



In the Kingdom of the Blind, a one-eyed man is King

I couldn't help offering a comment or two on Blinder's opinion piece in the WSJ for August 17, 2011 which I read late this evening (It is still the 16th here in North Fork). I print it in totality below because the real gems are worth contemplating. I would ignore his preachments about the Tea Party and Republican obstinacy. If you want to know about obstinacy, read Bret Stephen's remarkable Forrest Gump off take on President Obama!

“A Tale of Two Downgrades: Standard & Poor's lack of confidence in U.S. performance is risible. The Fed's is not.”

By ALAN S. BLINDER

What is it about August? Though it's only Aug. 17, the U.S. economy has already been downgraded twice. One of those downgrades was ridiculous. The other was serious.

The nonserious downgrade came first, on Aug. 5, when Standard & Poor's dropped its rating on the sovereign debt of the United States from AAA to AA+. Yes, S&P is now telling investors that lending to the U.S. government today is riskier than (it said) lending to Enron was in August 2001, or than buying any one of thousands of soon-to-be-toxic mortgage-related securities was in 2007. If you listen to such advice, you deserve what you get.

Fortunately, most people aren't listening. The downgrade succeeded in panicking the world's stock markets and leaving blood on many financial streets. But many frightened investors moved their money straight into what they still know is the world's safest asset: U.S. Treasuries. Treasury yields fell across the board—not exactly what you expect from a downgrade. In practice, S&P downgraded itself.

A credit rating agency's job is to gather information, including information that virtually no one else has, and issue opinions based on that information. In the case of a corporate security, the agency may know things that the rest of us do not—which is the main source of its value added. But does S&P have any special knowledge about the finances of the U.S. government? The question answers itself.

A rating agency's "opinion" is supposed to be about the risk that the bond or other fixed-income security will not pay off in full and on time. But S&P's downgrade seemed to be more about American politics—which probably does deserve a downgrade, though to a much lower rating than AA+. The agency is unhappy that the recent deal to raise the national debt ceiling—a ceiling we shouldn't have in the first place—embodied a measly \$2.4 trillion in promised budget cuts, not the \$4 trillion "grand bargain" they preferred. Well, I didn't like the deal either, but I didn't sell any T-bills.

S&P said it is concerned that "further near-term progress [toward reducing the deficit] is less likely than we previously assumed and will remain a contentious and fitful process." Let's parse those words, starting with "contentious and fitful." Gee, no kidding. Where have they been since Hamilton and Jefferson crossed swords—not to mention since Barack Obama ran into implacable Republican resistance on everything?

Is deficit reduction really "less likely" now than it was before Aug. 1? It seems to me that the real surprise is that we got any agreement at all. And American politics is now focused like a laser beam on the deficit. So, if you're a deficit hawk, the recent news was good, not bad.

Furthermore, "near-term" deficits are not America's main concern. The real fiscal problem doesn't come in the next decade, on which S&P focuses, but rather in the decades beyond. For example, the Congressional Budget Office's long-term budget projection shows the primary deficit (excluding interest payments) shrinking for most of the next decade, but then exploding after that. And let's not forget the folly of raising taxes or cutting spending when the economy is so weak. S&P may not worry much about our struggling economy. But I do.

Fortunately, so does Federal Reserve Chairman Ben Bernanke. Which brings me to the more serious downgrade. Meeting on Aug. 9, the Federal Open Market Committee (FOMC) downgraded its near-term assessment of the U.S. economy sharply. Since the Fed's code of conduct mandates the use of FedSpeak instead of English, let me offer a quick translation: "Yikes! Things have sure deteriorated quickly!"

The Fed expressed its alarm in two ways, both remarkable. The first was Mr. Bernanke's willingness to push ahead despite a level of discord that is almost unheard of on the consensus-bound FOMC: The motion passed on a far-from-resounding 7-3 vote. Second, his policy innovation stunned veteran Fed watchers (including me): The Committee more or less promised to maintain the current rock-bottom federal funds rate for almost two more years.



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In so doing, the Fed violated one of the most revered canons of central banking: Always keep your options open. No one knows what might happen between now and June 2013—not you, not me, and not the FOMC. A booming economy by, say, Christmas 2012 doesn't look too likely right now, but it could happen. And if it does, the Fed won't want to keep the federal-funds rate near zero. So why risk the loss of credibility?

The answer is that the FOMC majority was so concerned about the health of our economy that they felt a duty to offer some support to the frail economy and to soothe the nearly panicked financial markets. But they had used up all their good ammunition long ago.

The two-year interest-rate commitment is based on a wing and a prayer. Economists' main theory of the yield curve, the "expectations theory," holds that, for example, the two-year Treasury rate should approximate the average of the overnight interest rates expected over the next two years. So promising to hold the federal-funds rate in the zero-to-0.25% range for two years should push the two-year rate down into that range. Makes sense.

But there are two big problems, both of which Mr. Bernanke knows well. First, the expectations theory has been proven wrong six ways from Sunday. Did someone say "weak reed"? Second, markets were already expecting very low funds rates for the next two years. So the Fed's announcement, while stunning, didn't change market beliefs much. Accordingly, the two-year Treasury rate dropped just eight basis points between Aug. 8 and Aug. 9, to 19 basis points from 27. How much difference can eight basis points make?

What all this says to me is that the FOMC majority is very worried. So unless the storm clouds lift quickly, there is probably more easing to come. That could mean another round of quantitative easing, such as the Fed buying more Treasury bonds. Or it could mean paying a lower interest rate on excess reserves. Or the brilliant and creative Mr. Bernanke could pull another rabbit out of his oft-used hat.

So stay tuned—but to the Fed, not to S&P."

To, me there are three serious takeaways.

(1) "The game isn't over 'til it's over." In Linqua Berra, that means we have not heard the last on real "easing." Blinder emphasizes that Bernanke pushed ahead despite the split in the vote. Maybe the significance is that Bernanke didn't move to QE3 at this juncture because of the split. But the reservations on the state of the economy (Blinder says: "What all this says to me is that the FOMC majority is very worried"), means that one real bottom line is that the Fed will speak again. Bernanke is fearful. Maybe after Uncle Ben's does some climbing in Jackson Hole he will be prepared to offer inspiration about the economic hole in which we find ourselves?

2)"When you come to a fork in the road, take it," as the Yogi-man once said. The data stream over the past two months represents a fork. Down one road is the old Double Dipper and the implications for an expanding Budget Deficit caused by declining tax receipts. Blinder sees the issue as the Fed having to deal with financial anxiety when it has no bullets left.

3)"You've got to be very careful if you don't know where you are going because you might not get there." Blinder doesn't know where to go either. He may have given up on monetary policy. His fall back on the necessity of a strong fiscal policy reaction is a political non-starter. The S&P downgrade is theater. The declining U.S. economic prospects are the reality that policy makers now face. His punch line is the hope that his former colleague will (be Mandrake the Magician and)"pull another rabbit out of his oft-used hat." Bottom Line: Science isn't working—pray for magic.

The news from Europe says the U.S. is still the tallest pygmy! UGH!