



Business Forum

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PRESIDENT-ELECT OBAMA

CHRIS LESTER



COMMENTARY

COMMENTARY | Decoding the Fed's workings

WHY DID BUBBLE POP?

By WILLIAM A. BARNETT
Guest columnist

It is widely believed that the bubble economy was accommodated by years of excessively expansionary monetary policy.

Since all bubbles eventually burst, it is thereby argued that the current problems were unavoidable. Whether or not that view is correct, it is interesting to ask what broke the bubble, even if it eventually would have burst anyway.

Inspection of **Federal Reserve** data provides relevant information and some encouraging news.

By conventional measures, the Fed has been easing its monetary policy stance by reducing its target value for the federal funds interest rate from 4.25 percent at the beginning of the year to its current level of 1 percent. Has the Fed thereby

been engaging in actions that are stimulative? Low interest rates do not an expansionary monetary policy make.

It is helpful to illustrate the problem with a different central bank activity: sterilized exchange rate intervention.

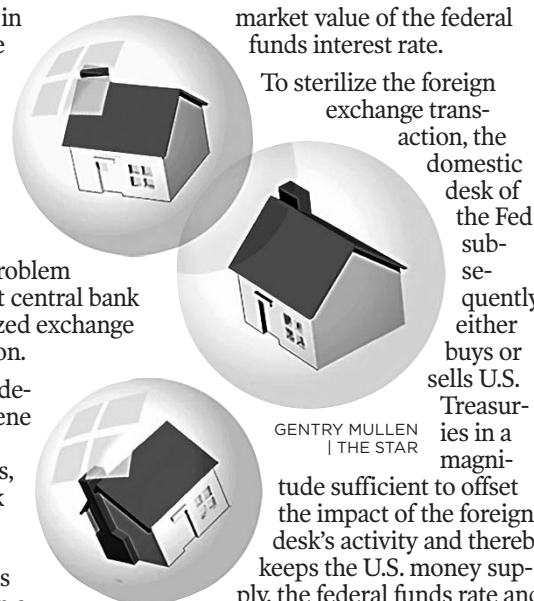
When the Fed decides to intervene in foreign exchange markets, its foreign desk swaps dollar-denominated assets for assets denominated in a foreign currency. Left unchecked at this point, the reserves of the U.S. banking system (and the U.S. money supply) would change, as would the

market value of the federal funds interest rate.

To sterilize the foreign exchange transaction, the domestic desk of the Fed subsequently either buys or sells U.S. Treasuries in a magnitude sufficient to offset the impact of the foreign desk's activity and thereby keeps the U.S. money supply, the federal funds rate and the reserves of the U.S. banking system unchanged.

On net, two things are accomplished by these offsetting

SEE FED | D9



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LETTERS

Supply and demand

During the 1990s, a recession was stopped in its tracks when taxes were increased on the wealthy and redistributed to the middle class. This was done to the horror and screams of the far right, which complained about "the largest tax increase in history."

Sound familiar? Back then, deficits were eliminated and a budget surplus was generated, creating over 20 million new American new jobs — the longest period of prosperity in generations.

How could this be if businesses and the wealthy had their taxes increased? The successful principle was that when money is in the hands of the largest part of the population — consumers — they deplete inventories and consequently jobs have to be added to replenish inventories.

More jobs create a chain reaction of more consumer spending, which again depletes inventories resulting in the need for even more employees.

It's logic. It's called the law of supply and demand.

Martin Kaynan
Olathe

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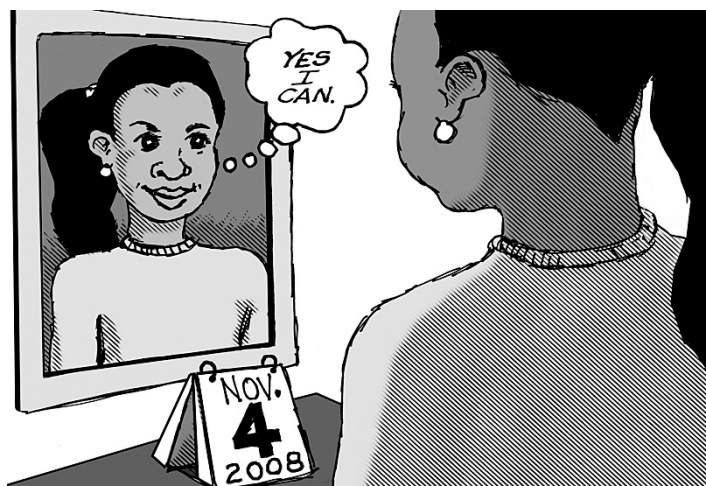
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LESTER: Quandary faces Obama and Democrats

FROM D8

That's the quandary facing Obama and the Democrats. The car they have been chasing — economically speaking — is going into the ditch. There is a real possibility that the economy will contract during the final quarter of the Bush administration at the fastest rate since the double-dip recessions of 1980-82.

Obama's policy options to help get the economy out of the ditch quickly are rather limited.

