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How the Fed Is Holding Back Recovery

By David Malpass

Congress will face a runaway train on taxes and spending when it reconvenes after the elections. The solution is to restrain both—especially to stop the \$6 trillion tax increase scheduled to take place on Jan. 1—in order to restore business confidence and help job growth.

Instead, Congress is more likely to do nothing and count on the central bank to flood the economy with more money. In his speech at the Boston Federal Reserve Bank on Friday, Fed Chairman Ben Bernanke practically promised to oblige by resuming the large purchases of Treasury notes carried out to help stop the 2008 financial crisis. It's a sweeping manipulation of longer-term government interest rates and the dollar that the Fed should consider only in the direst of national emergencies or with specific congressional authorization.

Mr. Bernanke argued that most of today's high unemployment is cyclical and therefore susceptible to monetary stimulus. "We see little evidence that the reallocation of workers across industries and regions is particularly pronounced relative to other periods of recession," he said, "suggesting that the pace of structural change is not greater than normal." This ignores the tax, regulatory and federal spending crises hammering workers and small businesses.

In reality, workers are being reallocated, and by the millions. Due to the mortgage shambles, they are not moving around as much as in

past recessions. But the structural reallocation is clearly pushing older workers into long-term unemployment.

Meanwhile, there's also been a powerful rechanneling of credit away from small businesses. Corporate and government jobs are faring better than small business jobs, another major structural change that Fed purchases will exacerbate by channeling cheap credit to big entities.

Jobs are moving to Asia as Washington's weak-dollar policy causes trillions of dollars to move abroad to protect against the risk of U.S. inflation and dollar debasement. Investors put their money into foreign factories, mines and workers, creating a boom there. They avoid long-term job-creating investments here, instead buying short-term IOUs from our government.

Whether in Republican or Democratic administrations, the Washington policy consensus for a decade has been "print and spend." When that doesn't work, the Washington prescription is to double the dose—more monetary easing and dollar devaluation, and always more government spending. The Fed in particular has become accustomed to subsidizing federal borrowing by holding interest rates too low, which distorts capital flows and fosters asset bubbles.

By claiming that most of our unemployment is cyclical and not

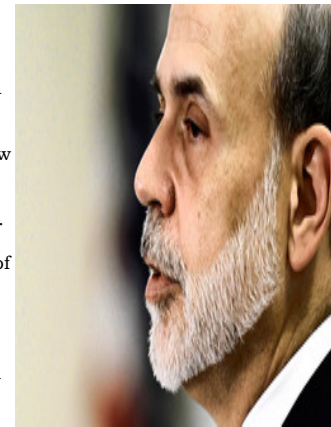
structural—and by not once mentioning the crashing dollar or small business profits—Mr. Bernanke has demonstrated that the central bank has blinders on. In his speech Mr. Bernanke cited the decline in the core PCE deflator (which uses the broad-based price index for personal consumption expenditures and excludes the volatile food and energy components) as evidence that inflation trends are subdued. This is the same backward-looking indicator that former Fed Chairman Alan Greenspan used to defend his disastrous low-interest, weak-dollar monetary policy from 2003 through 2006.

The reality is that core PCE inflation is regularly revised upward as the government takes into proper account rising prices for popular new items. Thus inflation gets underestimated and the Fed makes mistakes based on this mismeasure. For example, core PCE inflation was originally reported at 1.5% in most of 2004 with no real uptrend until Katrina hit in the second half of 2005. However, the corrected data now shows that core inflation was rising sharply in 2003 when the Fed hit the gas pedal and weakened the dollar. By April 2004, core inflation was already rising above the Fed's 2% ceiling and constantly exceeded it through 2008.

The Fed's public advocacy of bond purchases has already weakened the dollar. And the nearly \$100 billion per year in profit the Fed is earning from its investments are at the

expense of savers forced to compete with the Fed for bonds.

President Obama and Mr. Bernanke tried print-and-spend in trillion-dollar increments in 2009 and 2010, with no discernible improvement in unemployment (which is still almost 27 million counting underemployment) or small business investment plans, nearly the weakest on record according to the September survey by the National Federation of Independent Business.



Federal Reserve Chairman Ben Bernanke

The administration's centralized small business loan plan, enacted in September, was the latest spending flop. As the government controls more industries and allocates more of the nation's capital, small businesses

lower their hiring plans, as they did last month, on the expectation that the federal government will tax them more to pay for Washington's largess.

By electing a new Congress in November, voters may be able to slow federal spending growth, but they probably can't stop the Fed's latest expansion plan. The Fed is likely to buy more long-term government-guaranteed bonds, using newly created money to add to the over \$2 trillion in bonds it already owns.

The damage is substantial. Near-zero interest rates are hammering savers, while transferring hundreds of billions of dollars annually to bond issuers—mostly governments, banks and bigger corporations. The weaker dollar is pushing risk capital away from this country and toward Asia and emerging markets.

America's structural growth problems are clearly focused in small business and stem from high taxes, regulatory threats and the central control of credit. But the Fed's stimulus policy supports government over the private sector and big business over small—meanwhile, giving Congress an excuse to impose crippling increases in taxes and spending.

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