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Book Review

The Federal Reserve and the Financial Crisis

Ben S. Bernanke
Princeton and Oxford: Princeton University Press, 2013, 134 pp.

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Ben Bernanke, then chairman of the Federal Reserve System, gave a series of lectures to students at George Washington University in 2012. At the time, the American economy was amidst its weakest recovery of the post-war period and the Fed was widely heralded as having averted a second Great Depression. Bernanke's lectures focused on 1) the origin and role of the Fed, 2) its performance in the post-War era (conveniently excluding the Great Depression), 3) its policies and performance in the lead up and as a response to the credit crunch of 2008, and finally 4) a review of its post-crisis performance.

There is trouble lurking in each of the book's four chapters. The text gets off on a wrong foot as Bernanke overviews the origins and

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purposes of the Fed. By Bernanke's reckoning, any central bank is created to achieve stability in the economy (i.e., through low and stable inflation and by avoiding economic swings), and in the financial system, by preventing financial panics and freezes.

Where do such instabilities come from? Bernanke nonchalantly attributes instability to the fact that "no bank holds cash equal to its deposits" (p. 7). He does not refer to the possibility that fractional reserves could breed broader instabilities, and in a bid to underscore his point Bernanke notes that under the National Banking System (1873–1914), banks did indeed regularly close their doors during crises and panics. Recent research suggests that even though banking was not especially stabilizing during this period, hamstrung as it was by many onerous regulations, the Federal Reserve has fared far worse in terms of both monetary and macroeconomic instability (Selgin, White, and Lastrapes, 2012).

Not referencing the imperfections of the period prior to the Fed is not too surprising given the sad state of historical knowledge amongst economists. More serious is Bernanke's treatment of the Great Depression, partly because his research of the period is what he was best known for prior to becoming Fed chairman, and partly because it is so misguided. In the lead up to the crash of 1929, Bernanke lists nearly every fault possible in the global economy except a loose monetary policy: an overhang from the World War I, nondescript "problems" with the gold standard, a financial bubble and contagion all figure prominently as causes of the downturn (pp. 19–20). Recovery did not start until Roosevelt abandoned the gold standard in 1933, and deposit insurance was established in 1934. Similar to most mainstream discussions of the Great Depression, there is little attention paid on the pre-1929 period, nor is the thesis entertained that the financial boom of the late 1920s was indicative of a lax monetary policy, and a sign that deeper imbalances were being bred in the real economy. The analysis is quite limited in comparison to, e.g., Rothbard (1963).

Reading the chapters dealing with the Fed's more recent performance is the most frustrating part of the book. Bernanke fills nearly 100 pages with reasons for the credit crunch of 2008; only once does he concede that the Fed contributed to the instability leading up to the crisis, or the severity of the crash.

"Psychology" played a big role in the increase in housing prices (p. 42). Reduced lending standards and the proliferation of nonprime loans allowed first-time buyers to enter the market who would have been better off sitting on the sidelines (pp. 43–44). (He later [p. 113] mentions that credit scores on newly originated mortgages were not lower during the housing boom, but does not explain how this squares with the claim that lenders blindly pursued nonprime borrowers.) Credit rating agencies were either wrong in their risk assessments or manipulated to understate default risks (pp. 69–70). Insurers developed and sold complex derivatives that bred instabilities (p. 70). There was a lack of regulation and oversight (pp. 50–51). Only with this last point does Bernanke concede that the Fed did not perform this role as well as it could have and may have contributed to the crisis as a result. But its failure in this regard was, according to him, endemic under the former Fed Chair, Alan Greenspan, and not a failing during his tenure at the Fed, going so far as to state that "when I became chairman, we did undertake some of these protections but it was too late to avoid the crisis" (p. 50). One gets the impression that Bernanke thinks that if only he assumed the role a little sooner, a lot of pain could have been avoided.

Bernanke spills much ink explaining research (from inside the Fed or predominately written in association with the Federal Reserve) that absolves the Fed of responsibility in causing housing prices to become unhinged from fundamentals (pp. 52–54). This is not surprising coming from the Fed's chairman. What is surprising is that he spends almost as much time noting that the Fed's role in the housing crisis is hotly disputed and that "this question [about the relationship between monetary policy and housing prices] continues to be debated" (p. 54, fn. 4). On the one hand, Bernanke goes out of his way so many times to comment on the controversial nature of monetary policy having no effect on housing prices that one doubts his sincerity in making the claim. On the other hand, after the crisis the Fed pursued monetary policies explicitly aimed at supporting asset prices, so there can be little doubt that inside the Fed there is a belief that the institution does affect certain assets, including housing.

As in many books, what is not written is as telling as that which is. "Moral hazard" is not mentioned once. Bernanke does mention "too big to fail," but not in depth or in the context of the Fed promoting the problem (p. 86). Only when pressed by a student during question period does Bernanke follow up on the idea, but only to offer that the Fed's understanding of the problem is "evolving" and more time is needed to sort out how large a role it played in the crisis (p. 94–95). He does not mention the prospect of unwinding the Fed's positions until pressed by another student (p. 123), and just reiterates the standard line about reversing the positions through the standard means without giving any attention to the difficulties that will arise if its assets lose value or if the banking sector does not demand them back. It seems to this reviewer that exiting the most expansive monetary policy of the Fed's history is as important to its success as enacting it. I would have liked to see Bernanke voluntarily bring up the point and expand on it further.

Despite its shortcomings, there is one benefit to this book. Because of its student audience, Bernanke explains clearly what his thoughts are about the role of the Fed leading up to and during the crisis. However misplaced and incomplete his thoughts may be, the clarity of delivery gives merit to an otherwise lackluster book.

REFERENCES

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