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Professor Bernanke and his colleagues at the Federal Reserve have a big problem of their own making: their urgent rescue of investment dealer Bear Stearns worked! The world financial system avoided a derivative meltdown but now risks an inflation hangover from their easy money remedy.

That is not to say that Bernanke and Company were wrong to rescue Bear Stearns. The U.S. banks and investment dealers were already suffering from their ill advised forays into sub-prime credit and probably could not have withstood the further stress of the bankruptcy of a major derivatives counter party. The problem is that the Fed pushed through all its monetary and policy stops in the rescue effort and now sits with policy at full emergency power. With the increase in the U.S. Consumer Price Index at 4.2% year over year and the Fed Funds rate at 2%, the real interest rate in the U.S. is a very negative -2.2%. This will ultimately push the price level upwards as savers tire of real depreciation of their capital. They will choose to invest in hard assets or consume. It is not happenstance that sophisticated institutional investors are increasingly taking a pass on financial assets in favour of "inflation sensitive" assets.

When Do We Throttle Back?

The Fed is now struggling with the issue of when to pull back its stimulus throttles, given that the economy has not withered and died as a result of the credit crisis. It has slowed obviously, but not enough to affect the elevated rate of inflation in the United States. This defies the conventional economic wisdom of our times which holds that a slowing U.S. economy inevitably results in falling interest rates and inflation. This is not currently the case in the U.S. or in most other countries worldwide as rising inflation has combined with slowing economic growth. The 1970s word "stagflation" has reemerged in the popular financial press, echoing the angst of policymakers and commentators who can't truly accept that easy money and credit are not always the solution to real or imagined economic ills.

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Like aging Generals refighting the wars of their youth, Professor Bernanke and the Federal Reserve attacked the Bear Stearns problem with a heavy barrage of interest cuts. To his credit, Bernanke recognized the inflation risk looming globally which is why he initially tried a myriad of special borrowing programs for banks rather than use the blunt force of interest rates. Pictures of Bernanke at the time of the Bear Stearns affair speak volumes. His drawn face and haunted demeanor showed the terrible pressure on him to ease. Wall Street and Washington wanted easy money and they eventually got what they wanted. Bernanke was forced to resort to the massive interest rate reductions which have become the hallmark of Fed policy since Greenspan became Chair in 1987. Bernanke also threw the Federal Reserve balance sheet into the fray with the guarantee of a $52 billion portfolio of Bear Stearns assets and his special borrowing program for investment dealers which former Fed Chair Paul Volcker said were on the very edge of legality.

Bernanke still isn't looking very relaxed and still has the drawn features of a man under considerable stress. The problem now is that Bernanke and the rest of the Fed Governors know that they have employed nuclear weapons in what was previously a low grade conventional war. Their extreme policies reflected a groupthink in senior U.S. financial policy circles and the influence of Wall Street on the

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Fed and the Bush administration. Henry Paulson, the U.S. Secretary of Treasury was directly involved in the Bear rescue and is a former CEO of investment bank Goldman Sachs. He presided over development of a number of the structured products that have imploded. Fed Chair Bernanke met with a number of Wall Street CEOs just prior to the Bear bailout according to Fed records. Their comfortable Wall Street world was in very real peril and these pillars of Wall Street undoubtedly believed that extreme policy action was warranted. That their reckless and stupid behaviours caused the problems in the first place was not important to them. They were very motivated to protect the existing financial system which has been very lucrative for them and which they had created with their very vocal calls for financial deregulation. Their naked self interest now makes them big fans of government intervention.

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Dynamic Duo to the Rescue (Again !)

Paulson and Bernanke also rushed to the rescue of Fannie Mae and Freddie Mac in July. These two “Government Sponsored Entities” dominate the U.S. mortgage market. Fannie Mae was created in 1938 as part of Roosevelt’s New Deal and privatized in 1968. Freddie Mac was created as a private company in 1970 to provide competition for Fannie. Both were created by Congress to foster home ownership. Since they both had issued public equity, they proceeded to grow their assets to increase their profits and share prices. The problem is that they had every incentive to grow their assets as much as they could due to the widely held perception that they had an implicit guarantee from the U.S. Treasury, despite government protestations to the contrary.

