a profit.

In this phase of the business cycle, the overleveraged and over-indebted go belly up, and lenders and investors take losses as empty buildings and factories are sold for pennies on the dollar. Balance sheets are cleaned up as assets are liquidated and uncollectible debts are written off. The Federal Reserve's role in this contraction-of-credit phase is to provide sufficient liquidity for qualified borrowers to roll over their debt into new loans and for new buyers to purchase distressed assets.

This contraction phase is the process of capitalism known as creative destruction, and it is the essential foundation for future growth. Malinvested money is lost, risky speculations go bust, and patient capital eventually ends up owning the distressed assets. The process is painful in the short term. But the sooner the bad debt is cleared and the overcapacity shuttered or sold off, the sooner new enterprises and sound credit can expand.

Sometime after the deep 1981-82 recession, Fed policymakers decided to revoke the painful part of the business cycle and maintain only the happy part of expanding credit, rising speculation, and endless construction.

So when the excesses of the dot-com era led to an inevitable business-cycle contraction—*i.e.*, a recession—in late 2000, the Greenspan-led Federal Reserve responded by dropping interest rates to near zero and keeping them low for years. Coupled with monetary easing measures, this led not to a contraction of debt and speculation but to a massive increase in credit throughout every sector of the economy—especially real estate, with home mortgages rising from $5 trillion in the late 1990s to $7.8 trillion in 2004 and $10.5 trillion by 2006. Corporate debt leaped by over $3 trillion from 2004 to 2008, and non-corporate business debt jumped up by $2 trillion.

The Fed's plan to repeal the business cycle by flooding the economy with cheap, easy-to-borrow money succeeded for a time, but increasing borrowing, speculation, and overbuilding did not cancel the business cycle—it only ensured that the eventual popping of the credit bubble would be more devastating.

After denying that housing was in a credit-fueled bubble, Chairman Bernanke finally acted as the global financial meltdown gathered force in late 2008. His plan was a retread of the Greenspan policy: drop interest rates to near zero and flood the banking sector with fresh credit. But an unforeseen snag occurred in the Fed's plan to spark more borrowing and spending: households had just seen $15 trillion of their net worth wiped out in the meltdown, and they no longer had the collateral or the desire to borrow more.

Policymakers chose not to enforce a capitalist liquidation of uncollectible debt and malinvestment in the financial/banking sector, but to "extend and pretend" the sector's insolvency in the hope that assets such as real estate would climb back up in value and relieve the sector from the pain of business-cycle losses.

Alas, house values are still falling in the majority of markets, and the Fed's strategy has failed to incite either significant writedowns in bad debt or the expansion of new borrowing. Total household debt has dropped by a meager $50 billion, from $14.4 trillion to $13.9 trillion, with home mortgages accounting for a tiny $35 billion of that reduction.

In other words, with no liquidation of impaired debt and no real liquidation of malinvestment, households and banks are sagging under the load of too much debt. Few households are qualified to borrow more, and fewer still desire higher debt loads.

By attempting to repeal the business cycle with ever-larger injections of liquidity and credit, the Fed has sought to revoke capitalism itself. The failure of its grand plan was thus guaranteed from the start.

Enter the Fed's last desperate gamble: that a rising stock market would serve as a public-relations proxy for the real economy and that a rise in household stock portfolios would trigger the wealth effect—that is, the wealth created by a temporarily rising stock market would prompt consumers to start borrowing and spending freely.

But there is no evidence that a rising stock market actually leads to increased household income. On the contrary, the S&P 500 rose in the sharpest rally in a century last year, up 54 percent from March 2009 to September 2009, yet household income declined in 2009.

If a rising market doesn't actually increase incomes, it might increase "animal spirits," the magic elixir of desperate economists. But the Fed apparently neglected the fact that stock ownership is highly concentrated in the U.S.: a mere 5 percent of households own 72 percent of the nation's financial wealth, and the top 10 percent own 83 percent.

The Fed is betting on a narrow variant of the discredited trickle-down theory of wealth distribution, in which the top 10 percent of households would see their stock portfolios rise and then embark on a frenzy of consumption that would somehow trickle down to the bottom 90 percent who saw little direct impact of rising stocks.

In expanding its mandate from controlling the money supply to controlling the economy, the Fed has turned to the only intervention it has left: pumping up the stock market. But the public has experienced two catastrophic stock market meltdowns in less than a decade: the dot-com aftermath that saw the NASDAQ lose almost 80 percent of its value and the 2008 global crisis that slashed 45 percent off the S&P 500. They are wary of the ephemeral gains in stocks, and weary of the strains of overindebtedness. Individual investors responded to the Fed's massive intervention on behalf of the stock market by pulling money out of stock mutual funds for 24 straight weeks.

