Review of Ben S. Bernanke *, The Federal Reserve and the Financial Crisis*.

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This short book contains a series of lectures given to undergraduates at George Washington University in March 2012. Ben Bernanke, Chairman of the Federal Reserve System explains the actions taken by the Fed during the crisis of 2008-2009 within the backdrop of the history of central banking and especially of the Fed. The key lesson from the book is that the Fed has learned from its past mistakes. It was established in 1913 to maintain financial stability (as well as to preserve price stability under the gold standard). During the Great Contraction of 1929 to 33 the Fed failed in its mission to act as lender of last resort and to prevent deflation and recession. By contrast, in dealing with the financial crisis of 2007-2008, the Fed learned from its past mistakes. It acted effectively as a lender of last resort to mitigate a panic in the shadow banking system and used its tools of monetary policy to prevent deflation and a repeat of the Great Contraction. In the aftermath of the crisis , the Fed has once again accepted its original mandate to preserve financial stability and hence we are 'back to the future'.

The book is clearly written and is a very useful primer on what the Fed is, what it does, and how it has dealt with the crisis. Each lecture is followed by a question and answer section. These are captivating both because of the clarity of the questions and because the answers give more insights into Bernanke's views on current policy issues such as the Fed's exit strategy from its quantitative easing policy.

The four lectures are divided into two parts. The first two lectures provide an historical background to the last two lectures which focus on how the Fed dealt with the crisis (lecture 3) and the recovery (lecture 4).

Lecture 1. The Origins and Mission of the Federal Reserve. The author briefly surveys the evolution of central banks as they learned to act as lenders of last resort, follow Bagehot's strictures, and to provide price stability by managing the gold standard. The Federal Reserve was established to deal with the endemic banking panic problem of the national banking system. President Wilson's compromise in 1913 led to a federal type central bank with twelve regional (autonomous) Reserve banks coordinated by a government appointed Board in Washington DC. In the 1920s the Fed was successful in fulfilling its mandate of financial and macroeconomic stability but it failed to prevent the Great Contraction of 1929 to 1933.According to Bernanke, the Fed's failures in the 1930s originated with a bad idea—the liquidationist hypothesis. The Fed failed to act as lender of last resort to halt banking panics or use expansionary open market policy to offset deflation in 1930-33 because it was concerned about reigniting a speculative boom and forcing the U.S. off the gold standard. The liquidationists, who adhered to an extreme form of the Real Bills Doctrine, believed that the Fed should contract credit during recessions. Bernanke's emphasis on the role of liquidationist views stands in contrast with Friedman and Schwartz (1963a) , who emphasize a failure of leadership, and Meltzer (2003) who argues that the Fed was misled by adherence to erroneous indicators of monetary conditions and failed to distinguish between nominal and real interest rates. FDR ended the panic and deflation by instituting deposit insurance and leaving the gold standard. The lesson from this lecture is for the Fed to avoid the policy errors of the 1930s.

Lecture 2. The Federal Reserve after World War II. In the aftermath of the Great Contraction the Congress revised the Federal Reserve Act to diminish the independence of the Reserve Banks and concentrate power in the Board of Governors in Washington. However from the mid - 1930s to 1950 the Federal Reserve was subservient to the Treasury. During the Second World War the Fed pegged both short-term and long-term interest rates at low levels to aid Treasury funding. After the relaxation of wartime price controls in 1945 the low interest rate peg engendered rising inflation in the late 1940s. After a concerted struggle the Fed was successful in its campaign to regain its operational independence to use its interest rate tools to fight inflation in the Federal Reserve Treasury Accord of 1951.Under Chairman William McChesney Martin the Fed followed its 'lean against the wind policy' to maintain a relatively stable macroeconomic environment from the early 1950s to the mid 1960s. Starting in 1965 expansionary monetary policy led to rising inflation. Bernanke sees the origins of the Great Inflation (1965 to 1982) in the Fed's belief in a permanent Phillips Curve tradeoff. Other factors he cites for the Great Inflation include OPEC, the Fed's cooperation with the Treasury in funding its debt and wage and price controls. Bernanke praises Paul Volcker for breaking the back of inflation with his contractionary policies from 1979 to 1982. This led to the Great Moderation episode from the mid 1980s to 2006 characterized by low and stable inflation, mild business cycle fluctuations and rapid economic growth. The success of the Great Moderation, according to Bernanke is attributed to the Volcker and Greenspan Fed's strategy of maintaining credibility for low inflation.

