POINT OF VIEW | STEVE H. HANKE

SHELTER FROM THE STORM

IN MY APR. 16, 2007 COLUMN I WARNED THAT THE U.S. was trapped in a dangerous boom-bust cycle that began with cheap credit and would end with collapsing home and stock prices. When the bust came it was worse than I had imagined. Now what? To find a safe harbor in this storm, we must ignore panicked media headlines and understand how we got into such turbulent waters.

There is plenty of blame to go around, but the main culprit is the Federal Reserve. In late 2002 Ben S. Bernanke, then a Fed governor and now the chairman, persuaded Alan Greenspan, then chairman, that the U.S. was in the grip of deflation. In consequence, the Fed pushed down on the monetary accelerator. By July 2003 the Fed funds rate had been squeezed down to 1%, where it stayed for a year. This artificially low interest rate set off the mother of all liquidity cycles.

The Fed's laxity stimulated the economy and pushed final sales to an unsustainable growth rate of 7% in nominal terms, i.e., before inflation adjustment. (Final sales, defined as gross domestic product plus net imports minus inventory buildup, is a measure of goods and services absorbed in the U.S.) At the same time, the lax monetary policy encouraged investors to take undue risks chasing high yields. To make the most of tiny yields, leverage became the flavor of the day. Carry trades—borrowing in low-yield foreign currencies and investing in higher-yield ones—also became popular. Borrow, borrow, borrow. I watched this top-heavy structure go up with amazement and terror. It had to crumble. It did.

The Fed's policy blunder also weakened the dollar and thus stimulated commodity price inflation. When the dollar goes down relative to other currencies, the price of wheat, corn, rice and oil all go up in dollar terms. The currency began its downward course early in 2002, thanks in large part to Fed policy, and it bottomed out in mid-July 2008, having declined 44% against the euro in that period. At the same time, the price of a barrel of oil climbed sevenfold, from $20 to $146. About half of that climb was a function of rising demand (such as from India and China); the remainder can be laid to the weak dollar. The same happened with other internationally traded commodities such as rice and soybeans.

Congress played its part, too. In 2003 and 2004 Fannie Mae and Freddie Mac, the government-sponsored mortgage buyers, were engulfed in accounting scandals. To get Congress off their backs, they became more committed to financing homes for families with low incomes. The ploy worked like a charm. Congressman Barney Frank, who now chairs the House Financial Services Committee, turned a blind eye to their accounting shenanigans and praised their newfound zeal. That was typical. Fannie and Freddie became the largest purchasers of subprime and borderline (Alt-A) mortgages in the 2004–07 period with a total exposure of $1 trillion and thereby contributed mightily to the housing bubble as well as their own later collapse.

The Bush Administration wasn't sitting on its hands while the Fed and Congress were giving birth to a boom-bust disaster. It was making matters worse by spending recklessly and piling up debt. Just weeks before the giant bailout was signed into law, the Congressional Budget Office issued a report stating that the Administration's spending had put the economy "on an unsustainable path." It projected that over the next decade the government debt held by the public would grow from $5.4 trillion to $7.9 trillion in today's dollars, a 46% increase. That didn't include the unfunded liabilities of the Social Security and Medicare systems, which total $100 trillion in present value.

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As for the $700 billion bailout, to pass the bill the Administration and Congress had to scare the public to death and promise to lead the alarmed populace to safety—after the government's multiple failures had created the crisis. At least the scare tactics did their job. But will the bailout work as advertised?

Plan A called for the government to buy shaky mortgage paper from banks. Eventually it dawned on Henry Paulson that there was no price he could pay that would both help the banks and protect the Treasury. As this column went to press, the government was veering off in a different direction—using taxpayer capital to buy preferred stock from the banks.

Expect more irresponsible political behavior and market panic. We'll see deleveraging-driven deflation in the near term and more inflation in the long term. Maintain the gold hedges I have recommended before (most recently in my Aug. 11 column) and keep a full stockpile of U.S. Treasury inflation-protected securities. F

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