Reviews


Just as the role of the US Federal Reserve (the Fed) in precipitating and prolonging the Great Depression is still debated more than eighty years after the event, so the contribution of the Fed to the recent financial crisis and its resolution will be debated by economists and historians for many years. Nor will there be an immediate judgement of a definitive nature about the performance of the Fed's chairman, Ben Bernanke. These two books attribute blame for the crisis in different degrees to the Fed, Bernanke stressing its inadequate supervision and regulation of the financial system, while William Barnett emphasises the poor quality of the Fed's monetary statistics. As to resolving the crisis, Bernanke is convinced that the unorthodox policies adopted by the Fed, with some assistance from the Treasury, made the difference between a Great Recession and another Great Depression. Barnett believes that similar crises will recur until the Fed changes its method of aggregating monetary data.

How Bernanke saw events unfolding during the crisis, and the various influences that were brought to bear on his thoughts and actions, were outlined in four lectures he gave to students at George Washington University in March 2012; the lectures are reproduced in *The Federal Reserve and the Financial Crisis*. As well as focusing on the crisis, the lectures – and the book – include some coverage of the Fed's history: its role during the two world wars; its evolution during the boom of the 1920s; its failure to respond adequately to the depression of the 1930s; the regaining of its independence in the 1950s; its participation in the Great Inflation of the 1970s; and the recovery of its reputation during the Great Moderation of the 1980s and 1990s. The lectures, and Bernanke's answers to students' questions, are uniformly erudite, elegant and concise.

Perhaps, the most arresting aspect of the lectures is the fascinating insight they provide into the thinking and motivation of the world's most powerful central banker. The key to understanding the nature of his thought processes is the fact that he is an economic historian, whose major contributions to scholarship embrace aspects of US monetary policy during the Great Depression. Bernanke informs his audience at the beginning of the first Lecture that: 'My thinking about this (the Fed and the recent crisis) is conditioned by my experience as an economic historian'. And again, at the commencement of the second Lecture, he says that 'It is very helpful to put the recent crisis and the ongoing recovery into historical context'. It appears that he learnt several lessons from his study of the Great Depression, which undoubtedly influenced his approach to the recent crisis. One is that economic prosperity depends essentially on financial stability. Another is that, during a severe financial crisis, the monetary authorities must act 'forcefully, creatively and decisively'. The Federal Reserve manifestly failed to act in this way during the Great Depression, resulting in the catastrophe of the 1930s. A third lesson is that crises that are international in scope require an international response. Another lesson is that, while events tend to recur, they are never exactly replicated.

These lessons are rehearsed throughout the lectures. There is Bernanke's conception of the nature of the crisis. It was, he repeats on a number of occasions, 'a classic financial panic', but one that arose in a different institutional setting from the crisis of 1929–33. It occurred not in a bank setting, but rather 'in a broader financial market setting...It was not banks and depositors; it was broker-dealers and repo markets, money market funds and commercial paper'. But while the setting was different, the solution – the provision of short-term liquidity to avoid a panic – was the same as the one that Walter Bagehot had proposed in his classic work, *Lombard Street,*
published in 1873. Whereas the Fed in the 1930s failed to adopt monetary policies to prevent deflation and monetary contraction, the Federal Reserve and the federal government in the recent crisis 'took vigorous actions to stop the financial panic, working domestically with other agencies and internationally with foreign central banks and governments'.

To what extent was the Fed to blame for the crisis? Bernanke admits that it made 'mistakes in supervision and regulation'. Of the supervision of banks and bank holding companies, it failed to 'press hard enough on the[ ] issue of measuring risks'. Its provision of consumer protection was weak, especially in the area of mortgage lending; had greater provision been made to protect mortgage borrowers, and had it been used effectively, some of the questionable lending practices might never have occurred. There were other weaknesses in the regulatory system: the lack of adequate oversight of the entire financial system; some important financial firms had no significant regulatory agency watching over them; systematically important institutions needed tougher supervision; regular stress tests should have been undertaken; greater separation of traditional banking services from proprietary trading activities was warranted; and greater transparency was needed regarding the issuing and transfer of derivatives.

There were many reasons why there was poor supervision and regulation of the US financial sector leading up to the crisis, but Bernanke believes that complacency during the Great Moderation of the 1980s and 1990s must share some part of the responsibility. For as he explains: 'one of the inferences people took away from the Great Moderation was not only was the economy more stable, but the financial system seemed more stable as well. As a result, financial stability policies got de-emphasised'.

What about monetary policy in the years immediately preceding the crisis? According to the Taylor rule, monetary policy remained too loose, which led to excessive lending and borrowing, particularly for housing. But Bernanke dismisses this view. It appears that the Fed conducted extensive research into the role played by monetary policy and concluded that 'monetary policy did not play an important role in raising house prices during the upswing'. To support his case further, Bernanke points out that, while there was a housing boom in both the USA and the UK, the boom reached greater heights in the UK, even though monetary policy was tighter there than in the USA. And while the same monetary policy was applied in both Germany and Spain, house prices remained flat in Germany but there was a boom in Spain. The work of Robert Shiller is also invoked, which concluded that the housing bubble began in the USA in 1998, well before the 2001 recession when the Fed cut rates to 1 per cent. Moreover, Bernanke asserts that the increase in house prices in the USA was 'much too large to be explained by the relatively small change in interest rates associated with monetary policy in the early part of the 2000s'. The problem with using interest rates to dampen perceived bubbles and asset prices, he says, 'is that it is like using a sledge hammer to kill a mosquito'. Monetary policy, he suggests, should be used for the purpose of maintaining overall macroeconomic stability.

