Richard M. Salsman
THE CAPITALIST

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OPINIONS

How Bernanke's Fed Triggered the Great Recession

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Image by AFP/Getty Images via @daylife

As usual, when Fed chairman Ben Bernanke testified before Congress this week not a single Congressman asked him why he deliberately and transparently triggered the Great Recession of 2007-2009, which was accompanied by a frightening financial crisis, gargantuan bailouts and huge fiscal deficits. Nor has Bernanke been held accountable for his culpability during previous Congressional testimony or during his press conferences. Committee members and financial journalists alike are ignorant of the evidence staring them in the face.

Bernanke typically is described as that rarest of combinations: a Republican yet also an Ivy League academic, a bureaucrat who's nevertheless respectful of markets, an expert on the Great Depression yet aware of the Fed's role in it, and above all a man supposedly wise enough to not let "it" happen again. Yet in 2008-2009 Bernanke did nearly let "it"

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""Any evidence?" Yes. The only tangible commodity in the world that has held its real value over the decades..."
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happen again — a banking collapse, a depression, deflation — by bringing the U.S. financial system to its knees by roughly the *same* Fed policy adopted in the 1930s, followed by his blizzard of paper-money printing that has caused a dollar debasement unprecedented in U.S. history. The result has been a huge destruction of wealth, spreading fiscal chaos and stagflation as far as the eye can see.

How did Bernanke create this horrible morass? First, in 2006-2007 he deliberately inverted the Treasury yield curve, even while knowing it would cause a recession and credit-financial crisis. Second, he imposed on the reeling economy a $1.7 trillion flood of "quantitative easing" (QE), euphemistic for the hazardous policy of money-printing. His first policy caused economic stagnation, his second policy caused monetary inflation, and combined, his policies have generated "stagflation" — the corrosive mix last seen in the 1970s. It's the direct opposite of the supply-side polices (pro-growth, sound-money) that made the 1980s and 1990s so prosperous.

How can we hold Bernanke accountable for this widespread mess? Consider first the economic stagnation. By training, Bernanke knew full well (and still knows) that an inverted Treasury yield curve — wherein the Fed deliberately keeps short-term interest rates above longer-term Treasury bond yields — invariably causes recessions and crises in the modern (fiat paper money) era.

He knows that an inverted yield curve severely and nearly instantly renders unprofitable most financial intermediation, which is the process of "borrowing short to lend long." The normal case is for short-term borrowing yields to trade *below* long-term investment yields (an upward-sloped yield curve), which is profitable for credit intermediaries, given the positive yield margin. In contrast, the rarer case is for short-term rates to trade *above* long-term rates (an "inverted," or downward-sloped yield curve), which is far less profitable or an outright loser for lenders, due to the negative yield margin.

Bernanke knows all of this — and far better than his clueless interrogators. In a 2004 speech titled "What Policymakers Can Learn from Asset Prices" Bernanke recounted the unassailable historic evidence that an inverted yield curve is invariably bearish with a reliable time lag of a year or so. "Various yield spreads have been found to be informative about the future course of the economy," he said, and "some have exceptionally good forecasting track records," especially "the slope of the yield curve," which is "measured as the 10-year bond rate less the 3-month bill rate." He conceded that "evidence for the predictive power of the slope of the yield curve" is abundant, and exists "for other industrialized countries as well as the U.S."

As Bernanke acknowledged, "the slope of the Treasury yield curve" has been "recognized for some time as a useful indicator of cyclical conditions," that it "has turned negative between two and six quarters before every U.S. recession since 1964," that U.S. recessions invariably have "followed the inversion of the yield curve," and that the yield curve "captures the stance of monetary policy."

The latter concession means that the Fed can easily and deliberately invert the yield curve whenever it chooses, either with short-term rate hikes or passivity in the face of plunging bond yields. Likewise, the Fed also can always act to prevent an inverted yield curve – and thus also to prevent future recessions. Notably, the U.S. yield curve was inverted prior

ABOUT ME

Richard Salsman is president and chief market strategist of InterMarket Forecasting, Inc., a research and forecasting firm that quantifies market-price signals to guide the asset allocation and trading strategies of pensions, banks, investment managers, and hedge funds. Mr. Salsman has authored two books and six chapters on money, banking, economics and public policy. His work has appeared in Forbes, the Wall Street Journal, the Economist, Investor's Business Daily, Barron's and the New York Times. He has worked previously for the Bank of New York, Citicorp and H.C. Wainwright Economics.
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to all seven U.S. recessions in the past half-century and no recession occurred in that time without a prior inversion. That's a perfect forecasting record. The Fed also inverted the yield curve prior to the 1929 stock-price crash and Great Depression in the 1930s. The only "criticism" the Fed got in subsequent decades was that it didn't follow its punitive rate policy with massive money-printing.

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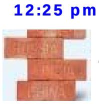

KENNETH RAPOZA
BRIC Breaker

Probably no one asked him that question because he didnt deliberately trigger the recesssion, but i could be wrong…

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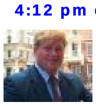

RICHARD M. SALSMAN
The Capitalist

Not so. I DID suggest a motive for Bernanke, however wrong-headed it is:

"There's no longer any excuse for ignorance of such facts. Although Bernanke knew the power of the yield curve, he and his colleagues deliberately inverted it in 2006-2007, ostensibly to "fight inflation" by slowing the economy's growth (which is nothing but the Keynesian myth that prosperity somehow boosts prices)."

