The Fed and the Financial Crisis

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On Monday, June 1st, Restore America's Mission is hosting a panel discussion at the National Press Club on the causes of the 2008 financial crisis. Only by understanding the policy mistakes that led to it can we hope to avoid repeating them. This is crucial if we expect to fuel a 21st century recovery for all Americans.

I am pleased to represent Put Growth First and join fellow panelists Peter Wallison of American Enterprise Institute, Steve Moore of Heritage Foundation, Peter Ferrara of Heartland Institute, and Matthew Vadum of Capital Research Center.

The panel's featured presenter is Wallison, AEI's Financial Policy Studies Fellow. In his new book, *Hidden in Plain Sight – What Really Caused the World's Worst Financial Crisis, and Why it Could Happen Again*, he shows how government regulation produced a combustible mix that led to the crisis and, therefore, why we should be alarmed that the policy response to it has been an onslaught of more regulations.

In a nutshell, the government essentially forced banks, through the Community Reinvestment Act, to make subprime loans, then changed Fannie Mae's mandate allowing it to acquire said loans. Fannie's quotas quickly rose and by 2008, 31 million of the nation's 55 million mortgages were subprime, and 76% of those were on the books of the government. What could go wrong?

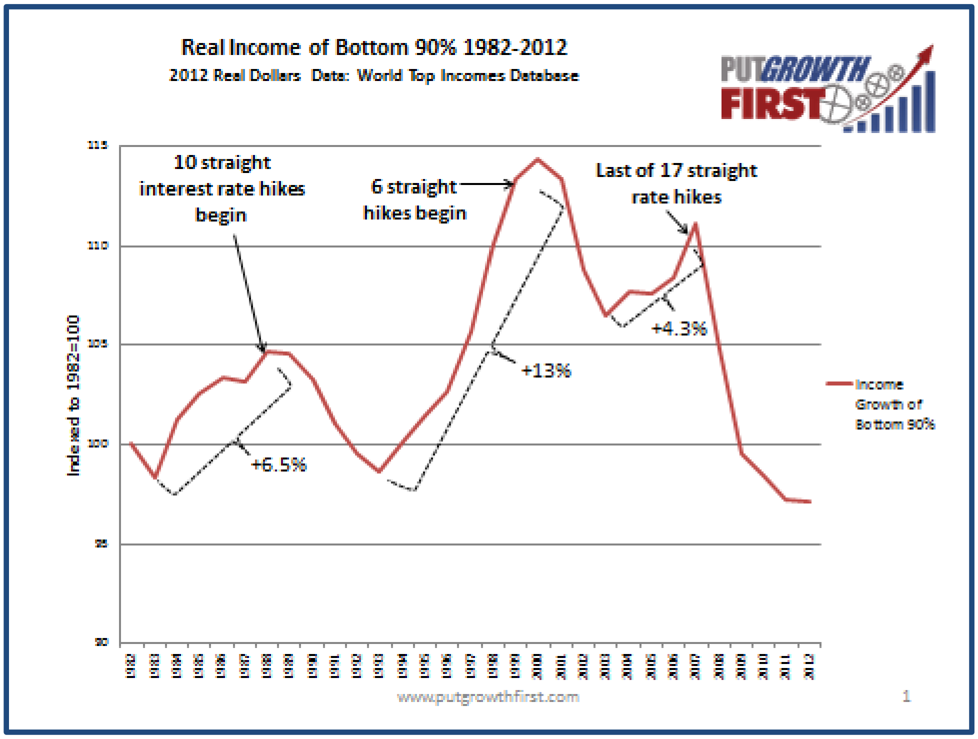
Our contribution to the panel will be on Federal Reserve policy from two separate but related perspectives. First, as shown in the table below, the dollar declined 53% from Fed Chair Ben Bernanke's infamous "helicopter" speech in 2002 (in which he said the Fed could print money and figuratively drop it from helicopters) to just prior to the financial crisis. This decline pushed up the price of real assets, including housing. When home prices outpaced the ability to pay, it created demand for "creative" financing, which the Fed helped supply with artificially low interest rates. Then, soon after the Bear Stearns collapse, there was a worldwide scramble for dollar based liquidity, which the Fed failed to meet. Hamstrung by backward looking indicators, the Fed presided over a de facto tightening of monetary conditions at exactly the wrong time by allowing the

Date Range	Dollar	Effect
8/02 – 6/08	Declines 53% over 6 years	Helicopter Ben inflates prices of real assets, including real estate. Home prices outpace ability to pay, a driver of "creative" financing.
6/08 – 2/09	Soars 119% over 8 months. Sharpest increase, 62%, occurs Sept. – Nov. 2008	Scramble for dollar based liquidity in wake of Bear Stearns collapse. Fed focused on rearview mirror indicators is slow to respond. Liquidity shortage strangles system, ignites crisis, becomes a solvency crisis.
2/09 – 4/11	Falls 43%	QE 1 & QE 2 push dollar lower, but have opposite effects on output, employment
4/11 – 5/15	Climbs 69%	"Operation Twist" and QE 3 have opposite effects on output and employment. Dollar strengthens as QE 3 removes collateral from repo market, and Europe embarks on QE. The dollar returns to its 8/02 value. But nobody got hurt?

dollar to soar 119% over 8 months. This choke hold was the spark that ignited Wallison's combustible mix.

