Bernanke's Pressure Cooker Policy

Fed Chairman Ben Bernanke's "Monetary Policy and the Housing Bubble"[1] speech, delivered on Sunday January 3rd, is worthy of very close attention. His arguments are as byzantine as his conclusions are bewildering. The implications of Bernanke's analysis for America's long term monetary policy and regulatory environment look to be quite profound.

The speech has three principal arguments:

1. When judged against the Taylor Rule, the Fed's monetary policy during the housing market boom was not as loose as is widely believed.
2. The magnitude of the housing market bubble was much greater than can be explained by econometric models, suggesting the bubble was not caused by monetary policy.
3. Other countries around the world had similarly easy monetary policy but most did not experience housing bubbles, also suggesting monetary policy did not cause the bubble.

These arguments lead Bernanke to two conclusions:

1. The housing bubble was caused by lax regulation rather than loose monetary policy.
2. Therefore, the way to prevent future bubbles is through tighter regulation rather than with higher interest rates.

Even by Bernanke's standards this is a long and involved speech, running to 22 pages with 10 supporting charts. So it is fair to say he is trying to achieve something important with this analysis.

The most obvious objective of the exercise is reputational defence se. As he says early on, *"Some observers have assigned monetary policy a central role in this crisis. Specifically, they claim that excessively easy monetary policy by the Federal Reserve in the first half of the decade helped cause a bubble in house prices in the United States…"*

Bernanke's employment contract is currently under review, and the US unemployment rate has surged to 10% in the last year, so countering such criticism would be helpful at the current juncture. That said, there is no serious challenger for Bernanke's position, suggesting this speech has a second agenda.

Back in November 2002 Bernanke delivered another important speech – "Deflation: Making Sure "it" Doesn't Happen Here"[2] – which presented the intellectual argument for additional interest rate cuts, taking the fed funds rate down from 1.75% to 1% in June 2003. The essence of the 2002 speech was an argument to cut interest rates far and fast: *"when inflation is already low and the fundamentals of the economy suddenly deteriorate, the central bank should act more preemptively and more aggressively than usual in cutting rates … By moving decisively and early, the Fed may be able to prevent the economy from slipping into deflation, with the special problems that entails."*

This Sunday's speech looks similar in nature to the 2002 speech in aiming to set the intellectual framework for policy over the coming years. In 2002 the agenda was to lower rates. Today it looks to be an argument to hold rates low even if evidence of bubbles begins to emerge.

Shoddy Tayloring

Bernanke devotes about a third of his speech to explaining how the Taylor rule shows that the Fed's monetary policy was not unduly accommodative from 2001 onwards. In order to reach this conclusion Bernanke creates his own version of the Taylor rule which is modified in some very important respects. Bernanke's justification for using the Taylor for this purpose is: "…*as much of the debate about monetary*

[1] http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm

[2] http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021121/default.htm

policy after the 2001 recession has made use of such rules, I will discuss them here as well". This is a curious argument, as this was a contentious period for monetary policy so measuring policy against the prevailing wisdom of the time can hardly be considered an objective metric of excellence.

The adjustments to the Taylor rule that Bernanke requires are also of dubious merit. The two key variables of the Taylor rule are the gap between the Fed's target inflation rate and its current value, and the gap between real GDP and potential GDP. Bernanke allows himself the freedom to 'correct' the Taylor rule from CPI to Core PCE (personal consumption expenditure inflation), which helps his case somewhat.

More importantly he replaces Taylor's variables with the Fed's own forecasts of those variables. If we assume that the Fed was working to a Taylor Rule framework in this period this little tweak means that Bernanke is measuring the appropriateness of the Fed's delivered policy, against a benchmark of what the Fed thought was appropriate at the time.

It's nice to know that the FOMC were following their own convictions, but Bernanke's tautological test says nothing whatsoever about the legitimacy of those convictions. The more important questions are not addressed: Were the forecasts accurate? and Was the Taylor Rule framework appropriate?

Even with these adjustments Bernanke's tortured Taylor rule still concludes that monetary policy was over simulative from 2001 onwards.

Vector Autoregression – garbage in garbage out

The next element of his defence rests on showing that the magnitude of the interest rate stimulus was insufficient to explain the magnitude of the housing bubble. Bernanke claims to have achieved this by using a vector autoregression model with seven macroeconomic variables, one of which was the Federal Funds rate.

