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Review of "The Federal Reserve and the Financial Crisis"

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Ben S. Bernanke. *The Federal Reserve and the Financial Crisis.* Princeton: Princeton University Press, 2013.

The year 2014 might not seem significant, but for those who follow economics, and more specifically, the Federal Reserve, it is an important year for many reasons. First, the Federal Reserve was created by the Federal Reserve Act, signed by President Woodrow Wilson on December 23, 1913. The details of the Federal Reserve System were hashed out, and the Federal Reserve Banks established in 1914. So, while 2013 marks the centennial of the Federal Reserve Act, for all practical purposes, 2014 marks the centennial of the Federal Reserve System. Second, 2014 marks a leadership transition – Ben S. Bernanke's term as chairman ended on January 31, and Janet Yellen became the first women to serve as chair of the Federal Reserve Board of Governors on February 3. Finally, the "tapering" (or slowing) of the economic stimulus pursued by the Federal Reserve as result of the deep recession and slow and painful economic recovery, has begun and will likely continue throughout the year.

For these reasons, it is a perfect time to read, "The Federal Reserve and the Financial Crisis" by Ben S. Bernanke. It is an excellent book for social studies teachers – providing an intersection of history, civics, and economics in a short, readable, volume by a brilliant economist and one of the most significant public servants of our time. Bernanke has been praised for his ability to communicate complex economic ideas to non-economists, and he justifies that praise with this book by demystifying the Fed for the reader. The book is based on a series of lectures he gave at George Washington University in March of 2012. The book was published in 2013. It is divided into two primary sections, 1) the history and development of the Federal Reserve as an institution, and 2) the Federal Reserve's actions during the financial crisis. Of course Bernanke was not a passive observer, as Chairman of the Federal Reserve he led the institution during a crucial period and established the roadmap for the Fed's management of the financial crisis.

When discussing the creation of the Fed, Bernanke says the mission of the Federal Reserve is to "achieve macroeconomic stability" and to "maintain financial stability." He comes back to these two objectives several times during the book. The first duty (macroeconomic stability) is the one that gets the media attention every six weeks as the FOMC meets to determine its monetary policy. The second (maintain financial stability) too often flies beneath the radar, but it was the reason the Fed was created – "to either prevent or mitigate financial panics or financial crises." At several points Bernanke describes the role of a central bank in maintaining financial stability by making the connection to Walter Bagehot's dictum, which says that central banks should lend freely, to solvent firms, against good collateral, at penalty interest rates (to discourage banks from taking advantage of the policy).

Bernanke is a self-described educator and proves to be an excellent communicator in this book as he explains complicated economic content in simple language. For example, Bernanke explains how bank panics occur and why they are dangerous without dragging his readers through a money and banking lecture. Instead, he leads the reader to understanding through the story of George Bailey, Jimmy Stewart's character from the classic movie "It's a Wonderful Life". Bernanke explains that banks sometimes have liquidity problems because their assets are long-term (tied up as loans), but their liabilities are short-term (consumers can demand their deposits at any time). If confidence crumbles, and depositors run to the bank and demand their money, but bank assets are tied up in long-term loans, banks can find themselves with liquidity problems. This was Jimmy Stewart's problem in the movie. Bernanke asks, "How could the Fed have helped Jimmy Stewart?" Stewart could have called the Fed and asked for a short term loan, using his loans as collateral (assuming the building and loan was solvent). He could use the money to pay depositors, and quell the run on his bank. This is the Federal Reserve, the nation's central bank, acting as the "lender of last resort."

Bernanke devotes the first half of the book to providing historical context for the recent financial crisis and the Federal Reserve's response. Prior to the Fed, Bernanke made his mark as a macroeconomist and economic historian. This is evident in his treatment of the Great Depression. He describes many factors which figured into the severity of the Great Depression, but freely acknowledges that the Fed's failure to act was a primary reason the depression was so deep and lasted for so long. There is little doubt that this knowledge influenced Bernanke's thinking during the dark days of the financial crisis of 2007 -2009. President Roosevelt, who is often painted as the person who saved the country from the Great Depression with his alphabet soup of programs, gets little discussion in Bernanke's treatment of the period. He says the most important of Roosevelt's actions were the creation of the FDIC and moving the country off the gold standard. In fact, Bernanke spends considerable time discussing the gold standard, which has gained much attention in recent years. He says that a gold standard does relatively well at maintaining low and stable inflation over long periods of time, but in shorter segments, fluctuations in the gold supply are likely to lead to volatile periods of inflation and deflation. As such, during the Great Depression, countries that abandoned the gold standard early recovered more quickly than those who remained on the gold standard. He finishes his historical survey by discussing the Fed's experience during WWII, "the great inflation" of the 1970s and early 1980s, Paul Volcker's painful (but much needed) medicine of high interest rates, and the Great Moderation -- a period when many felt that policymakers had figured out how to achieve low inflation and maximum employment for the long run. Bernanke credits his predecessors, Paul Volcker and Alan Greenspan, with establishing the Fed's credibility for maintaining price stability. He ends the section with a description of the origins of the financial crisis.

