



# Lombard Street Research

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## Bernanke's Fed shoots US in both feet

**WE SUGGEST: US monetary policy bad for stocks, € = \$1.50 a staging post**

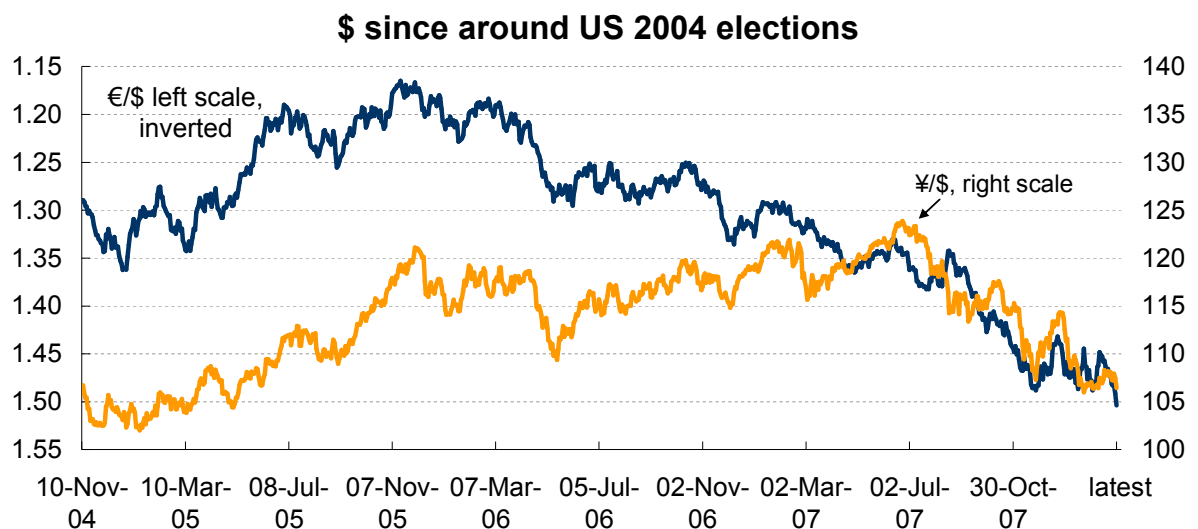
**SUMMARY: The Fed's drastic rate cuts are boosting inflation, inducing a back-door cut in debt and a back-door recession as real incomes erode. Its policy is disastrous.**

American solipsism is reaching new heights as the election season hots up. It is with increasing incredulity that one reads the US commentaries on monetary policy. Lower interest rates are regarded as a switch that can simply turn on the economic lights. It seems to occur to nobody that a country whose problem is utterly exhausted private-sector debt capacity cannot generate growth by encouraging more debt! The Fed's mandate (ignoring quantitative measures for a moment) is to

- Sustain growth
- Keep inflation low

Its recent policy of drastic interest rate cuts is likely to

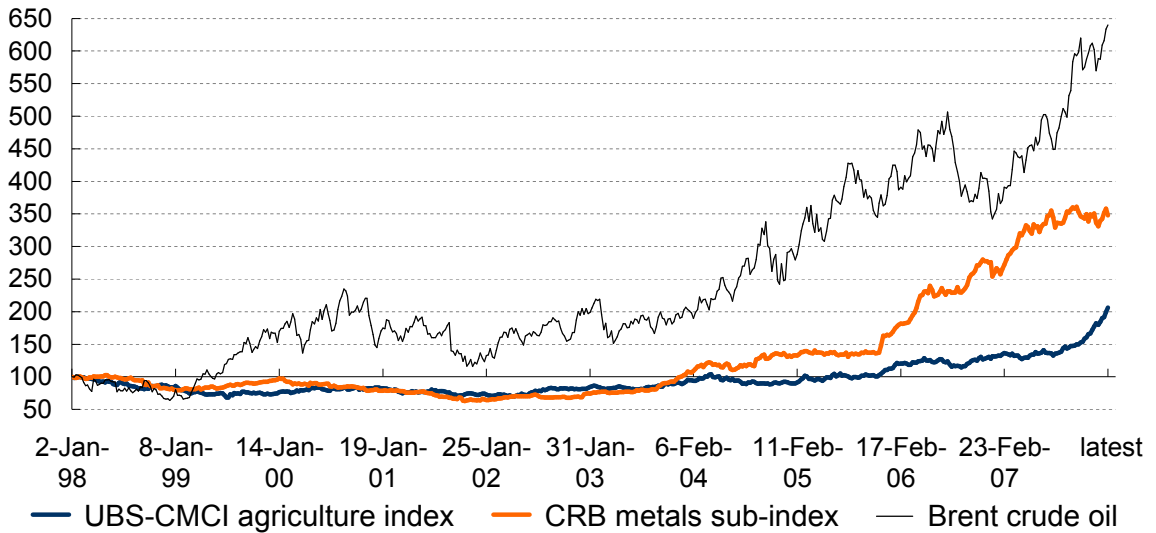
- Reduce real incomes, thereby hammering growth, by means of
- Rapidly worse inflation



