American Enterprise Institute for Public Policy Research

Economic Outlook

April 2009

The Fed Battles Deflation and Class Warfare

By John H. Makin

On March 18, Federal Reserve chairman Ben Bernanke intensified the important battle against global deflation with a commitment to expand the Fed's balance sheet by an extra $1.15 trillion. With some luck and persistence, that step could boost growth by a percentage point or more and, even more important, substantially reduce the risk of deflation.

Preempting Deflation Risk

The first response of dumbfounded Fed watchers to the move to purchase $1.15 trillion in mortgage and Treasury securities was to complain that it is going to be inflationary. That is like complaining that if a starving man eats too much, he will get sick. True, but it beats dying of starvation, and if the man eats gradually, he will get better. If the Fed had continued to delay action to preempt rising deflation, pressure would have led to the economic equivalent of starvation, a deflationary spiral that ended in a global depression. In reality, the Fed's addition to its balance sheet is large by historic standards but probably constitutes only about one-fifth of the increase that will be required of the Fed to preempt deflation at a time when demand is collapsing in the global economy under the weight of massive wealth losses, compromised bank balance sheets, and sharp cuts in production and employment.

When the central bank's policy instrument is an interest rate that has been fully used by taking it down to virtually zero, as is the case with the federal funds rate in the United States, it is necessary to devise an alternative measure tied to quantitative easing for driving monetary policy. Analysis by several investment banks and the Fed suggests that, given the current path of unemployment and a trend toward deflation, the fed funds rate should be somewhere between –700 and –800 basis points.

Given that moving the fed funds rate below zero is impossible, it is necessary to turn to an alternative metric—the size of the Fed's balance sheet—by which to judge policy. Current estimates suggest that a trillion dollars of balance sheet expansion is the equivalent of about 150 basis points of reductions in the fed funds rate. By that standard, the Fed's move to increase its balance sheet by $1.15 trillion was worth 172.5 basis points of rate cuts, or less than one-fourth of the total needed to get to an equivalent of reducing the fed funds rate by 750 basis points. In other words, the Fed may need to expand its balance sheet by another $4 trillion to get U.S. monetary policy to an adequately expansionary stance—the equivalent of –750 basis points on the fed funds rate. So, to repeat, while the Federal Reserve's March 18 balance sheet expansion of over a trillion dollars was huge by past standards, it is probably modest when measured against the total expansion that will be needed. The Federal Reserve is under immense pressure to initiate further stimulative measures in view of two other policy challenges: the negative effect of the attacks by the Obama administration and members of Congress on the recipients of funds from the Troubled Assets Relief Program (TARP) and the fact that other central banks, with the exception of the Bank of England, the Swiss National Bank, and the Bank of Israel, have not pursued expansionary policies on a scale adequate to address the global crisis.

John H. Makin (jmakin@aei.org) is a visiting scholar at AEI.

Class Warfare

At 5:00 p.m. on the same day the Fed acted, a media firestorm broke out over the revelation that the Obama administration had connived with Senator Christopher Dodd (D-Conn.) to slip into the February stimulus package a provision that permitted payment of 2008 bonuses to AIG employees and others. President Obama—in order to deflect attention from this intensely awkward revelation of breathtaking hypocrisy—chose to further intensify American class warfare by inciting a witch hunt against AIG employees that was sufficiently inflammatory to spark letters to members of Congress calling for strangulation with piano wire of AIG bonus recipients—and their families. A hysterical Barney Frank (D-Mass.), chairman of the House Financial Services Committee, berated Edward Liddy, the dollar-a-year CEO of AIG, while doltish Charles Grassley (R-Iowa), ranking Republican on the Senate Finance Committee, added that AIG executives should "resign or go commit suicide."

Still, Obama chose to keep the hysteria building when, on the following evening, March 19, he commended the House-passed legislation to tax—retroactively—the bonuses of all TARP recipients at a 90 percent rate. Many commentators have observed that ex post facto abrogation of contracts is unconstitutional and will not be sustained in a court of law. Yet the willingness of Obama—holder of a Harvard law degree—to advocate abrogation of contracts[1] has done immense damage to the process of repairing the financial system, all because he chose to whip up hysteria against Wall Street in an attempt to enlist the approval of Main Street. The lead editorial—entitled "Washington Gone Wild"—in the *Washington Post* on Friday, March 20, stated: "Rather than bringing reason to the debate, President Obama has stoked the anger, and last night, the White House commented favorably on the House action."