Next, Bernanke tackles the financial crisis and emphasizes the Fed's responsibility to "maintain financial stability" acting as the lender of last resort. He begins by describing some of the market vulnerabilities that existed prior to the financial crisis: exotic mortgages, poor lending practices, mortgage securitization, complex financial instruments (such as CDOs), and the role of rating agencies. Underlying the entire structure was the assumption by both borrowers and lenders of ever-rising housing prices. Of course, we know the story -- housing prices fell. These factors are well explained by Bernanke in plain language. He describes the financial crisis as a classic financial panic, which happened outside the traditional banking system. Bernanke refers back to the Great

Depression and reminds the reader that the role of the Fed during a financial crisis is to lend freely to halt runs and restore financial system functioning. So, Bernanke describes a Federal Reserve that acted for the purpose it was created -- to serve as lender of last resort. The difference is that the crisis was occurring outside the traditional banking sector, so the Fed under Bernanke's leadership used innovative methods to facilitate lending beyond the traditional banking sector, where liquidity and stability were most needed. And, Bernanke is clear, stating several times, that loans were made to solvent institutions and the loans were fully collateralized. In the end, all of the loans were paid back in full with interest-- the Fed lost no money.

Of course one of the more controversial moves was rescuing some firms (e.g. Bear Stearns and AIG), but allowing Lehman Brothers to fail. This has been much discussed by Monday morning quarterbacks who have been mulling the counterfactual ever since. First, Bernanke explains that Lehman Brothers was not a bank so it was not overseen by the Fed, but neither were Bear Stearns and AIG -- the Fed used section 13(3) of the Federal Reserve Act which allowed lending to non-traditional banking institutions in "unusual and exigent circumstances". More importantly, Lehman was not solvent. As the nation's central bank, the Fed gives collateralized loans to financial institutions that are solvent, but may lack liquidity. The Fed's loan to AIG was a collateralized loan to a solvent company, whereas Lehman was insolvent. Lehman was allowed to fail. Its failure shocked the financial system, particularly the money market, and quickly spread to the commercial paper market. The Fed acted to backstop these markets to minimize damage. At its root, says Bernanke, was the "too big to fail" problem -- these firms were so large that their failure posed a systemic economic risk, so government was obliged to rescue them. Bernanke says they should be allowed to fail, but in a way that it does not bring down the entire financial system (he addresses regulatory changes at the end of the book).

As a result of the financial crisis, the economy fell into deep recession. The Fed addressed the aftermath of the crisis through the use of monetary policy. He makes clear distinctions between fiscal and monetary policy, something that social studies students often struggle with. In fact, research has shown that monetary policy is among the most difficult concepts for students to learn and for teachers to teach (Walstad and Rebeck, 2001). Bernanke's treatment of monetary policy is clear, precise, and easy to understand. Of course, Fed policies to support the economy during the severe recession have been the topic of much criticism, but it is clear that Bernanke believes the Fed acted appropriately. Some common criticisms are that the Fed has been too aggressive in increasing the money supply, has used strange new monetary tools, and that inflation will be the inevitable result. Bernanke explains that after short-term rates had been reduced to essentially zero, the Fed used Large-Scale Asset Purchases (LSAP), which the press has labeled quantitative easing (QE), to lower longer term rates. Bernanke writes that QE employs the same mechanism as normal open market operations, but has the Fed accomplish the task by purchasing different assets. Bernanke says this is normal monetary policy, focused on longer-term rates rather than the short-term rates. So is the Fed "printing money" as is commonly heard in the press? The Fed has the unique ability to credit the accounts of the institutions from which it buys financial assets (U.S. Treasury Securities) -- essentially creating money out of thin air. When the Fed sells Treasuries, the money disappears, back into thin air. But, the Fed is not printing money in the sense that currency is being produced – Bernanke points out that the amount of currency in circulation has remained relatively flat. Instead, these asset purchases create deposits that exist as bank reserves. Banks can utilize reserves to make loans to businesses and individuals. As reserves increase, interest rates decrease, which makes purchasing cars, homes, and capital equipment more attractive to households and businesses. What about inflation fears? At the time the book was written, the Fed had increased the size of its balance sheet by $2 Trillion, and many were convinced that this would result in inflation. Bernanke points out that in recent years, inflation has not been the danger. Rather, there have been real fears of deflation. While the recession ended in June of 2009, the recovery has been slow and uneven; to many people it seems that the economy is still in recession. Bernanke ends the book by acknowledging the difficult economic period we have endured, and by expressing his confidence that the U.S. economy will recover its strength.

As economists and historians think about the history of the Fed, they often see Paul Volcker's time as Chairman as a key period – his emphasis on the importance of Fed credibility and price stability (a low and stable rate of inflation) influenced the economics profession and the way the Fed has done business since that time. It might very well be the case that the Bernanke years become another defining time – his innovative approach to providing liquidity and stability to financial institutions, and efforts to increase transparency and communication has enhanced modern economic theory and added a new dimension to an evolving institution. History will bear the burden of deciphering whether he was a visionary, or whether he missed the mark.

In short, this is a readable, approachable book that is a "must read" for the social studies community. It tells the economic history of the past 100 years, but also helps the reader understand the financial crisis and the resulting recession. And, it lets the reader see into the mind of one of our nation's brightest economists, and someone who (I believe) will be remembered as one of the most significant policymakers of our time.

Social studies teachers will be pleased to know that the lecture materials (from which this book is based) are available on the Federal Reserve Board of Governors website. http://www.federalreserve.gov/newsevents/lectures/about.htm

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Reference

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