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Your guide to understanding today's economy and financial markets

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Parallel Universe

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

Recent editorials in *The Wall Street Journal* (WSJ) have attacked the Federal Reserve and its Chair Ben Bernanke for its aggressive interest rates cuts of the past eight months. Numerous loud economists have expressed similar views.

The April 28, 2008 WSJ editorial noted that *"Eight months into the Fed's most recent rate-cutting spree, the evidence is overwhelming that it has been a major policy mistake."* In the eyes of the *Journal*, the Fed is almost singularly responsible for the spike in oil, farm, and other commodity prices, the decline of the U.S. dollar, and perhaps most any other malady suffered by American businesses and consumers.

Given the *Journal's* view that the Fed's interest rate cuts were "a major policy mistake," it seems worthwhile to consider a scenario wherein the Fed simply resisted pressure for interest rate cuts.

Such a scenario plays out in a parallel universe

The *Journal's* May 1, 2008 editorial again criticized the Fed for its seventh rate cut that occurred the prior day. The editorial noted that while the Fed is expecting inflation pressures to moderate over the balance of the year, *"…American consumers will have the privilege of paying $4 for gas and $2.20 for a dozen eggs."*

No argument here that the Fed under Ben Bernanke, and formerly under Alan Greenspan, has made some mistakes along the way. Hindsight is still 20/20.

However, the Fed can also take substantial credit for the fact that the U.S. economy has suffered but two mild eight-month recessions during the past 26 years…in an economy where prior recessions routinely occurred every 4-6 years. The Fed can also draw praise for recent rate cutting actions that have minimized or possibly eliminated the chance of recession in 2008.

Note: This is the same Federal Reserve that was widely criticized during 2007's final four months for the sluggish nature of its interest rate cuts. Many Fed critics at the time were strongly suggesting bolder Fed rate cut actions were necessary, which (to the delight of these Fed critics) did occur in January.

Given the *Journal's* view that the Fed's interest rate cuts were *"a major policy mistake,"* it seems worthwhile to consider a scenario wherein the Fed simply resisted pressure for interest rate cuts.

Such a scenario plays out in a parallel universe. The dates noted are the actual dates that the Fed enacted rate cuts in the *real* world…

September 18, 2007

The Fed's Open Market Committee (FOMC) left its key interest rate (the federal funds rate) unchanged today at 5.25%. The accompanying FOMC statement noted that inflation pressures were continuing to build, limiting any interest rate cut options of the Federal Reserve. Following the Fed's announcement stock prices fell sharply, while the U.S. dollar strengthened modestly. Criticism for the Fed's inaction was intense.

October 31, 2007

The FOMC left its key interest rate unchanged at 5.25% today at its FOMC meeting. Despite rising levels of anxiety in domestic and global financial markets, the Fed reiterated its view that any moves to cut its key interest rate would only aggravate inflation pressures. The Fed pointed to a similar policy being conducted by the European Central Bank (ECB).

Following the Fed's announcement U.S. and global stocks fell sharply, with the Dow Jones Industrial Average (DJIA or Dow) closing near 11000. The nation's unemployment rate rose to 5.6% earlier in the month, with home foreclosures continuing to rise sharply. Calls for Bernanke's dismissal remain intense.

December 11, 2007

The Federal Reserve concluded its latest FOMC meeting with an announcement that no change in the federal funds rate was enacted. The FOMC pointed to inflation pressures that are still higher than the Fed's desired range, perceived to be between 1.0% and 2.0%.

Following the FOMC announcement U.S. stocks again fell sharply, with the Dow closing slightly below 10000. Financial market participants and numerous economists expressed utter disbelief that the Fed would not cut its key rate even as "Rome is burning." Domestic banks and investment firms continue to report enormous losses and write-downs of loan and investment portfolios. Congressional leaders have demanded immediate interest rate cuts in order to help the U.S. economy.

The unemployment rate reached 5.9% in recent days as American companies of all types are slashing payrolls, fearful of what may lie ahead. The U.S. dollar, which had risen in value during autumn, fell sharply as prospects for a serious U.S. recession continue to build. *Business Week's* latest cover story was entitled "Mad Man at the Helm."

January 22, 2008

Fed Chair Bernanke noted in a speech that the Fed was having great success in reining in inflation pressures, thereby enhancing the Fed's inflation fighting credibility. Bernanke also noted that the Fed was providing "additional liquidity" to financial markets. Numerous financial reporters noted that declining inflation was primarily a result of the deep U.S. recession deemed to have gripped the economy in recent months.

Members of Congress approved a $400 billion fiscal stimulus package to help minimize the depth and duration of the recession. Such a program is expected to lead to an annual budget deficit approaching $800 billion, nearly twice the prior record. Congressional leaders also began hearings about bringing the Federal Reserve under closer Congressional scrutiny (Note: the Federal Reserve was created by the Congress in 1913).

The housing collapse continues to unfold, while the Dow fell below 9000. The nation's unemployment rate recently reached 6.5% as layoffs reached levels not seen in a generation. Numerous Wall Street and European investment firms are deemed on the brink of collapse.

January 30, 2008

No rate change…another FOMC statement about keeping inflation under control...another 500 point plunge in the Dow to near 8000. Oil prices continue to tumble as the global recession continues to worsen. Caricatures of Bernanke as a stork with his head in the sand are increasingly popular. Bernanke responds to his critics by suggesting that he is making the difficult decisions that he was "hired to make." Meanwhile, consumer confidence falls to its lowest level on record, while global business failures mount.

March 18, 2008

Another FOMC meeting…another lack of Fed response to the serious recession clearly underway in the U.S. Home values continue to erode as subprime mortgage loan interest rate resets decimate tens of thousands of home owners. The Congress recently sent legislation to the President to censure the Fed Chair for "irresponsible actions greatly detrimental to the American people."

Central banks around the world continue to cut their own key interest rates as global recession continues to worsen. Bernanke is widely viewed as the worst Fed Chair in history. Stock prices continue to fall while the unemployment rate recently approached 7.5%.

April 30, 2008

Good news! The Fed announced a 0.25% cut in its key interest rate, noting that inflation pressures are largely under control. The Dow gained 500 points, but still remains below 8000. Expectations that the U.S. economy might be able to emerge from its painful recession before the summer of 2009 are being voiced.

Back to the Real World

The Fed has had two choices during the past eight months. The first was to provide significant monetary stimulus to keep the domestic and global credit crisis at bay, while helping to minimize or avoid recession, even as inflation pressures have risen. The second option was to focus on inflation containment, even as the economy rolled over and died…

…the Fed selected the lesser of two evils

Jeff

"TEA"ser

Q: What do you get when you cross a four-leaf clover and poison ivy?

A: A rash of good luck!

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