They Chose Dishonour
& Now We Will Have Stagflation

When Neville Chamberlain returned from Munich in September 1938 after appeasing Hitler by ceding the Sudetenland, Winston Churchill famously commented, “Britain and France had to choose between war and dishonour. They chose dishonour. They will have war.” In the last few weeks, the Federal Reserve came under immense pressure from the markets and bankers to cut interest rates in an effort to stem the bleeding from the mortgage market crisis. Indeed, the Fed had to choose between dishonour in appeasing the markets and standing firm to its dual mandate of price stability and maximum sustainable employment. The Fed chose dishonour and now we may well have stagflation.

The extraordinarily accommodative monetary policy by the Federal Reserve from 2001 to 2005 helped to fuel a real estate bubble that saw prices rise at unsustainable rates to values that were significantly misaligned with fundamentals. As rates rose in 2006, many real estate market participants were squeezed as adjustable rate mortgages reset to higher rates and their ability to quickly exit their investments with substantial gains was largely mitigated by the general slowdown in real estate activity. The subprime industry was the hardest hit by this rise in rates, leading to a rise in defaults and foreclosures. These factors couple with fear that the crisis would have adverse systemic effects contributed to a massive credit crunch in August 2007.

From its January meeting until late August, the Federal Open Market Committee (FOMC) and Federal Reserve Chairman Ben Bernanke expressed concern that inflation would fail to be contained as expected. At its June 28, 2007 meeting, the FOMC indicated the following:

> *Readings on core inflation have improved modestly in recent months. However, a sustained moderation in inflation pressures has yet to be convincingly demonstrated. Moreover, the high level of resource utilization has the potential to sustain those pressures.*

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In these circumstances, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected…

Even in testimony to the Committee on Financial Services in the U.S. House of Representatives upon delivering the *Semi-Annual Monetary Policy Report to the Congress* on July 18, 2007, Chairman Bernanke stated,

As measured by changes in the price index for personal consumption expenditures (PCE inflation), inflation ran at an annual rate of 4.4 percent over the first five months of this year, a rate that, if maintained, would clearly be inconsistent with the objective of price stability.

Whilst it is true that headline inflation was roughly 2.3% for the preceding twelve months, the upsurge in inflation along with further increases in oil prices represent a worrying trend of an erosion of purchasing power of consumers, an engine of growth, and may indicate a proclivity of producers to pass along to consumers increased production costs resulting from higher energy prices. Core inflation, headline price index less food and energy prices, has also experienced some volatility and is often a preferred measure of inflation by academics and economists. However, consumers spend a large portion of their incomes on food, shelter, and energy costs. To exclude the food and energy components is, as is becoming a more widely-accepted position amongst economists, to distort the impact of rising prices on the purchasing power of consumers.

To be sure, the Fed found itself in a highly uncomfortable situation in early August. With credit conditions contracting, banks and lending institutions found themselves facing tighter liquidity and rising market rates. As a result, the Fed injected over $69 billion in liquidity into the financial system through open market operations over a week in mid-August to bring market rates more into line with the target federal funds rate. In addition, the Fed cut the discount rate whilst increasing the payback period to thirty days. These actions were intended to shore up confidence amongst lending institutions and help to ease the liquidity crunch. These actions at the discount window reduced the “penalty” that banks

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incurred by borrowing overnight from the Fed, the lender of last resort[1].

But somehow, the Fed's actions in August were lost in translation and the financial markets, banking industry, and real estate investors saw this as an opportunity to bail them out with a new "Bernanke put." Though the Fed's mandate is not to bail out market participants from financially disastrous situations, there has been a growing trend that the Fed can justify this type of action under the guise of ensuring properly functioning financial markets. Indeed, the pressure for a rate cut began to mount in late August and early September, despite the significant risks to the economy still posed by inflation. The real estate markets seized the opportunity to pressure for a rate cut in hopes of stimulating an industry still reeling from excessive speculation. And financial markets, of course, are always eager to have rate cuts to fuel investment.

In acquiescing to these outside pressures, the Fed failed to maintain its independence and has set the stage for lower growth and higher inflation. This rate cut has helped one party alone—the banking industry. The lower federal funds rate equates to lower lending charges for the banks. Banks such as Citigroup, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley paid out more than $65 million in additional lending charges from July to early September. The top twenty-five banks paid out a combined $300 million in extra lending charges from July to September. Needless to say, the rate cut will have substantial benefits for these institutions. The rate cut has not and will not help the real estate market. Investors and home buyers who got in over their heads with properties they could not afford will still not be able to afford these properties even after the rate cut. Rates would have to drop to virtually zero before these parties feel less pressure. Prices in real estate markets still have farther to fall before fundamentals and value are more closely aligned. Rate cuts will not stem this fall in prices yet. Financial markets had already reached record highs and were buoyed by stable corporate profits and earnings. Rate cuts may well fuel further increases in the financial markets, though fundamentals may be at odds with current valuations.

[1] It is important to note that banks are permitted to borrow from the discount window at any time in the event of liquidity issues at the discount rateon an overnight basis, which has typically been higher than market interest rates so that the borrower incurs an interest penalty.

However, the full effects of the decline in the real estate markets have yet to be felt. The extent to which this will adversely impact consumer confidence and spending have yet to be convincingly demonstrated. These factors, in addition to sustained higher energy prices, will likely have an adverse impact on GDP growth in the second half of the year. The magnitude of the slowdown in growth will largely be a function of energy prices and consumer spending. But in addition, higher energy prices pose a significant threat to rising inflationary pressures. As producers become more comfortable passing cost increases onto consumers, inflation will likely experience a noticeable uptick. The rise in food prices, fueled in part by rising corn prices associated with increased demand for ethanol production, is not likely to abate anytime soon. Thus, the stage is set already for increased inflation and lower growth—stagflation reminiscent of the 1970s on a smaller scale.

There is a possibility that the Fed's rate cut, which will inject additional liquidity and may lend itself to an uptick in inflation, may be just enough to stimulate additional economic activity so that inflation remains contained. This could well have been accomplished by natural market forces whereby lower growth and demand helps to contain inflationary pressures. Apparently, the Fed felt the need to reassure the markets of the next generation "Bernanke put" rather than let the situation work itself out.

To appease the large market participants, the Fed has set a dangerously destabilizing precedent that may ultimately lead to more far reaching and more devastating consequences in the near future. Perhaps the FOMC should visit the lonely monetary policy cave once occupied by Arthur Burns and Paul Volcker[2]…

[2] Arthur F. Burns was Chairman of the Federal Reserve Board of Governors from February 1, 1970 to January 31, 1978. Paul Volcker was Chairman from August 6, 1979 to August 11, 1987.

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