Fannie and Freddie certainly used the implied support of the U.S. government unwisely, growing the amount of mortgages they guaranteed and the mortgages they purchased for their own portfolios until they dominated the U.S. residential mortgage market. The problem was that they grew their portfolios with very little capital and now are the most highly levered financial institutions in the world. The capital standards for the GSEs remained low due to their extensive political lobbying which effectively prevented prudent regulation. Their accounting has also been shoddy, which has triggered several investigations over the last few years.

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The shareholders got all the upside from this convenient political reality and the market believed that the downside was held by the unfortunate U.S. taxpayers. It looks like the market was right, in that the imploding U.S. mortgage market forced the Bush administration into another hasty rescue. On July 13th, after a week which saw plunging share values for both Freddie and Fannie on capitalization worries, the dynamic financial bust fighting duo of Paulson and Bernanke sped once again to the rescue. Paulson announced a rescue package that included an increase in the existing $4.5 billion credit line to Fannie and Freddie to $300 billion! Permission was also given for the U.S. Treasury to inject equity into the GSEs at the Secretary’s discretion. Paulson announced these measures on the steps of the Treasury just to make sure the symbolism of the moment was appropriate: “You mess with Fannie and Freddie and you’re messing with me and my money machine!”

Not to be left out, Bernanke opened the Fed’s Discount Window to Fannie and Freddie, announcing that they could tender collateral in exchange for crisp new U.S. Treasury Bonds. The collateral included “Agency Bonds” which are the debt securities that Fannie and Freddie issue themselves to fund their operations. Talk about liquidity, they can issue bonds to tender to the Fed in exchange for crisp new Treasury Bonds!

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A Guarantee of More Debt

There is no question that these measures will work to restore liquidity to Fannie and Freddie's funding. The problem is that they still need capital to deal with the losses growing in their mortgage and insured mortgage portfolios. This is the reason for the request to let the Treasury make equity injections to the GSEs. **Fannie and Freddie have more than $5 trillion in mortgages or guarantees which is almost the same amount as the entire current U.S. marketable debt**. Recapitalizing them is no small affair which is why part of the rescue plan involves raising the U.S. national debt limit.

This rescue, after years of official U.S. policy maintaining there was no guarantee to Fannie and Freddie, implicit or explicit, shows the depths of the mortgage problem and how far its tentacles have spread. The New York Times summarized well:

> *"The government officials said that the more drastic alternative that has been considered - placing one or both companies under the control of a government-appointed conservator - would be done only as a last-ditch measure if the intermediate steps failed to restore confidence. The failure of just one of the companies could be catastrophic for economies around the world…'G.S.E. debt is held by financial institutions around the world,' Mr. Paulson said in his statement. 'Its continued strength is important to maintaining confidence and stability in our financial system and our financial markets. Therefore we must take steps to address the current situation as we move to a stronger regulatory structure.'"* ("Treasury Acts to Shore Up Fannie Mae and Freddie Mac", NY Times.com, Stephen Labotan, July 14, 2008)

Mr. Paulson has not yet used his personal authority to inject funds into Fannie and Freddie. After an initial rally in their stocks, the market came to the grim realization that the "protections" to the U.S. taxpayer built into Paulson's legislation would be massively dilutive to shareholders at best and implicit or explicit nationalization at worst. This caused their stocks to plummet further, although there was some recovery towards the end of August. The problem for Fannie and Freddie and the U.S. government is that the overhang of government dilution makes it very unlikely that they can successfully issue the common equity that they need to improve their balance sheets. The latest strategy seems to be to wait and hope desperately that their stocks recover enough to make a private sector recapitalization attractive.

Indy and the Temple of Deposit Doom

With all the fuss over Fannie and Freddie, it has almost escaped market and press attention that the Federal Deposit Insurance Corporation put mortgage bank Indy Mac into receivership in July. This means that the FDIC will manage Indy Mac and work it out over time. At $32 billion in assets, Indy Mac is the third largest bank to fail in U.S. history. There were 10,000 depositors above the $100,000 maximum insured amount or an estimated $1 billion out of the $19 billion in deposits. The FDIC estimated a recovery of 50% on uninsured amounts, but recently has announced that recoveries could be lower than they had expected. Since Indy Mac specialized in Alt-A mortgages which were considered to be higher quality than subprime, this is quite a comment on the value of U.S. residential mortgage portfolios.

With all the rescues of ailing financial institutions, it has not escaped the market that all the resulting liquidity might threaten the price level. The bond market is closely watching Fed policy to see when it will return to a more even keel. Bernanke needs Congress to support his proposals to increase the Fed's powers of regulation over the financial markets, however, and this complicates his moves to

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return monetary policy to a more normal stance. The Democrats in Congress do not want monetary policy tightened before the November Presidential and Congressional elections.