In the classical sense, the dollar is a unit of measure, like the foot, hour and pound, whose value should be just as stable. When it is not, it causes malfunctions in the economy, much like if measurements of time and distance "floated" and were volatile.

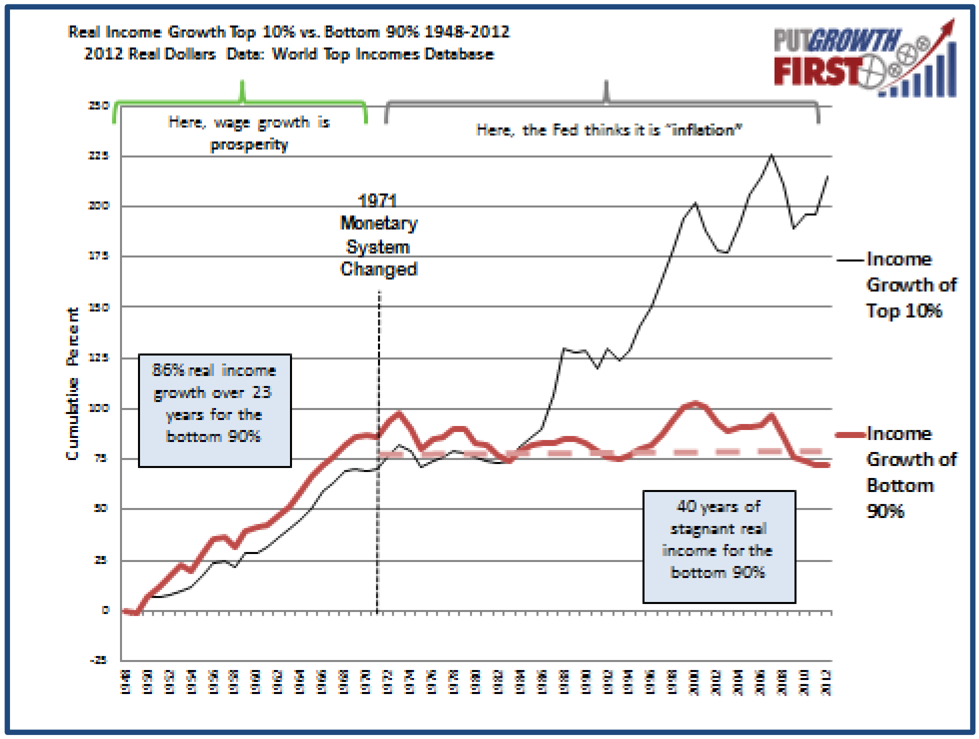
The second point is also tied to the Fed's neglect of the dollar. Namely, Fed policy is the primary driver of stagnant real income for the bottom 90% (aka. the "striving majority") over the last 40 years. This is because they have come to treat wage growth as a "cause" of inflation. As the nearby chart shows, when we've had robust economic growth, the Fed has embarked on a rate-tightening cycle as the benefits of growth were beginning to lift income of everyone. Rather than be puzzled by income stagnation, we should ask "Can we ever have the kind of across-the-board prosperity we all want, the kind capable of solving our fiscal crisis, if we continue to let the Fed think wage growth is bad?"



It wasn't always this way. When the Fed last had a mandate to stabilize the dollar, 1948-1971, real income for the striving majority rose 86%. It was the golden age of the middle class when a rising tide lifted all boats. A stable dollar meant stable material costs, lower risk premiums, and more productive investment so productivity could keep pace with wage growth. Further, profit margins were stable and we did not experience a single financial crisis.

What changed? For starters, the very definition of inflation did. No longer viewed as a decline in the real value of the dollar, it became known as an increase in a lagging price index. To keep the index from going up, the Fed targets the largest input cost to the goods and services that comprise the index: labor costs (i.e., your income). This is rooted in the Phillips Curve, which posits inflation is "caused" by too many people working and getting a raise, despite the fact it has been debunked by several Nobel laureate economists.

This much stagnation, for this many people, for this long is the force undermining confidence in free enterprise and inviting all the big government attacks upon it. When fewer people benefit from growth, demand for pro-growth policies wanes, and demand for government to "do something" climbs, resulting in a negative cycle that feeds itself. Had the previous trend of '48-'71 continued, real income for the striving majority would be 2.5x greater today. If that were the case, would there be any justification for the government to subsidize housing in the first place, let alone anything else? We wouldn't have spending, deficit, debt, and government dependency problems either. The above chart shows the contrast between a stable-dollar & prosperity vs. the floating-dollar & stagnation.



To borrow a phrase from Wallison, also hidden in plain sight is that the Fed treats wage growth as inflation, which is the root cause of our troubles.