My colleague Brian Reading's "three Ds" for dealing with a country's excess debt problem are a choice amongst default, devaluation and deflation. In general, the best combination is devaluation and (domestic monetary) deflation. This was the medicine over-zealously imposed on the Asian Tigers ten years ago in the Asian crisis, and in Britain in 1990-92,

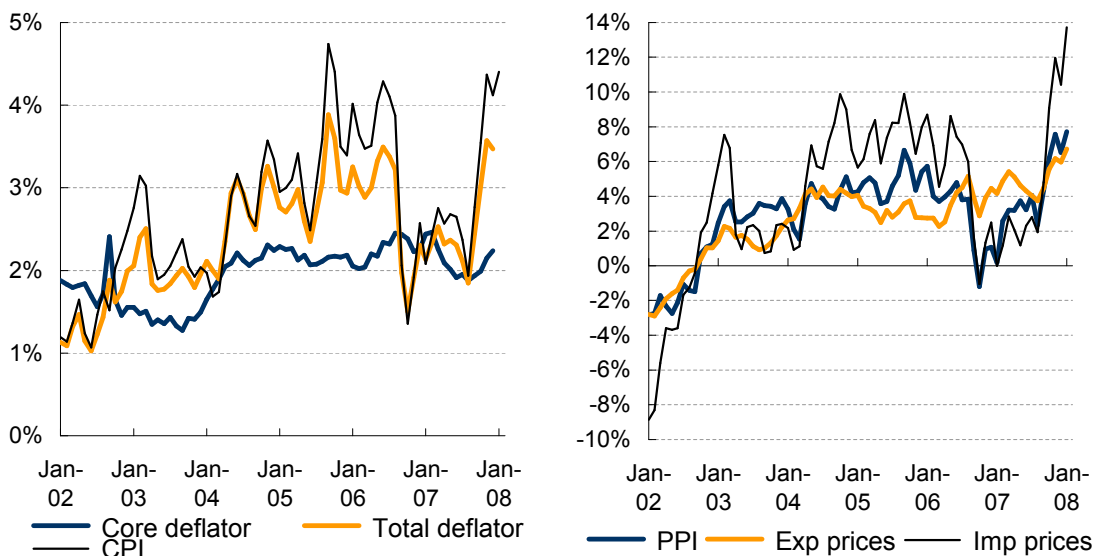
amongst many other examples, with long-run benefits in both these cases. Mr Bernanke, however, thinks the US can get away with simply devaluation. For the rest of the world that is little more than an announcement that the US is going to default on its debts by the back-door: inflation. A country that requires \$¾ trillion of fresh funding each year is ill advised to destroy wilfully the probity of its currency, even if this is an election year.

### Agricultural catch-up begins, 2-Jan-98 = 100



The Fed's childish denial that food and energy prices matter is contributing to the strong upward trend in commodity prices, as investors globally fly from the dollar into real assets. Overheating in China and India, which are both wasteful and intensive users of energy and – given poor populations – with a strong marginal propensity to consume more food, is a reality. Developed economies will simply have to pay more for food and energy, meaning in current conditions lower real incomes and spending.

### US inflation measures (deflators only to Dec.), 12-month % change



US policy-makers' denial of the need for less consumption (and higher domestic saving) has just produced a 26-year high for PPI inflation, taking one back to the tail-end of the Great Inflation. If the Fed's policy actually succeeded in averting recession, it would have to tighten again hard, producing a second, worse downward lurch, as in 1980 and 1982. It probably will not work. Inflation is now higher than the growth rate of incomes. So the US economy gets deflation by the back door too. With house prices tumbling to worsen the balance sheet damage from excessive household debt, the feared recession is probable.

The Fed is already dangerously over-stretched by its twin mandated objectives of growth and low inflation. It seems to have added another: bailing out Wall Street. (Though some say its policy is just panic.) But Wall Street's problems are a mix of liquidity and solvency. The Fed is right to supply plentiful liquidity, pending proper clarification by banks of their positions and exposures, thus providing the information needed for private-sector money market confidence to be restored: an essential condition of liquidity. But plentiful liquidity at the Fed does not require lower interest rates. And where solvency is the issue, as it may be for some institutions, the sooner the bankruptcies are out in the open, the sooner the isolation of toxic elements, followed by work-out, can begin. Until then, private-sector liquidity will certainly be constrained.

In the third quarter of last year, at the stock market peak, non-financial companies' equity was retired at an \$800 billion annual rate, mostly via LBOs. These have gone for the time being. The US current account needs about the same annual rate of financing. Outside the government it has no incremental debt capacity. The answer is simple, and goes beyond the "three Ds": an equity/debt swap. Stocks have to get cheap enough for foreigners to produce net equity inflows into the US of at least \$½ trillion, preferably \$¾ trillion. That time will probably come – particularly as the food price boom favours the US, for a change, as a big farming country. But how much inflation will the Fed will have baked into the system by then? Both stocks and economic growth suffered badly from inflation in the 1970s.

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