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> *" 'The chairman has done a good job at crisis management,' says Representative Carolyn Maloney of New York. 'I like the moves he's made', says Representative Mel Watt of North Carolina. Both are Democratic members of the House Financial Services Committee, which will question Bernanke July 16 after he delivers his semi-annual report on the economy to Congress…While Watt, 62, and Maloney, 60, give Bernanke high marks for helping to keep the economy out of a recession and stepping in to prevent the bankruptcy of Bear Stearns Cos.,* ***both say it's much too soon to be talking about higher interest rates.*** *Their support matters because the committee they sit on would decide on any expansion of the Fed's regulatory powers."* ("Bernanke Embrace May Turn as Fed Seeks More Powers", Bloomberg.com, Scott Lanman, July 14, 2008)

Stretching the Economic Imagination

When the Federal Reserve Open Market Committee sat down to its deliberations in June, it pondered the question of when to remove some of the stimulus it had provided in the aftermath of the Bear Stearns rescue. Although there were rumblings out of the Fed about reversing their massive accommodation, many market participants believed that the weakening U.S. economy and the continuing Greenspan easy money legacy dictated even lower interest rates ahead. After all, despite his initial interest rate reticence, "Helicopter Ben" Bernanke got his nickname after discussing dropping money out of a helicopter as Deputy Fed Governor.

The Fed shocked most of the financial chattering class and the Wall Street low interest rate lobby by leaving the Fed Fund steady at 2%. They have continued at this level over the summer. Of course, as we pointed out above, a 2% Fed Funds rate cannot be considered stringent monetary policy with inflation above 5% by any stretch of the economic imagination. To the horror of bankers depending heavily on low interest rates to skate their rotting portfolios onside, one stalwart Fed Governor dissented and was in favour of raising the Fed Funds rate.

Why Aren't Monetarists in Charge of Money Supply?

Central banks are now struggling with rising price pressures but are loathe to sharply limit the growth in money supply.

As central banks worldwide struggle with higher levels of inflation than was thought possible a few years ago, we cannot help but wonder what has happened to the strict doctrinal monetarists who ruled the monetary world post Volcker. Central banks are now struggling with rising price pressures but are loathe to sharply limit the growth in money supply. The inflation problem is worst in countries that have pegged their currency to the U.S. dollar for trade reasons and are importing its emergency low interest rate monetary policy. The stark realization that too much money supply is threatening economic stability seems to be slowly entering the collective financial consciousness as the Bloomberg article below shows:

> *"With currencies tied to the U.S. dollar, officials in many developing countries have had to keep their monetary policies linked to the Federal Reserve's. Now, after chairman Bernanke led the Fed's most aggressive easing in two decades, their central banks find themselves with interest rates too low for their economies and the worst bout of inflation in a generation………Prices are now surging across the developing world. China's inflation rate stayed near a 12-year high of 8.7 percent in May; prices in Vietnam jumped 27 percent in June and Indian wholesale prices increased 11.6 percent last month, the fastest in 13 years. Inflation ex-*

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ceeds benchmark lending rates in China, Russia, India and at least a dozen other emerging economies." ("Bernanke's Emerging-Market Disciples May Need to Follow Volcker", Bloomberg.com, John Fraher and Shamim Adam, July 7, 2008)

China has resorted to increasing bank reserves and limiting loan growth by fiat. India is raising interest rates in the face of exploding credit. The inflation problem is not limited to the developing world. The Bank of England is busy writing letters to the Chancellor of the Exchequer to explain why inflation is continually above its formal target. The European Central Bank, the inheritor of the strict monetary discipline of the Bundesbank, raised rates almost apologetically, but is terrified of the political cost and is now sitting on its hands. The Fed and the Bank of Canada are talking tough but have left their discount rates lower than the actual inflation in their countries.

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Should We Bring Volcker Out of Retirement?

