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Fed history is key to Bernanke legacy

Focus on price stability via credit supply defines operation

Scott Minerd
INSIGHT

Monetary historians have the opportunity to contemplate two legacies this year: that of the US Federal Reserve 100 years after its creation, and of Fed chairman Ben Bernanke as he steps down. Understanding the legacy of the institution will give us a better insight into that of the man.

The Fed was a creature imagined during secret meetings held in 1910 at Jekyll Island by political and financial power brokers under the guise of a duck hunt. A more liberal monetary standard would advance the bipartisan Progressive Movement's push for order in a chaotic financial system, but was also a pragmatic solution for bankers almost ruined by the Panic of 1907. It was time for a flexible monetary regime where credit could expand as a shock absorber when monetary conditions tightened from transient spikes in demand for gold.

The preceding 50 years had been marked by frequent, severe bank panics as a result of the inelastic credit supply associated with the gold standard. Regional Federal Reserve banks would now buffer these brief credit crunches by providing temporary increases in reserve balances.

Early officials such as Benjamin Strong, the inaugural president of the Federal Reserve Bank of New York, advocated price stability as a means of muting or even eliminating the business cycle. The key was maintaining a steady availability of credit. Too much credit relative to output would be inflationary, too little deflationary.

After decades of modestly declining prices, the Fed eradicated the deflationary forces bankers feared. A brief inflationary burst followed the first world war as the Fed sought to accommodate rising credit demands, then came a decade of modestly rising prices and general prosperity. Many believed that, by focusing on relative price stability, the Fed had finally tamed the business cycle.

In the days following the 1929 stock market crash there was a precipitous decline in credit demand. Fed policy makers contracted bank reserves to sop up the excess credit, which they perceived as inflationary. Having misinterpreted the decline in interest rates and credit demand, the Fed had lost track of price stability, setting in motion a deflationary spiral. Decades passed before economist Milton Friedman demonstrated the error of that 1930s orthodoxy.

After the experience of the 1930s, falling prices could not be tolerated. By the 1950s, William Phillips posited that not only was deflation bad but inflation could reduce unemployment. The Phillips experiment proved disappointing. In the 1980s when inflation hit double digits, Paul Volcker reverted to reserve management to cure the failed Phillips Curve experiment.

Subsequently, Alan Greenspan brought inflation to an acceptable target around 2 per cent. With inflation apparently dead, the time had come to guard against deflation. Under the circumstances no one fitted the bill better than Mr Bernanke, widely seen as America's greatest student of the Great Depression and a firm believer in relative price stability.

In 2002 Mr Bernanke, then Fed governor, gave a speech honouring Friedman's 90th birthday. He acknowledged that the Fed strayed from its original mandate during the 1930s and deepened and lengthened the Great Depression. Mr Bernanke praised Friedman, saying, "You're right, we did it. We're very sorry. But thanks to you, we won't do it again."

When the 2008 financial crisis hit just two years into his tenure as Fed chairman, Mr Bernanke stayed true to his word. In a Faustian bargain to assure price stability, he channelled the spirit of Jekyll Island in the alphabet soup of bailouts and lending that saved a banking system on the verge of collapse. Ultimately, for the sake of preserving price stability, he added almost $4tn to reserves in the banking system, five times the balance sheet accumulated in the 92 years before his arrival.

The Fed's policy of targeting one particular price level has certainly achieved some success. But despite the central bank's Herculean efforts, Federal Open Market Committee members remain concerned that inflation is stubbornly low and they may need to do more to ensure sustainable economic growth.

Any policy explicitly targeting one price inevitably distorts other prices. Ultimately, Mr Bernanke's efforts to preserve the banking system and avoid runaway price deflation will probably lead to a prolonged period of rising asset prices that may prove difficult to reverse.

The judgment of history waits as to whether the new monetary orthodoxy Mr Bernanke created will result in draconian consequences for markets and the economy, as some fear. If and when Mephistopheles calls, it will be incoming Fed chairwoman Janet Yellen who holds not only the legacy of Mr Bernanke but of the Fed itself in her hands.

Scott Minerd is global chief investment officer at Guggenheim Partners