Colonel Bernanke's Code Red

By David Zervos

The lesson of August 2011 is that this recovery from the "Great Contraction" is highly fragile. The policy responses required to assure a turnaround must be carefully calculated. We remain in uncharted waters and it is impossible to know what policy is "too easy" or "too tight". As we have argued for nearly 2 years – this is the greatest monetary policy experiment of all time! No one should have ever had a great deal of confidence in any GDP, unemployment, inflation or earnings projection. In the middle of uncharted waters that would be foolish. I certainly have taken no such forecast or projection seriously – these are less than guesswork, they are worthless. The ONLY thing worth banking on is the Fed policy reaction function. That is all we got – and to that end we at JEF have always been staunch believers in a Fed that would reflate – no matter what. That alone has been the basis for our asset price forecasts, not some ungrounded growth, unemployment, inflation or earnings forecast.

Thus far, since the mistakes of 2008, the Fed has never let us down. QE1, QE2 and most recently a forward looking commitment to 0 rates for two years were all part of their aggressive reflationary response function. This of course has not come without costs. The latest "commitment" not only generated external backlash (as with QE) but it garnered significant internal backlash via 3 dissents. Ben has been ruthless in his fight against a deflationary debt spiral – even taking out some of his own troops, those 1930s Marriner Eccles protypes who have shunned monetary policy solutions. Ben has earned his stripes as Colonel (Nathan R) Bernanke, the financial leader who uses even the most repugnant and controversial monetary procedures – debt and dollar devaluation (aka code reds) – to win the deflation battle!

Back on May 4th 2011 I spent some time working with an analogy between the character from the movie "A Few Good Men", Colonel Nathan R Jessop, and Ben Bernanke (this is not to be confused with the piece where compared Ben to Charlie Sheen's crack dealer). The commentary was titled – "Colonel Bernanke did you order the USD code red?". In that piece I suggested that Ben had covertly ordered a "code red" on the US dollar. In effect I claimed that Ben was subversively following a policy to generate excess inflation and devalue both US dollar and the US private and public sector nominal debt stocks. I lamented that no one attending his first post FOMC press conference had the Tom Cruise like ability to weasel the truth out of him, but nonetheless he was the Nathan R Jessup of the financial markets – he had ordered the code red.

As it turns out, the current battle with deflation requires a constant vigilance and a repeated use of "code red" like procedures. Unfortunately, just like in the movie, code reds are not "standard" or "by the book" policies. They are explicitly shunned by those who fail to understand the seriousness of the battle. Ben is "standing post", using some ugly methods to get the job done. Below I augment a Colonel Jessop speech from the movie to get this point across. I wish Ben would say something like this at his next semi-annual Congressional testimony:

"I have a greater responsibility than you could possibly fathom. You weep for creditors, and you curse the Fed. You have that luxury. You have the luxury of not knowing what I know. That destroying creditors with inflation and a weaker dollar, while tragic, probably saved lives. And my existence, while grotesque and incomprehensible to you, saves lives. You don't want the truth because deep down in places you don't talk about at parties, you want me on that Committee, you need me on that Committee. We use words like honor, code, loyalty. We use these words as the backbone of a life spent defending something. You use them as a

punchline. I have neither the time nor the inclination to explain myself to a man who rises and sleeps under the blanket of the very freedom that I provide, and then questions the manner in which I provide it. I would rather you just said thank you, and went on your way. Otherwise, I suggest you get your fiscal house in order, and stand a post. Either way, I don't give a damn what you think you are entitled to…."

While such a tirade would be beautiful to watch, it is too much to ask for. But the point is simple – why would anyone expect Ben to back down at Jackson Hole after all he has done to get to this point? His speech on Friday is critical and I fully expect Colonel Bernanke to deliver a stealth code red – ONCE AGAIN.

I'll stop there on the code red metaphor even though I could go on forever (I loved that movie). But before I stop today's commentary I want to focus some attention on the best chartist I know for sailing these uncharted waters – that would be Ken Rogoff. Ken's analysis (much of which was done jointly with Carmen Reinhart) has been spot on for 2 plus years. Very early, back late 2008/early 2009, Ken called for targeting an inflation rate above the "normal" level (say at 4 to 6 percent) for a few years in order to stop the debt deleveraging and bring the Great Contraction to an early end. As I was catching up on my reading yesterday, I noticed Ken once again penned a beautiful piece in early August. I have copied it below – and it is a MUST READ.

As I was reading this I couldn't help but recall walking back from lunch in 2009 via the under pass that connects the Martin and Eccles buildings at the Fed. Walking towards me we were Ben and Ken – by themselves heading to lunch – both were smiling and laughing like two eco-geeks that had just made up a knock knock joke about a representative agent! I thought nothing of it at the time, but as I reflect about our current state of affairs, this image

has a much deeper meaning. Ben and Ken are close. And that is important!