Why did not the Fed, as the lender of last resort, rescue Lehman Brothers? After all, its demise was associated with the most intense stage of the financial crisis. Bernanke's answer is that Lehman Brothers 'was essentially an insolvent firm'. While he admits that it was probably too big to fail - 'in the sense that its failure had enormous negative impacts on the global financial system' - it did not have enough collateral to borrow from the Fed. Bear Stearns, in contrast, was judged to be solvent, and its purchaser, J P Morgan Chase, was prepared to guarantee its obligations. The Fed felt, therefore, that its loans to Bear Stearns were well secured. Of the rescue of AIG, Bernanke argues that its failure 'would have been basically the end'. This was because it was 'interacting with so many different firms. It was so interconnected with both the USA and European financial systems and global banks. We were quite concerned that if AIG went bankrupt, we would not be able to control the crisis any further'. And furthermore, it had 'lots and lots of perfectly good assets. Therefore, it had collateral that it could offer the Fed to allow us to make a loan to provide the liquidity it needed to stay afloat'.

Asked by students whether he was concerned about the large amounts of liquidity now on the balance sheets of financial institutions and the possibility of inflation breaking out, Bernanke does not believe inflation will happen. Again, he invokes history to buttress his case. In the 1970s, 'everyone expected inflation to go up; nobody had any confidence that the Fed or the government in general would keep inflation low and stable'.

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Now the situation is different, for after 'a long period of low inflation, most people are pretty comfortable that inflation will stay reasonably low despite the fact that there are ups and downs'. In short, 'in a world in which inflation remains low year after year, people feel more and more confident that the central bank -- the Fed or whatever -- will meet its mandate of keeping inflation low'. The Fed had an inflation target of around 2 per cent (now 2.5 per cent), and that, Bernanke asserts, 'is where we plan to stay'. In any case, the Fed has a number of policy tools to deal with any inflationary threat. These tools, Bernanke adds, 'give us a lot of comfort'. This, however, could turn out to be a case of misguided hubris.

William Barnett also believes the Great Moderation was a significant cause of the financial crisis but is less equivocal than Bernanke about the Fed's role in causing the crisis. A distinguished professor of economics at the University of Kansas, and the editor of *Macroeconomic Dynamics*, Barnett worked for many years at the Federal Reserve Board in Washington. Regarded by many as the world's foremost authority on the measurement of financial aggregates, his book explains how faulty monetary statistics led the Fed into conducting inappropriate monetary policy. As a consequence, investors incorrectly assessed risk: leverage rose, and risk-taking activity flourished as a result. Most of 'the puzzles and paradoxes that have evolved in the monetary economics literature since the early 1970s', he contends, 'were produced by the simple-sum monetary aggregates, which are provided officially by many central banks, including the Federal Reserve'.

The nub of the problem is the failure of the Fed to adopt 'state-of-the-art' theory to measure monetary services, preferring instead to rely on simple aggregation techniques which produce flawed results. Different components of the various monetary aggregates are not weighted according to the services they provide. The M2 measure, for example, simply aggregates dollar amounts of assets including currency, demand deposits, savings accounts and some certificates of deposit. Cash is more liquid than CDs and therefore more valuable as a medium of exchange than money in a CD account, yet cash and CDs are weighted equally in the compilation of monetary aggregates. To obviate the problem, Barnett has devised what he calls the Divisia Index -- named after Francois Divisia, a Frenchman, who published important work on consumer-goods indexes in the 1920s. The Divisia index apportions the greatest weight to the most liquid components of the money supply, or those 'most used in transactions'.

Much of the book is taken up with reporting results obtained by using more appropriate sets of weights. Barnett argues that the money supply in recent decades grew at a much faster rate than the Fed's data suggest. For M1, Divisia shows about $400 billion more being added to the money supply from 1980 to 2005 than the Fed's numbers record. For M2, the difference is $2 trillion. Many investors and institutions, he claims, were lulled into thinking that there had been a 'Great Moderation' and greater leverage resulted. In contrast, the Divisia indexes indicate that monetary tightening at the outset of the crisis was excessive, plunging the aggregates to negative levels. Barnett claims the 'monetary tightening, leading into the financial crisis and recession, is the largest and most precipitous that has occurred over the entire 42-year period for which the data were available'. Unable to measure the money supply accurately, the Fed, he claims, has lurched from excessive expansion to excessive monetary contraction, causing unnecessary bubbles and recessions.

Had the correct data been used by the Fed, Barnett believes the crisis would not have occurred. But this is almost certainly an exaggeration. After all, there were many eminent economists -- Robert Shiller, Raghuram Rajan and Nouriel Roubini among them -- who predicted that the housing bubble would end badly. They did not need the Divisia Index to tell them that; the application of the Taylor rule would have been enough to warn of potential dangers. And yet there is probably some truth in Barnett's claim that poor Federal Reserve data 'unnecessarily complicated private decision-making and interfered with the abilities of the private sector to recognise the extent of the systemic risk existing at the time'. For this reason, his idea of a Bureau of Financial Statistics, analogous to the Bureau of Labour Statistics, deserves serious consideration.

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