- Richard

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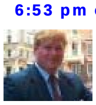

RICHARD M. SALSMAN
The Capitalist

In fact there's no such thing as a "bubble." At best this never-defined term is a placeholder for ignorance. Typically it's deployed when someone has no idea whatsoever about the cause of some price or price level, yet denies the price is valid. Invoking the term “bubble” is like invoking the myth of “God” when one can’t explain the origin of man or the universe. Fables and fantasy terms are never a valid substitute for real science. Like you, Bernanke believes in such myths as “bubbles” – as did Alan Greenspan – and sadly, this serves as yet another pseudo-excuse for the Fed to deliberately invert the yield curve and destroy prosperity. For historic parallels, see blood-letting by the savage quacks of Medieval times.

- Richard

In response to another comment. *See in context »*

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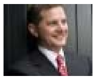

RICK FERRI
The Indexer

I thought the recession was created by an inflated housing bubble that burst caused by over speculation, lax regulation on lending standards, and no Congressional leadership to rein in Fannie, Freddie and Barney Frank’s other friends.

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8:08 am on 07/18/11

RICHARD M. SALSMAN
The Capitalist

You write that “Mr. Bernanke does not actually have a lot of tools in his tool chest. He can inject cash or withdraw it from the banking system. He can set interest rates. That is about it.” This is no exoneration of Mr. Bernanke. You agree with me that he “can set interest rates” – which means he can invert the yield curve – which means he can knowingly trigger a recession – which is precisely my argument – and he can cover it with whatever excuse he can imagine (as long as journalists and economists don’t challenge him) whether by the Keynesian myth that economic growth causes inflation, or the still-wider (and more popular) myth of “bubbles.”

- Richard

In response to another comment. *See in context »*

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8:30 am on 07/18/11

RICHARD M. SALSMAN
The Capitalist

To my knowledge Mr. Krugman never once warned that an inverted Treasury yield curve in 2006-2007 would cause a recession or financial crisis in 2008-2009. Nor has he argued, as do I, that financial history reveals the yield curve to be the pre-eminent signal of the business cycle, or that yield-curve inversions entail a deliberate Fed policy. But please let me know if you discover otherwise in Krugman’s writings. Here’s what he DOES claim, loudly and often, as an unreconstructed Keynesian: that economic growth somehow 'causes' inflation (see the textbook Phillips Curve) and that ‘bubbles’ exist. In short, Krugman joins numerous others in giving Fed officials their two biggest excuses for deliberately inverting the yield curve and sabotaging prosperity.

- Richard

In response to another comment. *See in context »*

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8:18 am on 07/18/11

RICHARD M. SALSMAN
The Capitalist

Nice try, but this does NOT exonerate Mr. Bernanke. To repeat: The yield curve inverts when short-term interest rates lie ABOVE long-term interest rates, and you admit that the Fed controls short-term interest rates. That means the Fed determines whether short-term rates will lie above long-term rates (or not). If long-term bond yields decline as markets foretell coming economic weakness, yet the Fed stands pat and keeps its short-term rate unchanged, thereby allowing an inversion, that’s it’s own doing and solely within its own power and discretion – and the Fed knows that doing this will invariably trigger a recession.

- Richard

In response to another comment. *See in context »*

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8:43 am on 07/18/11

RICHARD M. SALSMAN
The Capitalist

We shouldn't focus alone on the short-term rate, out of context: the yield curve entails a broad context, a relationship among many interest rates at many maturities. The policy implication of my essay is simple: the Fed should keep steady and normal the WIDTH between long-term and short-term rates, perserving a normal (upward-sloping) yield curve. It must never allow the width (i.e., the long-term bond yield minus the short-term bill yield) to get overly-wide (in the case of an excessively-low short-term rate) or allow the width to become negative (in the case of an inverted yield curve).

- Richard

In response to another comment. See in context »

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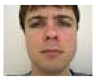

MARK ADOMANIS
The Russia Hand

Do you have any evidence that there was, in your words, "a dollar debasement unprecedented in U.S. history." Is there any actual evidence of this?

My understanding was that, from 2008-09, there was a "flight to quality" and the dollar actually increased in value against a broad basket of currencies including the Pound, the Euro, the Yuan, and the Ruble.

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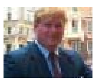

RICHARD M. SALSMAN
The Capitalist

"Any evidence?" Yes. The only tangible commodity in the world that has held its real value over the decades is gold, so it's the best market-based measure of the real purchasing power of the paper dollar (or of any other fiat paper currency). The U.S. dollar today purchases roughly 56% LESS gold than it did just 31 months ago (Nov. 2008) – that is, a mere 1/1600th of an ounce now, versus 1/710th an ounce of gold in Nov. '08, or one of the worst 31-month debasements in U.S. dollar history. See also the 31-mos. thru Jan. 1980, when the dollar's gold content plunged by 78%.

- Richard

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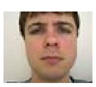

MARK ADOMANIS
The Russia Hand

If the dollar increased in value against other currencies, then that means virtually every other central bank was even MORE irresponsible than the Fed. So if the dollar's debasement was "unprecedented" the debasement of the ruble, the real, the pound, and the Euro was…super-duper-really unprecedented?

In response to another comment. See in context »

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