Rather than increase household wealth, Bernanke's QE has shaved $6 trillion from the purchasing power of household assets and unleashed a flood of higher commodity prices that will further impoverish American households. And rather than "promote economic growth," as the Chairman recently claimed, his unprecedented campaign of intervention has depreciated their wealth and future incomes. For this vast reduction in wealth and purchasing power, the Fed offers a rise in the stock market, which only benefits Wall Street and the top tranch of American households—the slice least in need of stimulus.

It was a bet with no factual evidence that success was even possible, much less likely, and a bet the Fed was never empowered to make. ■

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Swamps of Academe

Russell Kirk ran the sword of imagination through the educational establishment.

By John Willson

IT SHOULDN'T BE SURPRISING that a man who spent much of his life up to age 34 hanging around schools should retain a keen interest in them. Russell Kirk abandoned the professoriate early on, but a major source of his income came from speaking at colleges and universities. His fortnightly column for *National Review*, "From the Academy," was about education, and in 1960 he started an avocational journal, the *University Bookman*, to "publish short articles on higher education, and fairly lengthy reviews of select college textbooks."

He liked to quote sociologist Ernest van den Haag to the effect that both students and teachers had succumbed to "America's Pelagian heresy." "Old Pelagius, so drubbed by Saint Augustine, declared that all men will be saved eventually, without the operation of divine grace," Kirk writes in his autobiography, *The Sword of Imagination*. "The average American in our century has come to believe that all men may be saved through educationism, without need for thought."

"What was once academic community," he sadly concludes, "had become academic collectivism." American education is mired in the "Serbonian Bog."

Kirk loved such tropes. It delighted him to turn "Old Pelagius" into a cypher for American educational folly—"Deweyism," he also called it—or to recall the bog near the ancient Egyptian Lake Serbonis that was said to have swallowed whole armies. If you wade along the edge of the educational bog, he once wrote, "you weep when you don't sleep." But much as he lamented American education having been turned over to the "Dismal Swamp Teachers' College," he also insisted, with Walter Bagehot, that "conservatism is enjoyment."

The Serbonian Bog consisted in those institutions that swallow up intellect, morality, imagination, sound learning, beauty, humor, good books, true diversity, religion, academic freedom, wise teachers, and lively students. Kirk's columns almost never treated these as abstractions. In fact, he could be wickedly particular. He came to think of Michigan State, which he attended when it was "Michigan's udder university" and at which he taught for a few years, as "Behemoth U," the very definition of a university concerned more with vocationalism, mass education for the elusive goal of equality, and runaway scale than with anything that could be thought of as human or humane.

John Hannah, who presided over MSU's great growth, was to Kirk a "chickenologist"—his degree was in poultry science—and Kirk chuckled when it was said that "the concrete never sets on John Hannah's empire." Dr. Milton Eisenhower at Penn State got little better treatment. They were the "university imperialists." Such men and schools sucked up moral and intellectual energy, and Kirk saw them everywhere. In 1968 alone he visited almost 150 campuses.

Second only to Behemoth was the textbook monster, which he gave a special place in the Serbonian Bog. If Kirk devoted 50 or so of his "From the Academy" columns to Behemoth, he wrote perhaps as much and ten times more in the *University Bookman* on textbooks, criticizing them and their authors for their "bleak Deweyism," their servile attitudes to political authority, and their failure to waken the minds of our students.

"Textbook writing and publishing," he said, "have become a species of racket." It's interesting, though, that this man of letters would keep mining the textbook ore, seeking good veins, rarely finding them, but insisting to his readers that somebody had to do it. The ideologue dismisses the whole enterprise; the conservative keeps encouraging teachers and parents to find continuity with a better reading past. Russell Kirk was virtually a one-man front in this battle. The Left was marching through the institutions; most of the Right hurled thunderbolts but didn't read and review the books.

Third in the bog was the educationist establishment. The Deweyite Pelagians beckoned would-be teachers to Serbonis. Kirk cataloged their "involuntary servitude": departments of education ("I think we would do well to abolish Education as a separate department or school"), certification, accreditation, unions, "in-service training," consolidation of schools, federal aid (which, Kirk was among the first to see, meant federal control), mandatory sex education, uniform civics courses, and politically correct textbooks.

"No doubt these schemes are progressive," he said. "But toward what do we progress?" To the mantra, "You can't go back to the Little Red School House," Kirk replied, "Why not?" Absent all these collectivist schemes, he insisted that the little schools, and particularly "our American liberal arts colleges … have long done an incalculably valuable work in keeping alive among us the traditions