The lecture ends with a discussion of the origins of the Financial Crisis of 2007-2008 and the Great Recession. The crisis occurred after the collapse of the housing boom in 2006. Bernanke defends the Fed against the charges of John Taylor (2007) and others that the boom was fueled by the Fed keeping its policy rate too low between 2002 and 2005 because of misplaced fear of deflation. Bernanke's preferred explanation for fueling the boom is a savings glut in Asia and the demand for safe US securities. The collapse of house prices interacted with vulnerabilities in both the private and public sectors to produce the crisis.

Lecture 3. <u>The Fed's Response to the Crisis</u>. In this lecture Bernanke elaborates on the subprime mortgage crisis and the policies undertaken by the Fed to mitigate it. The crisis, he argues, reflected private sector vulnerabilities : excessive debt; the failure of the banks to monitor risk;short-term funding; and the proliferation of derivatives, and public sector vulnerabilities including: gaps in regulation; the failure to detect systemic risk; and flaws in the practices of the GSEs(Fannie Mae and Freddie Mac) that led to the origination of subprime mortgages and their proliferation in mortgage backed securities (MBS) . The financial crisis of 2008 according to Bernanke , was not a classic banking crisis but was centered in the non- bank financial system. Losses on subprime mortgages led to losses in MBSs and CDSs(credit default swaps--insurance contracts on the MBSs). The toxic subprime assets , although not of very large aggregate value, were distributed widely in MBSs leading to widespread uncertainty in the financial markets. This led to the drying up of short-term funding. Runs on the financial markets led to a collapse of funding for investment banks threatening their solvency. The first such non- bank financial firm affected was the investment bank Bear Stearns in March 2008, which the Fed rescued by arranging and subsidizing a merger with JP Morgan Chase. After a six month hiatus , the crisis spread in September 2008 to the GSEs which were in turn rescued, and then to the investment bank Lehman Brothers which was allowed to fail, and to the giant insurance company, AIG, which was bailed out. Bernanke justified the Bear Stearns and AIG bailouts on the grounds that they were too big and systemically connected to fail and they were solvent. Lehman was let go because it was deemed insolvent and because the Fed lacked the legal authority to rescue it. Bernanke viewed this experience as the successful application of Bagehot's rule and lender of last resort policy in marked contrast to what happened in 1930-33.

The collapse of Lehman led to a massive global financial market panic. Bernanke describes how the Fed invoked article 13(3) of the Federal Reserve Act to extend the discount window to non- bank financial institutions and financial markets. The Fed created special liquidity facilities to provide funding to the money market mutual funds (MMMFs) which were clobbered by the collapse of Lehmans and then to the commercial paper market that was funded by the MMMFs. Facilities for broker dealers, asset backed securities and many other institutions and markets were created. The author justifies the extension of access to the discount window as perfectly consistent with Bagehot's strictures because they were backed by collateral(although not made at penalty rates). These policies he argued prevented the collapse of the global financial system.

Lecture 4. Aftermath of the Crisis. Once the crisis was over, Bernanke describes how the tools of conventional monetary policy were used to prevent a repeat of the Great Contraction. The Fed cut its federal funds rate aggressively in the fall of 2007 and again in the fall of 2008 virtually to zero. Once the zero lower bound was reached the Fed shifted to LSAPS (large scale asset purchases) aka quantitative easing—open market purchases of long term Treasury securities and mortgage backed securities. The theoretical justification for this unorthodox policy was the portfolio adjustment mechanism first posited by Friedman and Schwartz (1963b). QE1 which began in March 2009 and QE2 in March 2010 led to close to a tripling of the Fed's balance sheet. According to Bernanke, these policies were successful in their stated goal of lowering long-term interest rates, especially mortgage rates. However the housing sector did not begin to recover until early 2013. Bernanke stressed that the LSAP policy did not lead to an inflationary expansion of the money supply because banks chose to hold large amounts of excess reserves at the Fed, rather than substantially increase their lending. Bernanke also discusses his view of the Fed's dual mandate—to maintain low inflation and low unemployment. Under his watch in 2012 the Fed adopted a 2 per cent inflation target and also a commitment to keep monetary policy expansionary until unemployment was reduced to the natural rate(so long as inflation and inflation expectations remained in check). He emphasizes his long-held commitment to transparency in monetary policy as evidenced by his introduction in 2012 of press conferences after FOMC meetings and in the introduction of forward guidance—announcements on the future path of policy rates.

