Bernanke's Bind

The Fed chairman is in the impossible position of trying to raise the price of real estate while lowering the costs of food and fuel.

By Nicholas von Hoffman

YOU MAY BE ABLE to go up the down escalator or you may be able to go down the up escalator, but until now nobody has been able to do both at the same time, which is what the U.S. is attempting.

The United States is struggling to hold down the price of gasoline and bread as it uses its artifices and devices to lift the price of housing, not to mention propping up the stock market. The greatest of prestidigitators would be hard pressed to deflate and inflate the same balloon simultaneously, and such accomplished masters of legerdemain are seldom found running the major financial organs of the U.S. government.

Even when there is no inflation or deflation, prices fluctuate. Under those circumstances, prices, taken together, would be flat on average even as the prices of individual goods and services bobbed up and down. But what's going on today is no tame bobbing. We are looking at an economy at war with itself. On one side is an inflationary cyclone propelled by oil prices. On the other, a deflationary hurricane making money vanish by the billions as it roars downward into a chasm whose bottom we cannot see. Tried and true remedies seem to intensify the storm. The measures taken in hopes of stemming the housing rout supercharge inflation, and the measures needed to stop rising prices intensify the mortgage market calamity.

The downward struggle is at its fiercest over mortgage foreclosures. The more foreclosures, the more the price of housing drops. And the more home prices fall, the less the bonds issued to pay for the mortgages are worth, and the closer the nation's distressed financial institutions come to bankruptcy. Hence Ben Bernanke, the chairman of the Federal Reserve Board, speaks of "the foreclosure crisis."

Crisis is not a word that trips lightly off the tongue of a Fed chairman. In the highly spookable world of money, Fed chairmen, secretaries of the Treasury, and such are given to soothing murmurs, as though they were horse-whispering into the ear of a skittish Kentucky Derby winner. These guys do not shout fire even when the barn is ablaze.

The cause of Mr. Bernanke's fear is obvious when he lays out the salient facts as he knows them:

> About one quarter of subprime adjustable-rate mortgages are currently 90 days or more delinquent or in foreclosure. Delinquency rates also have increased in the prime and near-prime segments of the mortgage market, although not nearly so much as in the subprime sector. As a consequence of rising delinquencies, foreclosure proceedings were initiated on some 1.5 million U.S. homes during 2007, up 53 percent from 2006, and the rate of foreclosure starts looks likely to be yet higher in 2008.

Should foreclosures continue to grow at the same rate as last year, three million properties will be going under the auctioneer's hammer before 2008 is over. Not all of them will be owner-occupied, but the dumping of that many houses on a real-estate market already heavily overhung with inventory must push prices below today's levels.

So even some of those who look on people who default on mortgages as cheats or losers believe they have an immediate material interest in having the government prevent foreclosures, if that's what it takes to stabilize real-estate prices and start pushing them back to a point where the debt on residential housing is no longer greater than what houses are worth on the open market.

To drive those prices back up, the Fed and other government entities have been resorting to a variety of tricks, none of which has worked spectacularly well so far. Price control or price manipulation has a mixed record to say the least.

Price controls are associated with keeping prices down, but it is price control nevertheless when the object is to stop prices from falling. The single most concerted attempt to do that can be found in the passage of the National Recovery Act of 1933. The bill, reluctantly signed into law by Franklin Roosevelt, but backed at that desperate moment by almost everyone, authorized the creation of industry councils that had the power to set the minimum price at which something could be sold. The results were an ungodly mess from which the Supreme Court mercifully delivered the country.

More recently, Alan Greenspan, Fed chairman emeritus and archetypical idiot savant, was seized with a premonition in the first years of this decade that prices were collapsing under a deflationary riptide. Rushing to the rescue with interest-rate cuts and large quantities of new money, he successfully triggered what became the explosive housing bubble of 2007.

Greenspan's successor, Ben Bernanke, has discovered that nothing is automatic. Employing the tools his predecessor used to lift prices and other tools of his own invention, Bernanke is finding out that, though he is contributing to the vertical take off in oil prices, he has had no luck with housing or the stock market. No method has yet been devised to manipulate markets so that you get to pick what goes up and what goes down.

congressional powerlessness to control prices by measures short of rationing, a method last used 60 years ago during the Second World War.

The contradiction facing those who seek to lower prices is that the more money Bernanke puts out to fight off the collapse of housing prices, the more he weakens the purchasing power of the dollar, which in turn results in higher prices for oil—and a lot of other things.

Bernanke knows this. He is not a perversely obdurate man but one who is terrified at what might happen if housing prices continue to drop, since so many financial instruments are directly or indirectly affected by what happens with those mortgages, both the prime and not so prime. Entities as distant as drudgy, dependable municipal bonds can rise or fall on what happens with housing. Many municipal bonds, used to finance such exciting projects as street lights and storm sewers, are dependent

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Not that Congress isn't trying. The air on Capitol Hill is heavy with proposals to, if not ameliorate the price of oil, at least reduce voter ire. Gas-tax holidays and the suspension of oil purchases for the Strategic Petroleum Reserve may give constituents the impression that Congress is about the work of lowering oil prices, but they will not see results at the pump. Republicans have renewed the endless argument about drilling in the Alaska National Wildlife Refuge, where there may or may not be a large amount of oil and, in any case, it would be years before it found its way to filling stations. The debate serves to underscore

on real-estate tax revenue expected from particular subdivisions. Thus, if the homeowners default, there may not be enough taxpayers left to pay the interest on the munis.

