REVIEW & OUTLOOK | OCTOBER 24, 2008

Another Bubble Bursts

Subprime mortgages were just the beginning.

Credit markets have started to thaw, yet stocks and the larger economy keep sliding. What's going on? Among the problems are the reality of recession and the uncertainty over Barack Obama's policies. But the larger story is that the global economy is fast popping its latest monetary bubble, the one over the last 14 months in commodity prices and non-dollar currencies.

AP

The original bubble was in housing prices and mortgage-related assets, which the Federal Reserve helped to create with its negative real interest rates from 2002 into 2005. This was Alan Greenspan's tragic mistake, not that the former Fed chief will acknowledge it. Testifying before Congress yesterday, Mr. Greenspan pinned the crisis on mortgage securitizers, risk modelers and lending institutions, thus contributing to the Washington narrative that government had little to do with it. The Fed's monetary policy apparently gets a pass. The media and Members of Congress will use Mr. Greenspan's testimony to impugn the very free market principles that the former Ayn Rand protégé has spent his life promoting. It was a painful spectacle to watch.

As for the second bubble, this one began in August 2007 with the onset of the credit panic. This is Ben Bernanke's creation. The Fed chose to confront the credit crunch as if it were mainly a problem of too little liquidity, not fear of insolvency. To that end it flooded the economy with money, while taking short-term interest rates down to 2% from 5.25% in seven months. The panic only got worse, and this September's stampede finally led the Treasury and Fed to address the solvency problem by supplying public capital and numerous guarantees to the financial system.

The Fed's liquidity burst nonetheless sent markets for a 14-month loop, as the nearby charts indicate. The Fed created a commodity bubble of record proportions, with oil doing a round trip in a single year from $70 up to $147 and back down to $69 yesterday. The dollar also plunged along the way against most global currencies, notably the euro, as the bottom chart illustrates.

The dollar price of oil and the dollar-euro exchange rate are probably the two most important prices in the world. They represent a huge share of global commerce, sending signals that shape trade and capital flows. When those two prices move up and down so sharply in so short a time -- based more on fear and expectations than on economic realities -- they distort price signals and can lead to a misallocation of resources. Commodity prices have now fallen back to Earth, as the reality of global recession hits home and the Fed can't ease much further. Meanwhile, the euro has fallen from the stratosphere as Europe heads into recession and the dollar becomes a safer haven in a world of fear.

But even as this bubble recedes, its consequences are hurting those countries and investors who bet on or benefited from higher prices. That includes emerging markets that are largely commodity plays, such as Russia and the Persian Gulf countries. Within the U.S., this includes the farm belt and ethanol alley in the Midwest. The ethanol lobby is already floating the prospect of a taxpayer bailout, as if it wasn't floating on taxpayer subsidies already. Hong Kong conglomerate Citic Pacific and a pair of Chinese companies may have lost hundreds of millions on faulty currency bets. Hedge funds that gambled on commodities or a weaker greenback have had to cover their bets and deleverage. You can expect more such country and hedge-fund blowups in the coming weeks.

The tragedy of the second bubble is that it has left the economy in a weaker position to ride out the housing slump and credit panic. The American consumer has been whipsawed with $4 dollar gas and food inflation, while entire industries have been put on the edge of bankruptcy. Detroit's auto makers have spent the last year taking down their truck and SUV assembly lines while gearing up to make hybrids and electric cars, even as their cash flow has been ravaged. Their new investments are based on the expectation that oil will stay high permanently, but will the market for hybrids exist if oil is $50 a barrel?

As Congress plumbs the causes of our current mess, the main one is hiding in plain sight: Reckless monetary policy that did so much to create the credit mania and then compounded the felony with a commodity bubble and run on the dollar whose damage is now becoming apparent. The American people intuitively understand what's been done to them, which is why they are so angry. If the next President ignores the monetary roots of our troubles, he is courting the same fate as George W. Bush.

Please add your comments to the Opinion Journal forum.

MORE IN OPINION

Email Printer Friendly Order Reprints

Share:

Wars

Microsoft Takes Wraps Off Windows 7

Most Read Articles Feed

Related Articles and Blogs from WSJ.com

Oil's Slide Threatens Future Supply OCT 29. 2008

Fed Is Set to Cut Rate Again Amid Economic Deterioration OCT 28. 2008

IOU, Uncle Sam: Loans Start Today OCT 27. 2008

Dinallo on Credit Default Swaps: "There Was No 'There' There" OCT 27. 2008

Related News From the Web

Crude leads broad rally in commodity futures OCT 29. 2008
marketwatch.com

Commodities take a hit OCT 24. 2008
money.cnn.com

Do Not Count Out Commodities OCT 21. 2008
forbes.com