

Questionable rescue operations

MILITARY HISTORY IS WRITTEN BY THE VICTORS. Economic history is written, to a degree, by central bankers. In both cases you have to take official accounts with a large dose of salt.

You thought you knew that the Duke of Wellington whipped Napoleon at the Battle of Waterloo.

But according to the expert on Waterloo, Peter Hofschröder, Wellington's army of 68,000 men was locked in a bloody stalemate with Napoleon's force of 73,140 until late in the afternoon of June 18, 1815. That's when Field Marshall Blücher's 47,000 Prussian troops entered the field of battle and turned the tide.

The Iron Duke's official account has Prince Blücher failing to arrive until early evening and with only 8,000 troops. Somehow 39,000 Prussians simply vanished. As they say, the rest is history—literally history as written by Wellington.

Doctored accounts often gain wide circulation in the sphere of economics, too. Unfortunately, false beliefs are very difficult to overturn by facts, and fallacies play a significant role in economic policy discourse.

Collapse

TO GET A HANDLE ON THE CURRENT STATE OF RECEIVED IDEAS concerning the Federal Reserve, there is no better place to start than former Fed Chairman Alan Greenspan's *The Age of Turbulence: Adventures in a New World*. According to Greenspan, the Fed got things just about right during his tenure (August 1987-January 2006).

Let's take a closer look. Were there any mistakes or perverse policy patterns during the Greenspan era? The easiest way to answer this question is to measure the trend rate of growth in nominal final sales to US purchasers (GDP – exports + imports – the change in inventories) and then examine deviations from that trend.

During Greenspan's tenure nominal final sales grew at a 5.4% annual rate (see chart). This reflects a combination of real sales growth of 3% and inflation of 2.4%.

The first deviation from the trend began shortly after Alan Greenspan became chairman. In response to the October 1987 stock market crash, the Fed turned on its money pump and over the next year final sales shot up by 7.5%, well above the trend line.

Having gone too far, the Fed then lurched back in the other direction. The ensuing Fed tightening produced a mild recession in 1991.

From 1992 through 1997 growth in the nominal value of final sales was quite stable. But successive collapses in certain Asian currencies, the Russian ruble, the Long Term Capital Man-

agement hedge fund and finally the Brazilian real triggered another excessive Fed liquidity injection and a boom in nominal final sales.

This was followed by another round of Fed tightening, which coincided with the bursting of the equity bubble in 2000 and a slump in 2001.

The last big jump in nominal final sales was set off by the Fed's liquidity injection to fend off the false deflation scare in 2002. Back then the annual increase in the price index for core personal consumption expenditures was drifting below 1%, signaling an approaching deflation.

This moved then Fed governor Ben S. Bernanke (now chairman) to deliver a dense and noteworthy speech, "Deflation: Making Sure it Doesn't Happen Here," on November 21, 2002.

The most memorable line: a semi-serious reference to the possibility that the Fed, in a real pinch, could increase the money supply by dropping bills from helicopters.

The Fed did not, in any event, employ aircraft in its open market operations. But it did manage to work the Fed funds rate down to 1% and final sales surged. And as night follows day, the Fed started putting on the brakes in 2004.

During the Greenspan era, the facts are clear: the Fed overreacted to real or perceived crises and created three post-crisis demand bubbles (see chart). These bubbles were followed by monetary tightness which was necessary to eliminate the bubbles.

Recently we have witnessed the Bernanke-led Fed reacting even more dramatically to a financial crisis than did the Greenspan Fed. In response to market turmoil in Europe on Martin Luther King's birthday (a national holiday in the US), the Fed enacted an emergency interest rate cut of 75 basis points in both the federal funds target rate and the discount rate the next day, January 22.

Austrian cycle

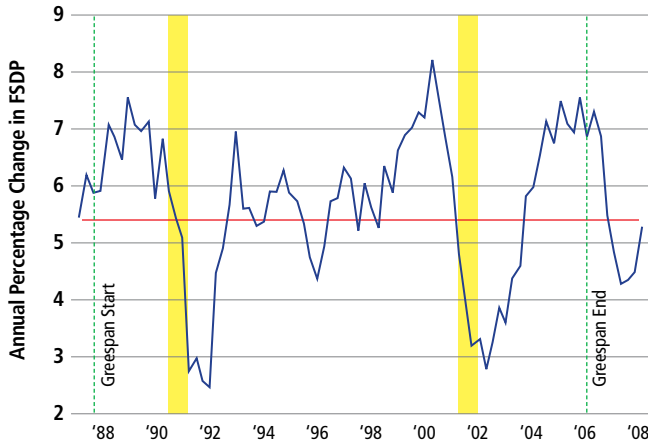
THIS WAS QUICKLY FOLLOWED BY ANOTHER 50 BASIS POINT CUT IN both rates at the Fed's regular open market committee meeting of January 30. This left the federal funds rate and the discount rate at 3.0% and 3.5%, respectively.