In the Chairman's words: *"For our purposes, the value of such a model is that it can be used to predict the behavior of any of the variables being studied, assuming historical relationships hold, and that the other variables in the system take on their actual historical values."*

The vector autoregression technique used by Bernanke assumes stable linear relationships, whereas asset bubbles are manifestly non linear positive-feedback phenomena, driven by unstable relationships. In choosing this technique Bernanke is trying to land a whale using a child's fishing net. That is to say he is giving himself absolutely no chance of achieving the claimed objective of modeling the housing bubble. It is therefore unsurprising that he is unable to explain the formation of the housing bubble on the basis of monetary policy in the period stimulus.

Absence of evidence is not evidence of absence

The final element of Bernanke's defence is the international argument; policy in other countries was loose but not all those countries experienced housing bubbles. While an accurate observation this defence is also undermined by its reliance on naïve linear ***stable*** models.

In a bubble, loose policy may well be responsible both for inflating a bubble in one period, but then also be required in the subsequent period to cope with the bubble's deflation. When examining bubbles it is necessary to consider non linear time varying relationships and recognize that the variables have path dependency. All of this makes a narrow cross sectional comparison between differing regions fraught with uncertainty and ambiguity.

Pointing the finger at regulation

Having supposedly exonerated monetary policy, Bernanke then suggests poor regulation and lax lending standards were the real cause of the housing bubble. He then goes on to infer that regulation should become the primary policy tool to address asset price bubbles, relegating monetary policy to a support role: "…*if adequate reforms are not made, or if they are made to prove insufficient to prevent dangerous buildups of financial risks, we must remain open to using monetary policy as a supplementary tool for addressing those risks…"*

Pressure Cooker Policy (PCP)

Bernanke's speech looks to be an argument for a Pressure Cooker Policy: keep the monetary policy heat turned up full, while using regulation to clamp down on the lid.

A great deal more than historical accuracy rests upon the quality of Mr Bernanke's analysis. If his analysis is sound and easy monetary policy does not cause asset price bubbles, then we need not worry. On the other hand if he has misread the historical lessons then this speech may be the precursor to repeating a very similar policy mistake to that which followed his 2002 speech.

It is reasonable to question the ability of regulation to restrain monetary policy from a number of angles. Particularly the question of timeliness should be considered. It will take time to identify signs of an emerging asset bubble. It will then take more time to build consensus on the correct remedial action. Only then will the regulators be able to step in, and only some time later will it become possible to assess if the regulation has worked. By the time the regulatory channel is shown to have failed the FOMC may be facing a bubble with such powerful momentum that bursting it risks another systemic shock.

Bernanke observes: "*the timing of the housing bubble does not rule out some contribution from monetary policy*".

We would go just a little further: *the timing of the housing bubble strongly suggests a significant contribution from monetary policy.*

Capital markets operate by trading discounted future cash flows, the net present value of which are inexorably linked with the current and expected future cost of capital. It is therefore unreasonable to absolve monetary policy of its role in the formation of asset price bubbles.

Back in 2002 Bernanke thought that cutting interest rates would stave off deflation by stimulating demand. In this speech Bernanke is asking that we believe such stimulus did not flow into the housing market. The Fed's current mortgage purchase program is just one of the many pieces of evidence suggesting otherwise.

Conclusions

Bernanke's self acquittal appears self serving and unsound. More worryingly, if this speech is a precursor to putting the US economy on PCP the longer term risks could be substantial.

Under the PCP further boom-bust asset and credit cycles are clearly a significant risk. Equally the policy could lead to a progressive socialization of risk through an ever increasing regulatory burden.

In the near term the implications for growth are likely to be positive. In the longer term it is difficult to see how such a policy can be anything other than negative for US growth. The short term inflation implications are ambiguous, but further out PCP looks like another inexorable step toward monetization and currency devaluation.

It took four decades for academics to help us unlearn the lesson of the Great Depression. This time round some of the same academics are helping us unlearn the lesson of the Great Recession within just a few months.

