

Book Review

The Federal Reserve and the Economic Crisis, by Ben S. Bernanke, Princeton University Press, 2013, 134pp.

This book is a compilation of a four-lecture series presented by Ben S. Bernanke, former chairman of the US Federal Reserve (Fed), at George Washington University in March 2012. The book discusses the inception of the US Federal Reserve right up to Bernanke's handling of the financial crisis in 2008. The strength of the book is the author himself. Bernanke is the best person to explain in detail the Fed's role during the global financial crisis in 2008. He tries to address the critics on the Fed's role to in dealing with the worst financial crisis since the Great Depression. Indeed, he did his best to justify the Fed's role during the crisis though he did not address some of the critical arguments surrounding the management of the crisis.

The first chapter traces the origin and mission of the US Federal Reserve that was established in 1914 primarily to serve as a lender of last resort and to manage gold standard. The Great Depression presented the first ever challenge for the Fed where the economic downturn lasted for more than a decade from 1929 until 1941. He criticised the Fed for failing to ease the monetary conditions and instead resorting to a rate hike to prevent massive outflows and safeguard the gold standard. He points at the "liquidationist theory" for causing price deflation which has the effect of squeezing out excess supply and allowing the price to be corrected downward. Massive deflationary pressure led to high unemployment rate and deterioration of loan quality that triggered bank runs. He added that Fed had also failed in its responsibilities to act as a lender of last resort leading to the collapse of banks. Almost ten thousand banks failed in the 1930s and the US economy only returned to a stable path in 1934 with the introduction of deposit insurance and by abandoning the gold standard. This gave flexibility to the Fed to manage its money supply more effectively. The lesson learned from the Great Depression served as the basis for his argument on the way the Fed dealt with the 2008 financial crisis.

Chapter two continues with the discussion on the Fed's role during the post World War II. In 1951, the Fed signed an agreement with Treasury (Fed-Treasury Accord of 1951) to allow it to operate independently in relation to monetary policy. Monetary policy was less complex in the 50s and 60s as the US economy was growing steadily and the Fed only needed to follow what is called "lean against the wind". The condition unfortunately changed over

the following decades. Policy makers were too optimistic with the ‘Phillips-curve’ notion to sustain low unemployment rate by compromising inflationary pressures. Loose fiscal and monetary policy coupled with the war in the Middle East, resulted in an oil shock crisis in 1970s. Paul Volcker was appointed as the Chairman in 1979 to rein in inflation. He tightened monetary policy sharply and brought down inflation from 13% in 1980 to about 3% three years later. High interest rate, yet, come with a cost to the real economy. Unemployment rate escalated during the period and the economy plunged into a recession. The great stagflation of the 1970s was followed by the great moderation era under the chairmanship of Greenspan. Inflationary pressure declined during the period and the economy as well as financial markets became more stable. As a result, interest rates declined and financial stability policies were de-emphasised. Easy credit resulted in a housing boom but the bubble burst in 2008. He argued that the worldwide recession in 2008 was much deeper and prolonged not because of a decline in housing prices but due to vulnerabilities from private and public sector which he noted as the triggering factor. Four vulnerabilities in the private sector were highlighted: First, there were too many borrowers and lenders had too much of debt and too much leverage. Second, financial transactions become too complex while the bank’s risk management measures were inadequate and inaccurate. Third, banks relied too much on short-term liabilities to fund its loan. Finally, there were substantial risks involved in exotic financial instruments and complex derivatives. The public sector also had its own problem. The regulatory gaps permitted the financial sectors to engage in various risk-taking especially in an unsupervised territory.

Interestingly, he viewed that monetary policy had little to do with the property boom and bust¹ despite agreeing that the view was controversial. This is an awkward statement from a central bank chairman as monetary policy usually influences the demand and supply dynamic of the domestic property market. Rather than explaining the ineffectiveness of the Fed’s monetary policy to curb the bubble, he blamed the emerging-market economies for accumulating large amount of dollar assets. A study by Rajan (2005) highlights the limited efficacy of the Fed’s monetary policies. Rajan notes that banks in the US increasingly accounts for a smaller share of credit expansion while the majority are fuelled by institutional organisations such as hedge funds and pension funds. In a persistently low interest rate environment, for example, these institutions that are compensated on the basis of nominal return will stretch for yield by taking on additional risks. Thus, monetary policy changes are pro-cyclical and not otherwise resulting in it being an ineffective instrument.