But municipal bonds aren't keeping Bernanke up at night. He is looking at the monsters of the Wall Street depths—financial arrangements with ugly names like credit default swap.

This kind of swap is a form of insurance dreamt up in the early 1990s for real-estate bond buyers to ensure that they got their money back in the event that the bonds defaulted. The market for credit default swaps now exceeds $45 trillion, more than the combined value of every residence in the United States. What started out as a sensible insurance mechanism has turned into speculation dwarfing the annual handle of all the casinos in the world.

Hanging in the air over lower Manhattan is what may happen if housing prices continue to fall, the bonds backing the mortgages on the foreclosed housing go into default, and those who sold the swaps aren't able to come up with enough money to cover the losses. Maybe the trillions of dollars in commitments get worked out some way or another, or maybe, faster than the Fed chairman can get to his office to stop it, the system implodes into something the size of a billiard ball.

Neither Bernanke nor anyone else knows if the swaps—or other financial instruments similar in size and risk—will collapse. Bernanke is a long-time student of the 1929-1934 catastrophe, when the absolute worst did happen. To forestall a repetition, he has taken a number of actions the legality of which some people question. But if not he, who? And if not that, what?

For all it has done in the face of the crisis, Congress might as well be a bathtub toy boat with a broken rudder. The White House has more important business to take care of, which leaves Bernanke and the Fed.

What he has done so far may work out. If it doesn't, we shall all know soon enough. In the meantime, no one else has a plan. Everybody senses the danger, and no one can say how to escape it.

Escape it we may, but if we do, it will be by luck and muddle. ■

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Smart Money

Political futures markets are better predictors than polls.

By Michael Brendan Dougherty

IN NOVEMBER 2004, a man with half a million dollars was looking to double his money. He could have gone to a high-stakes table in Vegas. He could have put his money in a hedge fund and waited. Instead, he signed on to a Dublin-based website, Intrade, the night before the presidential election and put everything on George W. Bush, then running even with John Kerry. The next morning, he was a millionaire.

Carl Wolfenden, the acting exchange manager of Intrade, explains the logic of prediction markets: "Our members sign up and trade with the intention of making money. One of the byproducts of that, the pricing information that they generate, translates into probability. The market pricing is measuring the probability of uncertain future events." The results are eerily accurate.

Tens of thousands of people bet money on who would win each state in the 2004 general election, and Intrade's political futures market predicted the winner in all 50. Two years later, the Intrade favorite won every single Senate race. Investors, or, if you prefer, gamblers, were generating political predictions far more accurate than professional pollsters'. They were also winning and losing piles of money.

But the political prediction markets didn't begin with high-rolling political junkies. They started with a few dozen college students. In 1988, the University of Iowa business school opened the Iowa Electronic Markets as an experiment. They allowed anyone to buy contracts based on how they thought a given candidate would do in an upcoming election. The market developed a price per share. If the market moved Candidate A's price up to 50 cents a share, it was saying that Candidate A had a 50 percent chance of winning.

"We collected almost 1,000 polls that came out during the election cycles, and compared the poll prediction to the IEM prediction," says Professor Joyce Berg, "and in 75 percent of cases the IEM was closer to the actual outcome than the polls were." One study showed that IEM's prices on the eve of an election were off by an average of just 1.37 percent.

Berg says that the people trading are nothing like a random sample of voters. "In 1988, everyone was from Iowa, and we only had 155 people in the voteshare market. Even now, when we have thousands of people in each market, we are not distributed among states by population. Our traders are overwhelmingly male. They have more education than the average voter. They have a higher income than the average voter. But the market mechanism is one where we don't need a random sample of voters, we need people with information." In other words, a large representative sample of the electorate cannot accurately predict its own behavior when asked a simple question. But a group of students betting their spring break money can.

The IEM limits its traders to accounts between $5 and $500 in order to avoid a crackdown by the government. Those who want to make larger wagers have to go overseas and deal with Intrade. The Internet Gambling Enforcement Act of 2006 prohibits American banks from making credit-card payments to offshore gambling sites. The only Americans betting on Intrade have offshore accounts and use foreign addresses. If Wolfenden set foot on U.S. soil, he would probably face arrest and prison. But the exchange he runs is the most hailed prediction market worldwide.

This year, over 50,000 contracts were bought on the New Hampshire primary, and so far 2 million contracts have been purchased on the Democratic nomination. Clinton's futures were more highly valued than Obama's even after a string of Super Tuesday defeats. But once news broke that Clinton was lending her own campaign money, Obama's price surged ahead in both the IEM and Intrade.

There was almost as much interest in Republican outcomes. Those poor souls who were bullish on Fred Thompson either sold short or stayed in their bad position, losing everything. But one couple gained a small fortune. Last summer there seemed to be no chance that John McCain would be the nominee. His amnesty bid backfired, his poll numbers in Iowa plummeted, and he couldn't raise any money. His price on Intrade dipped below 5 cents a share. But one trading duo, Bethen and Jonathan, saw an opportunity. If McCain won the nomination, each share they bought for a little under 5 cents would pay a dollar. Already