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Bernanke's bond market bash

A central bank such as the US Fed, willing to buy long-term bonds, should also be willing to sell them

Vivek Moorthy

There is growing realization that the serial tsunamis of liquidity unleashed by Alan Greenspan upon the world economy contributed greatly to the deepening recession. The pertinent question is what role did the current Fed chairman Ben Bernanke play in these policies. He was a member of the Federal Reserve Board from 2002 to June 2005, under Alan Greenspan. He took over as chairman in January 2006, with an intervening stint as chairman of the council of economic advisers in between.

In evaluating a central banker's performance, to begin with, it needs to be strongly emphasized that monetary policy works with long and variable lags. Much of what happens in a given year, and even over several years, is the outcome of earlier decisions. Bernanke inherited almost the fag end of a prolonged lax monetary policy. Under him, the drastic rate cut from 5.25% in late 2007 to 0.25% as of now (see chart), and the simultaneous massive "quantitative easing" might prevent a very severe slump from getting even worse. Whether they do or not, Bernanke's performance should be judged by his voting record and speeches as Fed board member during 2002-05.

In a speech as a board member ("Deflation: Making Sure it Doesn't Happen Here") in November 2002, Bernanke advocated strategies to avert deflation. Even mild deflation is a graver threat to an economy than moderate inflation. Conventional monetary policy—lowering the policy rate—is of no use once the short-term policy rate reaches the "zero bound", as for Japan. For almost a decade, Japan has been unsuccessfully tackling mild deflation (about 1% a year), that is keeping a paralysed banking and financial system from recovering.

Also See US Bond Yields VS Policy Rate (Graphic)

In his speech, Bernanke advocated the Fed buy longer-term bonds to tackle deflation. Normally, when the Fed lowers the short rate, the long rate also follows, although by a fraction of that. The lower long (treasury bond) rate feeds into lower mortgage rates and corporate bond rates, stimulating housing and business investment. But when the short rate cannot be cut any more, then long rates also cannot fall.

Bernanke suggested that to lower long rates in such a situation, the Fed should "begin announcing explicit ceilings" for yields up to two years, and enforce these by "committing to make unlimited purchases" of those securities with targeted yields. He also stated that if this proved inadequate, the Fed could cap yields up to six years and also buy mortgage-backed securities issued by Ginnie Mae, the Government National Mortgage Association.

Now, Bernanke's Fed has gone way beyond buying long-term government bonds. It has been buying up much of the US—"quantitative easing" on a massive scale to directly increase private spending. Compared with recent drastic actions, buying long-term bonds is a mild move.

Nevertheless, many people were aghast by these "mild" suggestions in 2002. Justifiably so. A well-functioning central bank changes money supply through short-term money market operations, while the treasury borrows at the long end. This "market segmentation" is one vital step to ensure the independence of the central bank from the treasury, and to help keep the fiscal deficit from being monetized. Not for nothing did Bernanke earn the title "Helicopter Ben" after this deflation speech. (The "helicopter drop of money" in textbooks is used to explain money's impact along Quantity Theory lines).

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Granted, a serious threat of deflation may warrant such policies. But announcing it in advance creates the moral hazard of assuring private players that even if they expand recklessly, they are immune to deflation risk since the Fed stands ready to bail them out. Whether the deflation threat in 2002 was concrete enough to justify this speech requires evaluating the inflation and other data in real time.

As things turned out, the Fed reacted aggressively to deflation risk when its preferred inflation measure, the core personal consumption expenditures deflator, fell below the implicit 2% target. The funds rate was lowered to 1% during 2003 and 2004 (see chart), partly in response to this deflation scare. That huge infusion of liquidity paved the way for the emerging markets equity boom in recent years.

By the same logic, when the Fed raises the funds rate to ward off inflation or tackle an asset bubble, suppose the long rate does not rise, what should it do? The answer is obvious—sell bonds, and continue to do so in any amount, or some equivalent transactions, to ensure that long rates also rise enough.

However, the Fed failed to do so. Greenspan in February 2005 stated that the failure of long rates to rise despite the steep funds rate hike (200 basis points then) was a “conundrum”, an expression that caught on (implicitly, the Fed was powerless to raise mortgage rates to tackle the housing bubble). Bernanke explained this conundrum in an April 2005 speech as a “global savings glut” that was keeping bond yields low globally. Maybe so, but the Fed could have acted.

Overall, Bernanke has continued his predecessor’s tradition. The “Greenspan put” (as in a put option) was a Wall Street expression to characterize his asymmetric bias towards equity price movements. When the dot-com bubble was under way, Greenspan repeatedly stressed that it was incorrect, and perhaps impossible, to fight market forces. But when the stock market declined, he would cut rates quickly and hugely. In effect, Bernanke extended the Greenspan equity put to the bond market.

Vivek Moorthy is professor of economics at IIM Bangalore. Comment at theirview@livemint.com

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Govt should regulate licensing in a systematic manner rather than spring surprises and shocks to the broadcasting industry which is expanding, creating jobs and media values.

The broadcast industry has just begun.. and the government has started to apply brakes, why can't govt restrict broadcasters who show Rs 1.50 crores nett worth and get a channel license, they then use the license as a bargaining tool to make money by selling the defunct or lousy channels to new entrants, this is a big money making racket, licenses are sold at premium prices and all sorts of black marketing is now a big game in broadcasting.

There are so many broadcasters who start the channel .. only to sell it to a buyer and again launch a new channel, and this continues forever, such broadcasters should be restricted or not given approval for new license.

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