Bernanke discusses the Fed’s response to the financial crisis in the third chapter. He concentrates primarily on the Fed’s role as a “lender of last resort”. In this chapter, the chronological events that culminated in the financial crisis of 2008 are presented. The crisis was a classic case of financial panic but the

impact was beyond the banking institutions and affected the broader financial market setting. For various reasons, as explained in his book, large financial institutions have engaged in high-risk investment activities. When asset prices began to fall, many of these institutions were in a serious risk with some filing for bankruptcy. The Fed and Federal government intervened by providing liquidity and guarantees to these institutions. The Fed during the period fully subscribed to the “Bagehot Principle” to calm the panic that prevailed in the market amidst criticism that the Fed “bailed out” financial institutions using taxpayers’ money. The chairman justifies the rationale behind his action. He notes that while there was increasing pressure to calm the market, the Fed nevertheless had been responsible and selective in providing liquidity support to the financial institution although some of them were not directly supervised by the Fed. He emphasised that these loans were collateralised and some of them have been recovered with additional profits and interest earning; others were deemed safe by the Fed. The Fed’s action has helped to restore financial stability not only in the US but also globally. Nonetheless, the “moral” issue was not resolved. Bernanke agrees to the notion of “too big to fail” and wants the current rule to be changed to facilitate large financial institutions to exit without causing serious collateral consequences that could jeopardise the stability of the financial sector. It appears that his concerns are in direct contrast to his actions. While he believes large financial institutions pose greater risks, he on the other hand, has engineered in his capacity as the Fed Chairman many mergers and takeovers to result in large firms becoming even larger.

The final chapter of the book explains the Fed’s role in the aftermath of the financial crisis. In addition to the short-term liquidity programme, the Fed also supported the market through various programmes. The most criticised is the large-scale asset purchase programme often known as quantitative easing or QE. It is an unconventional monetary tool and the Fed has embarked on at least three versions of QE and expanded its asset size by more than three folds since 2008. The core function of QE is to influence the long-term interest rate. The mortgage rate has declined since then to a historical low. But the question is on the risk and returns of such a programme. Bernanke has underplayed the risks of the unconventional monetary policy. In his opinion, the investments are safe and his action has benefited the US economy by reducing the fiscal deficit through the profit earned from transactions. In contrast, Kozicki et.al (2011) has stressed that central banks should account for negative externalities caused by unconventional monetary tools which they often neglect. These risks include financial market distortion, accountability and governance mechanism for managing a change related to asset under management of the central bank, exit problems and potential loss of the central bank’s independence and credibility.

On the regulatory changes, he welcomes the Dodd-Frank Act which allows the Fed to supervise systemically important institutions, especially large

institutions that have lack oversight. The act includes more stringent scrutiny and policy to tackle “too big to fail” institutions with better supervision, more capital requirement and fail-proof stress test.

Certainly, the Fed’s policy in 2008 to stabilise the financial market was crucial and successful as the aftermath the crisis showed that the policy helped to ease monetary conditions despite the “liquidity trap” as the benchmark interest rate was near zero. The mortgage rate was at historical low but nonetheless, the housing market recovery remained weak. Economic recovery was sluggish and labour participation rate has stayed stubbornly low. In defending the Fed, Bernanke argued that monetary policy is a powerful tool, but it cannot solve the structural weakness that prevails in the labour market and fiscal problems that affect the economy. If monetary policy is not effective in influencing the labour market, the question arises as to why the Fed has been persistently trying to reduce unemployment and inflation rate which influences the direction of its monetary policy. Instead, in my opinion the Fed should target other indicators especially the total money supply as posited by Friedman (1982). Based on Fischer’s “quantity theory of money”, money supply and velocity are crucial in determining nominal Gross Domestic Product (GDP). Hence, targeting money supply will improve nominal growth and subsequently boost labour demand. Strangely, the importance of money supply is hardly discussed in the book.

The book is still an excellent contribution from Bernanke as he is the best person to explain the Fed’s policy during and after the financial crisis. His policy was successful in calming the financial market and had the effect of immediately restoring financial stability. However, it seems that the Fed has underestimated the cost and risks of negative externalities from pursuing such a policy. I strongly recommend the book for those who are interested in monetary economics and the history of economic crisis.

Note

1. “Many countries around the world had booms and busts in housing prices which were not closely related to the monetary policies of those particular countries.” pg.52.

References

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