We know from the Volcker period that inflation can be defeated by severely limiting money supply and credit. This of course hammers economic growth and employment, which is exactly what it is intended to do. The problem is that there is no will to do this among central bankers or their political masters at present. Jeffrey Lacker, President of the Federal Reserve Bank of Richmond, believes that the accommodation should be removed in any event. *" 'Just as easing policy in response to emerging downside risks made sense, withdrawing some of that stimulus as those risks diminish makes eminent sense as well,' Lacker said today in a speech to the National Economists Club in Washington."* ("Fed's Lacker Says Recovery Should Prompt Higher Rates", Bloomberg.com, Steve Matthews and Craig Torres, July 8, 2008)

The only trouble for strict central bankers like Lacker is that there is a huge political constituency for interest rate cuts but there are seldom political proponents of interest rate hikes.

Since the political appetite for a steep economic setback is lacking, we are left waiting to see whether the damage wrought by the credit crunch is in itself sufficient to slow the global inflation pressures. This is clearly the fervent hope of Benanke and his central bank brethren worldwide. The stimulative monetary policy loosed in their Bear campaign is itself a threat to the price level. Despite the current economic orthodoxy, inflation can exist in a recessionary environment, as was the case in the 1970s.

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"Yellen" at Inflation

Janet Yellen, President of the Federal Reserve Bank of San Francisco, is under the impression that vigilant central bankers can react in time to prevent higher inflation. *"(Yellen) said yesterday the central bank shouldn't allow any increase in wages and prices to fuel an inflationary cycle… 'If we saw a wage-price spiral developing, then we need to act,' she said. 'Nobody wants a repeat of the 1970s.'"* (Bloomberg.com) Looking at the surging price level worldwide, the thought occurs to us that nobody in the 1970s wanted the 1970s inflation wage and price spiral. The problem was that they inflated money supply to ease the economic shock of the Arab oil embargo and ended up with inflation they didn't want. It was a central bank easing in the face of rising energy prices and economic shock to prevent a recession. Sound familiar?

Is Wall Street Distorting the Fed's Reality?

At the Federal Reserve's annual symposium at Jackson Hole in August, a blunt paper by economist Willem Buiter caused much consternation. Buiter, a former Bank of England policy maker ungraciously criticized his host for paying too

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much attention to financial institutions. *"The Fed listens to Wall Street and believes what it hears…….This distortion into a partial and often highly distorted perception of reality is unhealthy and dangerous."* (Ex-BOE Official Slams Fed, Sparking Hottest Jackson Hole Debate, Bloomberg.com, John Fraher, Scott Lanman, August 24th 2008)

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Fed Governors Mishkin and Blinder, both Greenspan trained monetary commandos, rejected Buiter's criticism of the Fed's interventionist crisis management. *"Mishkin, a leading advocate of the Fed's effort to sustain economic growth through rapid rate reductions, said research shows that 'what you need to do is act more aggressively'"(Bloomberg).* Buiter aimed his criticism particularly at the Fed's special lending programs: *"You don't let your borrower determine the value of the collateral offered to you…That's just crazy."* Other papers at the conference pointed out that the Fed's programs could allow financial institutions to "window dress" by substituting the Fed's treasuries for lower quality securities over reporting periods.

The objective of the Fed's special lending programs is to provide liquidity to financial institutions after the complete breakdown of the securitization financing channel. The unprecedented ability of these financial institutions to exchange their unwanted asset backed securities for treasury bonds allows them to avoid insolvency but has introduced considerable risk into the portfolios of the Fed. The Fed portfolio previously held treasuries and it lent against treasury collateral from banks. This meant the Fed previously offered short term financing against the highest quality collateral. It now accepts asset backed securities rated BBB or above as collateral. Considering the huge losses on "super senior" AAA rated ABS, the Fed is now highly exposed on the credit front. It also has seen its balance sheet balloon as it has become the primary source of funds for the U.S. banking system and investment banks.

The Highest Octane Monetary Policy

The downside of all this financial chicanery is simple. The Fed funds its programs by printing money and using it to pay the Treasury for the bonds it will offer against asset backed securities. This is called "debt monetization" which is the most stimulative and high octane monetary policy known to financial kind. Why Mishkin and Blinder think further "rapid rate reductions" are necessary is not obvious to the economically aware. Perhaps it's a Pavlovian conditioning response from their years in the Greenspan Fed.

This epic battle between the credit forces of deflation and the inflation of money supply and credit by the world's central banks is not over. The prices of real assets financed by the securitized debt mania are plunging and financial stocks are swooning in sympathy. Arrayed against these forces of financial evil are the Bernanke Fed and its printing presses and the Paulson Treasury and its bond issuance machine. The dynamic financial bust fighting duo will almost certainly triumph. The collateral damage might be inflation at higher levels than now thought possible.