We will soon see some sort of economic stimulus package out of Congress, but financial constraints will limit its effect because we've committed so much to recapitalizing the financial system. Particularly tough calls will have to be made on how much relief to offer struggling homeowners facing foreclosure and whether to bail out the Big Three automakers. There also will be regulatory reform within the financial sector, but this will be like fighting the last war.

Meanwhile, talk of sharply increasing taxes on the wealthy may be blunted, at least temporarily, by the realization that it's rarely good for economic activity to raise taxes, and it's even worse to do so in a recession. A more likely scenario is that the Bush tax cuts will simply be allowed to expire in 2010.

Moreover, some of the more ambitious long-term elements of Obama's economic agenda — most notably health-care reform and pushing alternative energy and conservation — probably will be deferred until the economy recovers.

The message in all this is rather simple. Expectations for an Obama presidency may be high in some quarters. But the expectations should be kept in check. We've got quite a mess on our hands, and the president will spend more time reacting than dictating in the early months.

In the short term, the most important decisions will be whom Obama gathers around to advise him on economic matters. Name dropping that includes former **Federal Reserve** Chairman Paul Volcker and value investor Warren Buffett has been somewhat reassuring.

In the long-term, we also can take comfort in historic evidence that suggests the stock market and economy tend to do better during Democratic administrations than Republican ones.

According to the *Stock Trader's Almanac*, here's how the **Standard & Poor's 500** has performed following the 14 presidential elections between 1952 and 2004. (We're looking at the Oct. 31-Oct. 31 period for simplicity's sake.)

It's a split decision on whether stocks rose or fell following those presidential elections — a seven-to-seven tie.

Following the election of nine Republicans, though, the market rose just three times and fell six times. Stock market performance ranged from a 25.9 percent decline following the election of George W. Bush in 2000 to a 22 percent increase following the election of his father, George H.W. Bush, in 1988.

After the election of five Democrats, the market rose four times and fell just once. Performance ranged from a 10.3 percent decline following the election of Jimmy Carter in 1976 to a 29.7 percent increase following the re-election of Bill Clinton in 1996.

Here's a little more trivia from other sources:

I Ned Davis Research reckons that since 1901 the S&P 500 has increased an average of 7.2 percent under Democratic presidents and 3.2 percent under Republicans.

I Bespoke Investment Group, meanwhile, offers the factoid that the S&P 500 increased an average of 14.7 percent during seven periods in which Democrats had control of both houses of Congress and the White House.

You'll find absolutely no claims for causation here. Past performance does not guarantee future results. But it does offer a bit of hope during a dark period as we transition from the Bush administration to the Obama administration.

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FED: Rates don't tell the story

FROM D8

transactions: creating the symbolic gesture of "doing something" about the dollar's value and exposing the U.S. taxpayer to potential losses, if subsequent changes in the exchange rate cause losses in the market value of the foreign assets now on the Fed's books.

Similarly, much Federal Reserve activity this year, including its role in bailouts, has had little effect on bank reserves, while exposing the taxpayers to substandard asset risk.

Notably, the total amount of reserves in the U.S. banking system — the raw material from which loans and spending are created — is lower in mid-2008 than in August of 2003.

But changes in the funds rate are usually interpreted in the media as the product of Fed policy actions. According to that view, if the funds rate declines, it must be the result of an expansionary policy action.

Missing from this analysis is the other side of the reserves market: those who demand reserves have some ability to affect the price — i.e., the federal funds rate — at which reserves trade. Those demanders are banks that see the demand for reserves rise and fall along with the demand for loans.

When the demand for loans falls, the demand for reserves by banks declines. Hence, the federal funds rate can decline, because of declines in the demands for loans and reserves, without the Fed taking any policy action.

While a decline in the funds rate is usually interpreted as "evidence" of an easy policy stance, the real signal in the market may be that the economy is weakening.

As David Laidler at the **University of Western Ontario** has pointed out, this appears to be what happened in Japan during the 1990s. The **Bank of Japan** thought its monetary policy was "easy" because interest rates were low. The Japanese economy did not begin its recovery, after a decade of stagnation, until the quantity of money began to expand.

The Great Depression and the recent history of Japan's long

stagnation reveal that low interest rates are ambiguous indicators of the relative ease of monetary policy. The missing ingredient is the flow of bank reserves, the ultimate source of credit from which all other lending ultimately grows. For better or for worse, intentional or unintentional, herein may lie the pin that pricked the recent bubble.

But there now is good news. Recently, there has just been an enormous surge of reserves injected into the banking system through the Fed's lender-of-last-resort function at its discount window, through new

credit facilities and through the long-overdue initiation of the Fed's payment of interest on reserves — an important new reform that provides an incentive for banks to increase their holdings of reserves.

Although uncertainty in financial markets remains high, the recent dramatic injection of reserves by the Fed is encouraging. There is light at the end of the tunnel.

William A. Barnett is the Oswald distinguished professor of macroeconomics at the University of Kansas and co-author with Nobel laureate Paul Samuelson of "Inside the Economist's Mind."

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