

Point of View | Steve H. Hanke



OVERSTEERING

CENTRAL BANKERS RARELY ADMIT MISTAKES UNLESS they are discussing events long lost in the fog of history. That's what makes the Nov. 2 remarks by Richard Fisher, president of the Federal Reserve Bank of Dallas, so remarkable. Fisher candidly told a gathering of the New York Association for Business Economics that an inflation gauge relied on by the Fed (the index for core personal consumption expenditures) was malfunctioning four years ago.

Back in those days the annual increase in the core PCE 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 Nov. 21, 2002. The most memorable line: a semiserious 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%, providing considerable fuel to the inflation in commodity and home prices over the past four years. Fisher concluded that this looseness in the money supply was a mistake and that it was caused by faulty statistics. The Fed's favorite measure was underreporting inflation.

If nothing else, Fisher's diagnosis of the recent past is yet another good reason to dust off the works of economists from the Austrian School, particularly Friedrich Hayek's. The main lesson from the Austrians was their extreme skepticism about the exclusive reliance on one magic index—the price level—to guide central bank policy. Indeed, Hayek stressed that changes in general price indexes don't contain much useful information. He demonstrated that it was the divergent movements of different market prices during the business cycle that counted. Even a casual review of prices for different commodities, goods and services, as well as assets and the value of the dollar, would have enabled the Fed to avoid its mistake. This, of course, doesn't provide much comfort for those who are now trying to unload real estate after being enveloped in

the Fed's liquidity-driven housing bubble.

To get a handle on where we are and where the Fed may be going, let's look at the entire Greenspan era: Were there other mistakes or perverse policy patterns between August 1987 and January 2006? The easiest way to do this is to measure the trend rate of growth in nominal final sales to U.S. purchasers and then examine deviations from that trend. During Greenspan's tenure nominal final sales grew at a 5.4% annual rate. 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.

The Federal Reserve's zigzag pattern is clear: Overreact to a so-called crisis, create a boom, then a bust.

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 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 then a near recession 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. And as night follows day the Fed started putting on the brakes in 2004, and final sales are rapidly slowing, with growth over the past year at 5.6%.

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The problem for investors this time around is that the economy is only starting to search for a bottom. But you wouldn't know it by looking at the way risks are priced. Risk is cheap. Specifically, the cost of purchasing credit protection against the nonpayment of corporate debt (with a credit default swap) has recently reached an alltime low. The best way for investors to protect themselves from the Fed's oversteering is to build a core position in Treasury Inflation-Protected Securities. TIPS generate a real yield of 2.3% at the 10-year maturity and 2.2% at 20 years. **F**



Steve H. Hanke is a professor of applied economics at the Johns Hopkins University in Baltimore and a senior fellow at the Cato Institute in Washington, D.C. Visit his home page at www.forbes.com/hanke.