The AIG witch hunt and the attack it has engendered on financial institutions will prompt banks that have received TARP funds to repay them as quickly as possible. Goldman Sachs is already moving to repay its TARP funds. Deleveraging will result. (Note to President Obama: ask Larry Summers or Tim Geithner to explain what that means.) Let us assume that the institutions that have had to draw more than once on TARP funds do not have the means to repay. Nevertheless, the remaining institutions, each of which has received $5 billion or more, collectively have taken $76.6 billion in TARP funds. If they return those funds to the Treasury, the aggregate Tier 1 risk-weighted ratio for U.S. banks would drop by 0.68 percentage points—just enough to cut GDP by 1 percent and eliminate 1 million jobs.[2]

> While the Federal Reserve's March 18 balance sheet expansion of over a trillion dollars was huge by past standards, it is probably modest when measured against the total expansion that will be needed.

One is left to wonder if Obama will now proceed to vilify banks that threaten to pay back the TARP funds, most of which they did not want to take in the first place. Or, better yet, if they do that, perhaps he will just cancel the contracts—ex post, of course.

The Public-Private Investment Program

After a week of approving the class-warfare frenzy directed at AIG executives, Obama abruptly reversed field and sought to temper the unconstitutional House bill aimed at taxing back bonuses. Next, on March 23, beleaguered Treasury Secretary Timothy Geithner unveiled the Public-Private Investment Program (PPIP), which harkened back to former treasury secretary Henry Paulson's initial plan to use public, TARP funds to buy toxic assets from banks and insurance companies. The plan was also adjusted to allow highly leveraged private-sector participation in the purchase of the banks' problem assets.

PPIP is a risky effort to buy time while the Obama administration tries to find a way to convince an immensely hostile Congress to supply another $1 trillion, or more, to remove toxic assets from bank balance sheets. It would be far better to move directly to the endpoint in all successful resolutions of financial crises. This would entail acknowledging the $1.5–2 trillion in lost asset values on financial-institution balance sheets while closing down the weakest institutions, making sure to protect depositors in the process.

The transparent, proactive approach to acknowledge losses and leave only clearly viable banks and insurance companies in operation is all the more important now that the hysteria driven by AIG bonuses has poisoned the chance for substantial private participation in PPIP. The plan offers substantial, taxpayer-financed subsidies for private investors to purchase toxic assets. But no one can indemnify investors from congressional steps to tax away any profits that might accrue to private investors from PPIP participation—least of all President Obama, who has lost control of the Democrat-controlled Congress.

The initial stock market euphoria over the announcement of PPIP on March 23 coincided with a rise in the S&P 500 Index by nearly 7 percent that day and stoked a bear market rally already underway. That was typical of the initial responses lately to government financial rescue plans. The pattern also fits the sell-off—still not fully reversed—after the February 10 revelation that Secretary Geithner did not have a real plan at that point. The market rebound that started on March 23 could continue until the end of this quarter. Such a development would only reinforce the harmful effort by the Obama administration to make believe that the damage to the financial sector wrought by the collapse of the housing bubble can be overcome without allowing weak institutions to fail. Bear in mind as well that house prices are still falling at an accelerating pace.

> Transparency with regard to which banks are solvent and which banks are not will be necessary in order to restore confidence to the financial system.

Global Policy Moves

The Fed's greater quantitative easing has become significant as a catalyst for a much-needed increase in quantitative easing on a global scale. Growth in Japan, the world's second-largest economy, is contracting at a 15 percent annual rate in the current quarter. European growth is still decelerating rapidly, underscored by an accelerating contraction in industrial production. A report on March 20 showed European industrial production dropping 3.5 percent during January alone, implying a 17.3 percent year-over-year contraction. The slowdown represents an acceleration beyond the 2.7 percent drops in eurozone industrial production in November and December.

After the Fed's sharp increase in quantitative easing on March 18, the dollar fell by about 3 percent against the currencies of Europe and Japan. That, of course, represents a deflationary impulse in those rapidly slowing economies and so may prompt further quantitative easing. The Bank of Japan did announce, also on March 18, additional purchases of government securities that imply additions to its balance sheet equivalent to about 1 percent of GDP over the coming year. That, however, translates into a modest easing of twenty-one basis points over that period of time—far too little and far too gradually implemented to provide the extra stimulus Japan needs. The European Central Bank has, over the past year, expanded its balance sheet by a net €400 billion, or the equivalent of about ninety-four basis points of easing. However, the sharp slowdown in European growth indicates that far more is needed.

As we have noted, to the extent that the Fed's more aggressive easing pushes down the dollar and transmits deflationary pressure to other countries, it may provide the leverage necessary to accelerate the move by those countries toward further quantitative easing. Of course, there is the troublesome possibility that part of the dollar's weakening is due more to the damaging spectacle of the Obama administration's delay and disarray on providing support for the financial sector while simultaneously trying to pursue its original agenda of health care reform and increasing taxation on energy. True health care reform that helps to conserve precious resources in that sector in a way that contains spiraling costs is a worthy goal, but pursuing it may have to await the steps that avoid a financial meltdown. Moreover, the proposal in the Obama budget to sharply increase taxes on energy amounts to a negative shift in the aggregate supply curve at a time when demand is collapsing.

