

# Bagehot's Playbook for Bernanke

The Fed chief faces his first real test.

BY IRWIN M. STELZER

When the inability of a relatively few overstretched homeowners to meet their mortgage obligations results in the firing of the CEO of Bear Stearns, the forced bailout of a German lender, the suspension of three asset-backed funds by France's largest bank, and the cancellation of several private equity deals, attention must be paid, as Arthur Miller warned about troubled salesman Willie Loman. No one listened, and Loman committed suicide.

Market watchers and traders have not reached that point yet, but market volatility has them biting their fingernails down to stubs. Most worrying, President Bush personally took to the airwaves on August 9 to assure us that "the fundamentals of our economy are strong . . . there is enough liquidity in the system to enable markets to correct, . . . we're headed for a soft landing." Unfortunately, this only prompted memories of similar assurances by Herbert Hoover.

One trader says that until now, all he worried about is what he didn't know. But the discovery of France's BNP Paribas that it could not determine the value of some of its funds came only a few days after its CEO, Baudouin Prot, assured the markets that his bank's exposure to the problems of the sub-prime market was "absolutely negligible." So traders now worry about what the people who should know in fact don't know. And investors have been reminded that when America sneezes, Europe and Britain catch a cold.

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*Irwin M. Stelzer is a contributing editor to THE WEEKLY STANDARD, director of economic policy studies at the Hudson Institute, and a columnist for the Sunday Times (London).*

In this atmosphere, almost anything the authorities do is seen as a sign that the situation might be worse than it seems. The European Central Bank (ECB) injected a whopping 140 billion euros (about \$200 billion) of liquidity into the banking system, and the Federal Reserve Board added about \$30 billion of liquidity to its usual seasonal injection, and markets—instead of being relieved—worried more than ever. The ECB action, in particular, led lenders to believe that the ECB has only belatedly discovered that the situation is worse than it seems.

Main Street is not as convinced as Wall Street that the world is coming to an end. Karlyn Bowman, Washington's savvy poll analyst, tells me that a majority of Americans say the recent movements in the stock market have had no effect on their views of the nation's economic condition, and that 77 percent say the recent decline in house prices had "no impact either way" on their own financial situation. To which many economists are saying, "Just wait a few weeks."

As they see it, there is more going on than a mere correction of too-loose credit. Companies that were planning to sell high-yield bonds to finance expansion have found that there are no takers, and have withdrawn their planned offerings. In July, only \$2.4 billion of these bonds were issued, down 90 percent from \$22.4 billion in June. More ominous, high-quality, investment-grade bond offerings of companies with impeccable credit fell from \$109 billion in June to \$30.4 billion last month. Unable to expand, these companies cannot create the jobs and rising

incomes that an expanding economy requires.

Consumers who want to buy a home—and there are some—are finding that banks are reluctant to lend them money, even if they have unblemished credit records. Worse still, adjustable rate mortgages on some 2.5 million to 3 million homes are going to "reset" in 2008, meaning that interest rates on some \$700 billion of mortgages will rise, and with them defaults. At minimum, consumers will feel poorer, triggering a further contraction of consumer spending power. So the decline in the housing market is likely to end in a crash, rather than the soft landing the president is predicting.

Banks are finding that they can't determine the value of many of their assets, making these assets impossible to sell—illiquid in the jargon of the Street. The observation of the great 19th-century essayist Walter Bagehot that a banker has "no special means of judging" the credit worthiness of "people not his customers" has been ignored. In addition, U.S. banks find themselves unable to syndicate—stuck with, in nontechnical jargon—some \$200 billion of loans they have made to private equity players. Not knowing just what their balance sheets will look like when the current turmoil settles down, they are turning down many potential borrowers who only a few weeks ago they would have showered with money.

Switch now to the real economy, or, as some would have it, economic fundamentals. The job market remains strong, with unemployment at a low 4.6 percent. Inflation is low. Retail sales may not be all that merchants wish, but stores such as Saks, J.C. Penney, and Nordstrom are reporting strong sales.

Meanwhile, all eyes are on policymakers. Larry Lindsey, the economist who crafted the tax cuts that President Bush credits with the \$1.9 trillion economic expansion since he moved into the White House, says the important distinction is between liquidity and solvency. Only if the liquidity crisis drives banks and other

businesses into insolvency will the current troubles do more than reduce next year's economic growth to perhaps 1.5 percent—not great, but not a recession either.

That can be avoided if the Fed does what it is designed to do: act as the buyer of last resort for the assets that are now illiquid. That does not mean it should arrange a bailout, for it is important that imprudent lenders feel pain, lest they repeat their errors sooner than they otherwise inevitably will. Bagehot urged central banks faced with a credit crunch to “lend freely at a penalty rate”—prevent insolvencies that would cause future pain, but make the lenders suffer for past sins.

Fed Chairman Ben Bernanke might end up doing just that. So far, he has not been panicked into triggering a massive purchase of dicey mortgage-backed securities. Which is just as well since, even after the recent bloodbath, share prices remain above last year's levels, and on Friday, August 10, closed just where they were when the week started.

This is really the first test of Bernanke's skill and nerve since he succeeded the fabled Alan Greenspan. Scholars who blame the prolongation of the Great Depression of the 1930s on mistaken decisions by the Fed are hoping that monetary policymakers get it right this time. ♦