Bernanke expresses his concern over the slow recovery from the Great Recession which he attributed to the housing bust ,the impairment of credit markets after the crisis, and the European debt crisis which began in 2010. Although optimistic about recovery of the economy to its normal levels and the role of aggressive monetary policy to achieve this, he admits that the Fed can - not solve all of the economy's ills.

Finally, the chairman discussed regulatory policy and the changes incorporated in the Dodd Frank Bill of 2010.The new legislation gave the Fed , as a key player in the FSOC(Financial Stability Oversight Council), new powers to deal with systemic risk and to designate firms capable of creating systemic risk for additional supervision and regulation(eg higher capital requirements) and to conduct stress tests. At the same time Dodd Frank by taking away the Fed's powers to use 13(3) to set up discount window facilities for non banks, may have reduced the Fed's ability to deal with a future crisis (Gorton and Metrick 2013). Finally Dodd Frank aimed to avoid the too big to fail problem altogether by giving the FDIC, with Fed assistance ,orderly liquidation authority over non bank financial institutions.

In conclusion, Bernanke reiterated his theme of ' back to the future'. The Fed was established to conduct monetary policy and preserve financial stability. It failed at both in the 1930s. It learned from its mistakes in monetary policy making during the Great Moderation , after lapsing in the Great Inflation, and now has also learned from its mistakes in providing financial stability.

<u>Comment.</u> Because Ben Bernanke is Fed chairman, he comes across at times in lectures 3 and 4 as justifying virtually everything that the Fed has done on his watch and pays little attention to the many criticisms of his actions. In lecture 3 he dismisses the view espoused by John Taylor and others that expansionary monetary policy in the early 2000s fueled the housing boom by citing the cases of countries like Ireland and Spain which had housing booms without expansionary monetary policy. Yet there is a considerable body of evidence to the fact that expansionary monetary policy has been a significant contributory factor to many housing booms in the past century (Bordo and Landon Lane 2013).

The author also skates over the Lehman Brothers collapse. There is no discussion of the possibility that the Fed let Lehman go to discourage the belief that all insolvent institutions would be saved in an attempt to prevent moral hazard—" pour encourager les autres". One wonders whether the severe crisis in September/October 2008 could have been avoided if Bear Stearns had been allowed to fail in March 2008. Had Bear Stearns simply been closed and liquidated, it is unlikely that more demand for Fed credit would have come forward than actually occurred. The fact that general creditors and derivative counterparties of Bear Stearns were fully protected by the merger of the firm with JP Morgan Chase had greater spillover effects than would have been the case had the Fed appointed a receiver and frozen old accounts and payments as of the date of the appointment. Fewer public funds would have been subject to risk. When Drexel Burnham Lambert was shut down in 1990 there were no spillover effects. Furthermore assume , that there would have been a crisis in March like the one that followed Lehman's failure in September. Would it have been as bad as the latter event? Assume that the moral hazard implications of bailing out Bear Stearns led the remaining investment banks and other market players to follow riskier strategies than otherwise on the assumption that they would also be bailed out. This surely made the financial system more fragile than otherwise. So that when the monetary authorities decided to let Lehman fail the shock that ensued and the damage to confidence was much worse (Bordo 2008) .

In addition, in response to Bernanke's claim that legally the Fed could do nothing to save Lehman, the history of financial crises provides examples when monetary authorities bent the rules and rescued 'insolvent' banks whose failure would have otherwise led to a panic. The chairman's statement that the Fed was legally prevented from rescuing Lehman reads like ex post hoc ergo propter hoc justification to cover the Fed's tracks from what turned out to be a disastrous decision.

Moreover, no mention is made of the critique that the Fed's extension of discount window lending under 13(3) was a form of credit policy (a type of fiscal policy)—of picking winners and losers—and affecting the allocation of resources, which the Fed swore off a half century ago.(Goodfriend 2012). One wonders if the Fed had engaged in general liquidity expansion through open market operations and let the markets determine who will receive the funds , if the outcome would have been any worse without the threat to the Fed's independence (Schwartz 2008).

Finally , no mention is made of the pause in the Fed's cutting the funds rate in the first half of 2008 because of concern over a run up of commodity driven inflation. According to Hetzel (2012) this policy increased real interest rates and guaranteed that there would be a recession even before the collapse of Lehmans.

Despite these shortcomings, I highly recommend the book to the educated reader as well as to academic and policy economists. Ben Bernanke has broken new ground by telling his story to the public while still in office.

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