"MONETARY SHOCK AND AWE:" THE FED PREPARED TO LAUNCH MOST RADICAL INTERVENTION IN HISTORY[1]

Mike Whitney©

The equities markets are in disarray while the bond markets continue to surge. The avalanche of bad news has started to take its toll on investor sentiment. Barry Ritholtz's "The Big Picture" reports that the bears have taken the high-ground and bullishness has dropped to its lowest level since March '09 when the market did a quick about-face and began a year-long rally. Could it happen again? No one knows, but the mood has definitely darkened along with the data. There's no talk of green shoots any more, and even the deficit hawks have gone into hibernation. It feels like the calm before the storm, which is why all eyes were on Jackson Hole this morning where Fed chairman Ben Bernanke delivered his verdict on the state of the economy on Friday. Wall Street was hoping the Fed would "go big" and promise another hefty dose of quantitative easing to push down long-term interest rates and jolt consumers out of their lethargy. But Bernanke provided few details choosing instead this vague commitment:

> "*The Committee is prepared to provide additional monetary accommodation through unconventional measures if it proves necessary, especially if the outlook were to deteriorate significantly.*"

Check. There's no doubt that Helicopter Ben would be in mid-flight right now tossing bundles of $100 bills into the jet-stream like confetti if he had the option. But Bernanke is fighting a rearguard action from inside the FOMC where a fractious group of rebels want to wait and see if the recent downturn is just a blip on the radar or something more serious, another tumble into recessionary hell.

This week, the markets were blindsided by two days of dismal housing news, grim durable goods orders, a slowdown in manufacturing, and modest gains in employment. 4 years later, and housing is still mired in a depression. When does it end? Households and consumers are buried under a mountain of debt; personal bankruptcies, delinquencies, defaults and foreclosures continue to mount while politicians threaten to tighten the purse-strings putting more pressure on families who can barley put food on the table let alone pay the mortgage.

Just months ago, 57 out of 57 economists surveyed predicted that the economy would avoid a double dip recession. Now they're not so sure. Stock market gains have been wiped out and the S&P 500 has dropped 14 percent from its high in April. All of the main economic indicators are testing new lows. The so-called "soft patch" is looking like another hard landing. The fear is palpable. On Thursday, the Dow slipped another 74 points by the end of the session. It could have been worse. The markets have been holding on by their fingernails hoping that Bernanke will bail them out. But it's going to take more than the usual promise of low interest rates for an "extended period" to boost enthusiasm. Wall Street is looking for the "big fix", a trillion dollar resumption of the Fed's bond purchasing program (QE) to pump up flaccid asset prices, electro-

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shock demand, and raise consumer inflation expectations. The big banks and the brokerage houses want Bernanke to rout the Cassandras and the gloomsters and pump some adrenalin into sluggish indexes. The Fed chairman promised to help.....but not just yet, which is why the markets continue to seesaw. Bernanke takes the threat of deflation seriously. His earlier speeches laid out a deflation-fighting strategy that is so radical it would shock the public and Wall Street alike. Here's an excerpt from a speech Bernanke gave in 2002 which illustrates the Fed boss's willingness to move heaven and earth to fend off the scourge of pernicious deflation.

> "*My thesis here is that cooperation between the monetary and fiscal authorities in Japan could help solve the problems that each policymaker faces on its own. Consider for example a tax cut for households and businesses that is explicitly coupled with incremental BOJ purchases of government debt – so that the tax cut is in effect financed by money creation. Moreover, assume that the Bank of Japan has made a commitment, by announcing a price-level target, to reflate the economy, so that much or all of the increase in the money stock is viewed as permanent.*
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> *Under this plan, the BOJ's balance sheet is protected by the bond conversion program, and the government's concerns about its outstanding stock of debt are mitigated because increases in its debt are purchased by the BOJ rather than sold to the private sector. Moreover, consumers and businesses should be willing to spend rather than save the bulk of their tax cut: They have extra cash on hand, but – because the BOJ purchased government debt in the amount of the tax cut – no current or future debt service burden has been created to imply increased future taxes. Essentially, monetary and fiscal policies together have increased the nominal wealth of the household sector, increasing nominal spending and hence prices....from a fiscal perspective, the policy would almost certainly be stabilizing, in the sense of reducing the debt-to-GDP ratio....*
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> *Potential roles for monetary-fiscal cooperation are not limited to BOJ support of tax cuts. BOJ purchases of government debt could also support spending programs, to facilitate industrial restructuring, for example. The BOJ's purchases would mitigate the effect of the new spending on the burden of debt and future interest payments perceived by households, which should reduce the offset from decreased consumption. More generally, by replacing interest-bearing debt with money, BOJ purchases of government debt lower current deficits and interest burdens and thus the public's expectations of future tax obligations."* (Some Thoughts on Monetary Policy in Japan, Governor Ben S. Bernanke, The Federal Reserve Board Tokyo, Japan, May 31, 2003)

Yikes! This is monetization writ large. Anyone who thought Bernanke lacked cohones should reread this passage. The Fed chair is prepared to launch the most radical intervention in history, monetary Shock and Awe. But will the bewhiskered professor be able to persuade congress to follow his lead, after all, the fiscal component is critical to the program's success. They're two spokes on the same wheel. Here's how (I imagine) it would work: Congress passes emergency legislation to suspend the payroll tax for two years stuffing hundreds of billions instantly into the pockets of struggling consumers. The Fed makes up the difference by purchasing an equal amount of long-term Treasuries keeping the yields low while the economy resets, employment rises, asset prices balloon, and markets soar. As the economy accelerates, the dollar steadily loses ground triggering a sharp increase in exports and sparking a viscous trade war with foreign trading partners. Then......it's anyone's guess? Either Bernanke's "nuclear option" succeeds in resuscitating the comatose economy or foreign holders of dollars and dollar-backed assets dump their gargantuan trove of US loot in a pile and set it ablaze. It's all a roll of the dice.