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The Fed and the Financial Crisis*

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Ben S. Bernanke
The Federal Reserve and the Financial Crisis – Lectures by Ben Bernanke
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Ben Bernanke was the chairman of the Federal Reserve System (Fed) between 2006 and 2014. The book is a transcription of his series of lectures given in March 2012 at George Washington University, consisting of four parts. In these lectures, Bernanke presents the main functions of the central bank in an understandable form, taking the approach of economic history. He then summarises the activities of the Fed going back to its establishment and gives a detailed explanation of the causes of the latest financial crisis, presenting the essence of the crisis management actions of the Fed, and finally he draws some conclusions.

In his first lecture, he presents the role of central banks in the economy and outlines the activity of the US central bank, from its establishment until the end of World War II. Readers well-versed in economics will be familiar with the main functions of the central bank and the related tools. In the framework of monetary policy, the central bank tries to motivate or restrict the economy primarily by influencing interest rates, while in order to maintain financial stability, if necessary, it provides – as the lender of last resort – liquidity to financial institutions that need it, thereby preventing the emergence of a market panic and bank crises. This last function would have been needed quite often from the second half of the 19th century in the United States, since classic bank panics developed many times, sometimes even in the wake of unwarranted rumours. There were many runs by depositors on banks owing to loss of confidence, and these caused the failure of a large number of banks, until the Fed was created in 1914.

The first 15 years of operation by the Fed was a favourable period economically, which ended with the stock market crash of 1929 and the crisis that it triggered. It resulted in a severe economic depression, deflation, high unemployment, and the loss of market confidence once again led to several bank runs. In the opinion of

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Bernanke, from a historical perspective we can now conclude that the policy of the Fed pursued during that period – which intentionally let several thousand banks fail, among others – was not appropriate. Finally, the crisis was overcome by a more loose monetary policy and implementation of the deposit insurance system in 1934.

The second lecture briefly reviews the years after World War II and then presents in detail the causes leading to the most recent crisis. The central bank was granted independence in 1951, which enabled monetary policy to become more effective, but since it eventually grew too loose, by the end of the 1970s inflation had got out of control. This was overcome during the mandate of Paul Volcker, and then for a period of almost 20 years that started in 1987, when Alan Greenspan was the chairman, the economy of the United States was characterised by relatively stable inflation and growth. However, from the end of the 1990s housing prices had gone through a period of very strong increases, and the classic process of a bubble development could be observed. People expected this increase to continue forever, and so more and more people borrowed loans for housing, which was facilitated by the increasing relaxation of the lending conditions. More and more risky customers received loans with constantly dropping down payments, practically without any check of creditworthiness. Eventually, however, housing prices became so high that demand dropped very sharply, and thus the process of price collapse started.

In the meantime, very complex financial products were created related to mortgage loans, and insurance against non-payment by debtors (credit default swaps – CDSs) became common. Even institutions specialised in these products were unable to assess the actual risks involved. Bernanke also states that there were serious deficiencies on the side of the regulator as well: for example, Lehman Brothers was practically not subject to any meaningful regulation. He himself also acknowledges that the Fed did not pay enough attention to surveying and controlling systemic risks. On the other hand, he stands by his position that monetary policy played no special role in housing prices getting out of control.

In his third lecture, he presents the process of how the even more risky securities created by bundling hundreds or thousands of high risk loans with even other types of debt elements led to a crisis of confidence in the financial markets. Investors could purchase these securities sliced up into tranches carrying various levels of risk with relative confidence, since the rating agencies gave the best ratings to these, and they could even receive a guarantee from specialised insurance companies in the case of default on the underlying mortgage loans. It was not even really the defaults that caused the real problem, but rather the fact that no one knew which investors held the most risky parts and who would have to bear the largest losses. This was what led to the crisis of confidence and the total freezing of the market. The investment banks holding the securities had to sell their assets, and the wave of selling pushed the prices of the securities to rock bottom.

The Fed started to provide a significant volume of liquidity, granting over 21,000 loans, not only to banks but also to other financial institutions. Bernanke highlights two cases. On the one hand, giving loans to money market funds, by which they contributed to stopping the withdrawal of capital from these funds, and on the other hand, the bailout of one of the largest insurance companies in the world, which was necessary because the losses incurred on the underlying mortgage loans jumped up to such heights that the obligation to repay these pushed this huge institution to the edge of bankruptcy. This posed a global risk in the opinion of the Fed, so they provided liquid funds amounting to as much as USD 85 billion to the company. In the opinion of Bernanke this step was unavoidable, but at the same time, he expressed his grave concerns subsequently as well.

Finally, in his fourth lecture he focuses on the lessons learned from the crisis, the directions of development in the operation as a central bank and as a supervisory agency. He emphasises that basically, there were not really many new elements not known previously in the management of the crisis. The central bank simply fulfilled its function as the lender of last resort, and the state recapitalised certain financial institutions and provided a guarantee for their bonds. But there were also novelties: communication of the positive results of the stress tests of the banks contributed greatly to the recovery of confidence in the market. Launched in March 2009, the unconventional monetary policy tool of quantitative easing successfully contributed to the reduction of longer-term yields, and the transparent communication of actions planned for the future and forward guidance also served to comfort the markets.

After learning the lessons of the crisis, the financial supervisory agency received stronger powers, an organisation with an overview of the entire system was established, capital requirements were tightened, from time to time stress tests are performed in order to explore their risks, and by now exotic financial instruments have also become more transparent. However, the most important element is probably the attempt to resolve the "too big to fail" problem: work started on creating the conditions of a regulated failure. It is the final conclusion of Bernanke that in the future the central banks must not give priority to monetary stability over financial stability. Monetary policy is a tool that is useful, but not omnipotent.