Ken is a legend in international economics – and one day he is likely to be Nobel in caliber. His early work with Maury Obsfeld was critical in the development of intertemporal (RBC) type models of exchange rate fluctuations. His work on exchange rate over shooting, fixed exchange rate regimes and sustainable current account deficits was also monumental. He worked closely with Ben at the NBER and I am sure his opinion is taken VERY seriously by the Chairman – certainly more seriously than that of the hacks who inhabit institutions such as the Bundesbank or some of our regional Federal Reserve Banks. Hopefully, Ken has stopped by recently for another lunch with the Chairman – to bend his ear and make sure he recognizes how important the job at hand truly is. Colonel Bernanke needs strong supporters. He needs to maintain the vision that this is a "reflation or bust" moment in US history. A code red on both the dollar and debt holders must be executed – whether Perry, Paul, Meltzer, Plosser, Fisher, Weidmann or Jintao object. Without code reds we are destined for 1937 all over again and Colonel Bernanke knows it! Good luck trading and enjoy Rogoff's rant below!

From Ken Rogoff

CAMBRIDGE – Why is everyone still referring to the recent financial crisis as the "Great Recession"? The term, after all, is predicated on a dangerous misdiagnosis of the problems that confront the United States and other countries, leading to bad forecasts and bad policy.

The phrase "Great Recession" creates the impression that the economy is following the contours of a typical recession, only more severe – something like a really bad cold. That is why,

throughout this downturn, forecasters and analysts who have tried to make analogies to past post-war US recessions have gotten it so wrong. Moreover, too many policymakers have relied on the belief that, at the end of the day, this is just a deep recession that can be subdued by a generous helping of conventional policy tools, whether fiscal policy or massive bailouts.

But the real problem is that the global economy is badly overleveraged, and there is no quick escape without a scheme to transfer wealth from creditors to debtors, either through defaults, financial repression, or inflation.

A more accurate, if less reassuring, term for the ongoing crisis is the "Second Great Contraction." Carmen Reinhart and I proposed this moniker in our 2009 book *This Time is Different,* based on our diagnosis of the crisis as a typical deep financial crisis, not a typical deep recession. The first "Great Contraction" of course, was the Great Depression, as emphasized by Anna Schwarz and the late Milton Friedman. The contraction applies not only to output and employment, as in a normal recession, but to debt and credit, and the deleveraging that typically takes many years to complete.

Why argue about semantics? Well, imagine you have pneumonia, but you think it is only a bad cold. You could easily fail to take the right medicine, and you would certainly expect your life to return to normal much faster than is realistic.

In a conventional recession, the resumption of growth implies a reasonably brisk return to normalcy. The economy not only regains its lost ground, but, within a year, it typically catches up to its rising long-run trend.

The aftermath of a typical deep financial crisis is something completely different. As Reinhart and I demonstrated, it typically

takes an economy more than four years just to reach the same per capita income level that it had attained at its pre-crisis peak. So far, across a broad range of macroeconomic variables, including output, employment, debt, housing prices, and even equity, our quantitative benchmarks based on previous deep post-war financial crises have proved far more accurate than conventional recession logic.

Many commentators have argued that fiscal stimulus has largely failed not because it was misguided, but because it was not large enough to fight a "Great Recession." But, in a "Great Contraction," problem number one is too much debt. If governments that retain strong credit ratings are to spend scarce resources effectively, the most effective approach is to catalyze debt workouts and reductions.

For example, governments could facilitate the write-down of mortgages in exchange for a share of any future home-price appreciation. An analogous approach can be done for countries. For example, rich countries' voters in Europe could perhaps be persuaded to engage in a much larger bailout for Greece (one that is actually big enough to work), in exchange for higher payments in ten to fifteen years if Greek growth outperforms.

Is there any alternative to years of political gyrations and indecision?

In my December 2008 column, I argued that the only practical way to shorten the coming period of painful deleveraging and slow growth would be a sustained burst of moderate inflation, say, 4-6% for several years. Of course, inflation is an unfair and arbitrary transfer of income from savers to debtors. But, at the end of the day, such a transfer is the most direct approach to faster recovery. Eventually, it will take place one way or another, anyway, as Europe is painfully learning.

Some observers regard any suggestion of even modestly elevated inflation as a form of heresy. But Great Contractions, as opposed to recessions, are very infrequent events, occurring perhaps once every 70 or 80 years. These are times when central banks need to spend some of the credibility that they accumulate in normal times.

The big rush to jump on the "Great Recession" bandwagon happened because most analysts and policymakers simply had the wrong framework in mind. Unfortunately, by now it is far too clear how wrong they were.

Acknowledging that we have been using the wrong framework is the first step toward finding a solution. History suggests that recessions are often renamed when the smoke clears. Perhaps today the smoke will clear a bit faster if we dump the "Great Recession" label immediately and replace it with something more apt, like "Great Contraction." It is too late to undo the bad forecasts and mistaken policies that have marked the aftermath of the financial crisis, but it is not too late to do better.

Kenneth Rogoff is Professor of Economics and Public Policy at Harvard University, and was formerly chief economist at the IMF.