George Cooper

This communication has been provided to you for informational purposes only and may not be relied upon by you in evaluating the merits of investing in any securities or interests referred to herein. This communication is not intended as and is not to be taken as an offer or solicitation with respect to the purchase or sale of any security or interest, nor does it constitute an offer or solicitation in any jurisdiction, including those in which such an offer or solicitation is not authorised or to any person to whom it is unlawful to make such a solicitation or offer. Any decision to purchase securities or interests with respect to any of the Funds described herein must be based solely upon the information contained in the Prospectus or Private Placement Memorandum for that Fund, including any supplements thereto, which must be received and reviewed prior to any investment decision. Any person subscribing for an investment must be able to bear the risks involved and must meet the suitability requirements relating to such investments. Some or all alternative investment programs may not be suitable for certain investors.

Please note that the estimates provided for the LP feeder fund are based on an investment made in the relevant class and series on the first day of the calendar year (or on the first day such class and/or series was offered or tracked, as applicable). Due to 'series accounting' used to track the returns of individual investors, the actual 'month to date' and 'year to date' returns of an individual investor will vary from the estimates provided above, depending on the initial date of such investor's investment. Please contact your BlueCrest representative to determine which series most closely represents the returns of your particular interest in the fund. Actual 'month to date' returns for each investor will be provided by our independent administrator after the end of each month."

Certain of the performance results provided herein were not achieved from the actual management of the Fund, but are instead simulated results achieved by means of the retroactive application of the adviser's investment methodology, or the real-time application of a hypothetical capital allocation to such strategy. This approach has inherent limitations, including that results may not reflect the impact that material economic and market factors might have had on the adviser's decision-making if the adviser actually had been managing client money.

Although the information in this communication is believed to be materially correct, no representation or warranty is given as to the accuracy of any of the information provided. Certain information included in this communication is based on information obtained from sources considered to be reliable. However, any projections or analysis provided to assist the recipient of this communication in evaluating the matters described herein may be based on subjective assessments and assumptions and may use one among alternative methodologies that produce different results. Accordingly, any projections or analysis should not be viewed as factual and should not be relied upon as an accurate prediction of future results. Furthermore, to the extent permitted by law, neither the Funds nor any of their agents, service providers or professional advisers assumes any liability or responsibility nor owes any duty of care for any consequences of any person acting or refraining to act in reliance on the information contained in this communication or for any decision based on it.

Past performance is not necessarily indicative of future results. The actual performance realised by any given investor will depend on, amongst other things, the Fund invested into, the class of shares/interests subscribed for, the period during which such shares/interests are held and in what currency such shares/interests are held. This communication may include returns for various indices. These indices are not intended to be direct benchmarks for a particular Fund, nor are they intended to be indicative of the type of assets in which a particular Fund may invest. The assets invested in by the Funds will likely be materially different than the assets underlying these indices, and will likely have a significantly different risk profile. Target returns, volatility and Sharpe ratio figures quoted are targets only and are based over the long term on the performance projections of the investment strategy and market interest rates at time of modelling and therefore may change.

Among the risks we wish to call to the particular attention of prospective investors are the following: (1) Each Fund's investment programme is speculative in nature and entails substantial risks; (2) The investments of each Fund may be subject to sudden and large falls in price or value and there could be a large loss upon realisation of a holder's investment, which could equal the total amount invested; (3) As there is no recognised market for many of the investments of the Funds, it may be difficult or impossible for a Fund to obtain complete and/or reliable information about the value of such investments or the extent of the risks to which such investments are exposed; (4) BCMLLP has total trading authority over the Funds, and the use of a single adviser could mean a lack of diversification and, consequently, higher risk, and BCMLLP is dependent upon the services of key personnel, and if certain or all of them become unavailable, the Funds may prematurely terminate; (5) An investment in a Fund is illiquid and there is no secondary market for the sale of interests in a Fund and none is expected to develop; (6) There are restrictions on transferring interests in a Fund; (7) BCMLLP will receive performance-based compensation, which may result in riskier investments, and the Funds' fees may offset trading profits; (8) The Funds are subject to certain conflicts of interest; (9) Certain securities and instruments in which Funds may invest can be highly volatile; (10) The Funds may be leveraged; and (11) A substantial portion of the trades executed for the Funds take place on non-U.S. exchanges.
Changes in rates of exchange may also have an adverse effect on the value, price or income of the investments of each Fund.