But the Fed's money pump might not work this time around. The current US downturn has all the hallmarks of an Austrian business cycle. In this type of cycle, a credit boom spawns an asset price boom which eventually sows the seeds of its own destruction-- a slump.

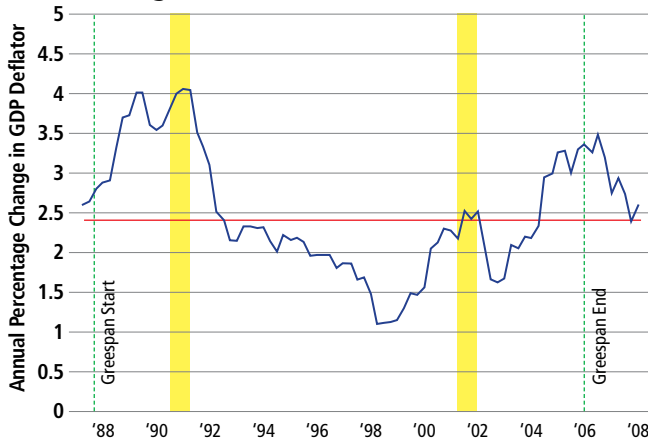
The US and European business cycle of the late 1920s and early 1930s was a classic Austrian cycle. The Japanese boom and bust of the late 1980s was also a manifestation of the Austrian cycle.



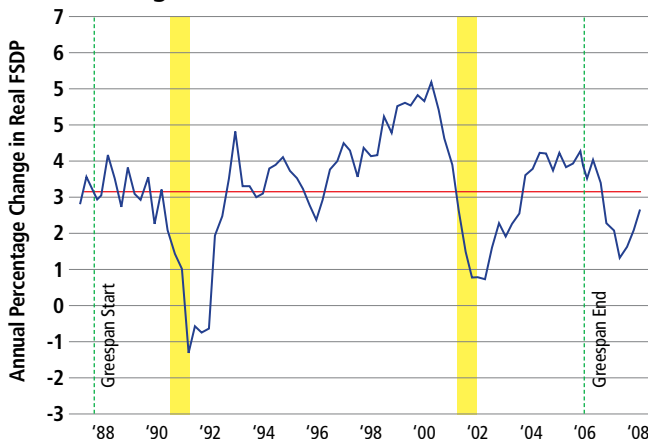
Final Domestic Sales (FSDP) from 1Q 1987 to 4Q 2007



Annual Change in GDP Deflator from 1Q 1987 to 4Q 2007



Annual Change in Real FSDP from 1Q 1987 to 4Q 2007



With an Austrian cycle, banks play a key role -- both on the way up and down. As the downturn unfolds asset prices begin to deflate. In consequence, banks' capital becomes impaired and banks scramble to rebuild it.

The economy is vulnerable to what economists of the Austrian school of economics terms a "secondary deflation," where banks call in loans and are stingy about extending credit.

Households produce their own version, liquidating riskier assets (like stock mutual funds) and moving into cash and government bonds. In the economy at large, investment and consumption suffer.

If this scenario plays out, the Fed's rescue package will be thrown into doubt as the banks become averse to creating credit, build reserves and use their liquidity to purchase government bonds. In short, the credit creation mechanism clogs up and becomes inoperative.

If there is a chance that monetary policy might fail to rescue the slumping US economy, what about fiscal policy? President Bush signed a \$170 billion fiscal stimulus package on February 13.

Most of this involves tax rebates— checks from the government. The idea behind this is that people will rush out to spend their windfalls and consumption will get a boost.

There is a problem with this type of Keynesian fiscal policy. People adjust their consumption with respect to variations in their long-term expected (or permanent) income, and pay little heed to transitory variations.

In consequence, one-time tax rebates (such as those adopted in 1975) do not result in more consumption because they do not alter people's permanent income.

As the US economy sinks, the monetary and fiscal life buoys have been deployed. Beware. There are good reasons to question the efficacy of these rescue operations. GA

Remembrances of Suharto

My column "On the Fall of the Rupiah and Suharto," which appeared in the launch issue of *GlobeAsia* (February 2007), contains my reflections as Suharto's economic advisor. With the passing of Suharto, I would add that during our regular evening meetings in a small den at his residence, I was struck by the fact that in the middle of the storm Suharto was always very cool and relaxed. He was also clear-headed about the geopolitics associated with the storm, and expressed his thoughts with frankness. That is the side of Suharto I knew.

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