There are some bright spots in the global monetary-policy picture. Approximately two weeks prior to the Fed's steps, the Bank of England announced similar measures to pursue aggressive purchases of government bonds, equivalent to about 5 percent of GDP in the first tranche with a total move to 10 percent of GDP likely to follow. These steps would be equivalent to more than two hundred basis points of rate cuts and will help to contain the financial crisis and economic slowdown in the United Kingdom.

The Swiss National Bank recently announced aggressive purchases of foreign currency in order to signal its desire to avoid a sharp deflationary appreciation of the Swiss franc. Such unprecedented moves are part of the deflation preemption tool kit that central bankers have been discussing for years. Avoiding further sharp appreciation of the Swiss currency will also help to cushion the financial crisis in Eastern Europe, which is tied to a collapse of the currencies in that region against harder currencies, a collapse that has sharply increased the burden of mortgage loans denominated in currencies such as the Swiss franc.

Further Steps against Deflation

The Fed can underscore its commitment to the battle against deflation by setting a price level target. If, say, a target is set for 2 percent average inflation rate over the next four years, it will send a message that should deflation appear at, say, –1 percent, it would be followed by a subsequent move to push inflation up to 3 percent in order to hit the 2 percent target path. The price level target would provide the benefit of underscoring a long-term central bank commitment to avoiding deflation.

The embattled U.S. financial sector still struggles with the reality of substantial underlying losses on the balance sheets of banks and insurance companies like AIG. Transparency with regard to which banks are solvent and which banks are not will be necessary in order to restore confidence to the financial system. Banks or financial institutions that are deemed insolvent should be placed into receivership, with the depositors fully protected, while the claims of common stockholders and debt-holders are dealt with under the auspices of well-established bankruptcy procedures.

The Obama administration has gone from failing to address the crisis to actually making it worse—even as the Fed and several other central banks have struggled to contain it.

Finally, the Obama administration needs to rethink its priorities radically. Stabilizing the financial system and restoring economic growth should be the primary focus. While paying lip service to these goals, the actions of the administration, so far, have been extraordinarily counterproductive. On the stimulus front, the option remains open for the administration to propose a reduction in the payroll tax for both employees and employers that would help stabilize the economy and mitigate rising unemployment. Employers relieved of paying the 7 percent payroll tax will be less likely to lay off workers. And workers with a 7 percent increase in their take-home pay will be more likely to provide the spending increase necessary to support the economy.

Looking Ahead

The financial crisis now engulfing the global economy emerged after collapses of the housing bubble and the stock market. Those developments together have erased so much wealth—about $40 trillion worldwide, so far—that the global economy has collapsed and the financial system has ceased to function as a provider of credit to households and firms.

The Obama administration has gone from failing to address the crisis to actually making it worse—even as the Fed and several other central banks have struggled to contain it. Obama's first strategic error was to pass a weak stimulus package *before* moving to stabilize the financial sector. Slipping legislation enabling AIG bonuses into the stimulus package was a very bad tactic, as was inciting a virtual class war to cover it up.

To recap, the basic problems remaining are a lack of transparency concerning the extent of the losses of banks and insurance companies and the identification of which institutions remain solvent and which do not. Insolvent ones should be compelled to enter Chapter 11 bankruptcy proceedings. The depositors—all depositors—of insolvent banks should be fully protected—if necessary, with additional resources from the Federal Deposit Insurance Corporation. Once insolvent banks and insurance companies are closed, full transparency concerning the solvency of remaining institutions will enable those institutions to begin functioning again as viable financial intermediaries willing to extend credit to borrowers clearly able to service and repay loans.

This transformation of the financial system will take time—all the more time in view of the hostility toward financial firms engendered by the Obama-inspired, congressionally enhanced AIG fiasco that played out in March. Meanwhile, the Fed's balance sheet expansion is the only game in town when it comes to avoiding a total financial meltdown.

Mr. President, please be sure to send a nice thank-you note to Chairman Bernanke. Oh, and do not even think about not reappointing him next year as Fed chairman—if he is willing to hold the job.

Notes

1. President Obama has also approved of legislation to allow judges to abrogate terms of mortgage contracts with "cram down" bills.

2. These estimates are from researchers at JPMorgan Chase and the International Monetary Fund, except for the job loss estimate given a 1 percent reduction in GDP. That figure is taken from a report, "The Job Impact of the American Recovery and Reinvestment Plan" (January 9, 2009), written by Christina Romer after she had been selected by President-elect Obama to lead his Council of Economic Advisers.