## Economics

# *Apart From That, Mrs. Lincoln, How Was The Play?*

*John Ryding (212) 272-4221 / jryding@bear.com*
*Conrad DeQuadros (212) 272-4026 / cdequadros@bear.com*
*Meghna Mittal (212) 272-1961 / mamittal@bear.com*

From our perch, it is very difficult to write about the economic, financial, and monetary policy developments of the last week from a completely dispassionate perspective, but we will give it a shot. We had warned—dating back to the events of August last year—that the safety-net framework of the financial system was a Great Depression era bank-centered infrastructure for a 21st Century financial system. We were concerned about a run on the bank (although we never imagined that we would be the bank!) and the inadequacy of the tools that the Federal Reserve had to address the problem, which left us feeling that monetary policy would be diverted from maintaining price stability to supporting the financial system. In turn, we felt that this diversion of monetary policy would weaken the dollar and boost inflation. We take no joy that these themes are playing out.

The Federal Reserve has now rolled out four different financial support programs—including a collateralized lending facility for primary dealers (announced with ironic timing at 7:13 pm on Sunday!)—to provide a patchwork support system in lieu of a comprehensive reform of the regulatory and lender of last resort framework. The lending facility to primary dealers—effectively the use of the Fed's discount window for nonbank financial institutions—and the cumulative 300 bp reduction in the fed funds target rate, including today's 75 bp cut to 2¼%, should add plenty of liquidity and reassure the markets that the liquidity can be channeled to wherever it is needed in the financial system. However, the financial system likely needs to raise capital and further reduce leverage and it still appears to us that the economy has fallen into a technical recession, which points to further rate cuts from the Fed. The fed funds futures contract for May has a further quarter-point cut fully priced in for the April 30th meeting and implicitly puts the odds of a half-point cut at 88%.

*How Did We Get Here?*

We strongly believe that the seeds of the current credit crisis and financial market turmoil that appear to have pushed the U.S. economy into recession were sown from late-2003 to mid-2006. In late 2003, drawing primarily on Phillips-Curve reasoning, then Fed Governor Ben Bernanke argued that the economy still faced an unwelcome fall in inflation. In a speech before an economic outlook panel at Bloomberg's New York headquarters on September 13, 2003, Bernanke said, "By a standard textbook calculation (Bernanke, 2003b), this amount of slack should lead to additional disinflation of a few tenths of a percentage point or so by the end of 2004. So by my reckoning, inflation in 2004 might well be a bit lower than in the second half of 2003, not higher as the majority of private-sector forecasters have projected."

The Fed was so concerned about the prospect of deflation that it maintained a commitment to a 1% funds rate target until June 2004 and then a commitment to gradually raising the funds rate in an extremely predictable manner. At that panel, one of us pointed out to Bernanke that gold, then around $370 an ounce, commodities and the dollar were pointing to reflation and that the Fed might want to consider beginning the process of renormalizing short-term interest rates. Our advice was dismissed by Bernanke who, during the panel discussion, said "I was very interested to hear that at least three of the panelists evinced the view that they thought my disinflation risk was a realistic risk and therefore that they thought that the idea of the funds rate being kept low for a long time was a likely forecast," and went on to add "I think I would like to respond a little bit to John Ryding's view about the inflation. I wrote a few textbooks, so I'm not completely naive about the Phillips Curve and some of these models …So while I admit that inflation's very hard to predict and I take seriously the point that you'd want to look at things like commodity prices and so on, my best guess still is the disinflationary risk is greater." As it turned out, core PCE price inflation rose from 1.4% in the second quarter of 2003 to 2.2% by the end of 2004 despite the unemployment rate remaining above the Fed's estimate for NAIRU.

When the Fed began to shift gears in 2004 towards rate hikes, Bernanke laid out his thesis that rate hikes should be gradual. In a speech on May 20, 2004 ("Gradualism"), Bernanke argued in favor of gradualism for several reasons, including "a slower adjustment of policy rates enhances financial stability." We argued against Bernanke's gradualist policy in "Gradualism: Putting to the Green!" (May 26, 2004). However, we did not see the link between gradualism and leverage and, with hindsight, the explosion in the asset-backed commercial paper market and the rise of the SIVs appears to have been a direct consequence of the gradualist policy. We also did not foresee that much of the excess liquidity that the Fed created would be channeled into the housing market and be accompanied by a sharp deterioration in lending standards. Our fear was that rising inflation expectations would be the bane of financial stability. In that we were wrong—but we still fear that this lies ahead.

In anticipation of the latest rate cuts and in the wake of the Fed's latest lending facility, gold successfully made its assault on $1000 an ounce and the dollar fell to record lows against the euro. The Fed appears to remain committed to cutting

interest rates in the latest FOMC statement and we are holding to our forecast of a 1¾% fed funds rate target by mid-year. It is only a pity (and from our perspective that is a massive understatement) that the Fed did not hike rates more rapidly in 2004 and 2005, which would likely have headed off the rise in leverage and the boom in mortgage lending. It is also unfortunate that the Fed did not introduce its new lending facilities when the pressures first emerged in the financing system in August 2007. If these things had happened, monetary policy would likely not have the funds rate set to 2¼% and holders of the dollar would not have suffered such a massive loss of wealth. The economy, in our judgment, would, under those circumstances likely not be in recession and we would not be facing rising inflation pressures. As for ourselves…

---