Mitchell's Musings 1-20-14: Big Ben

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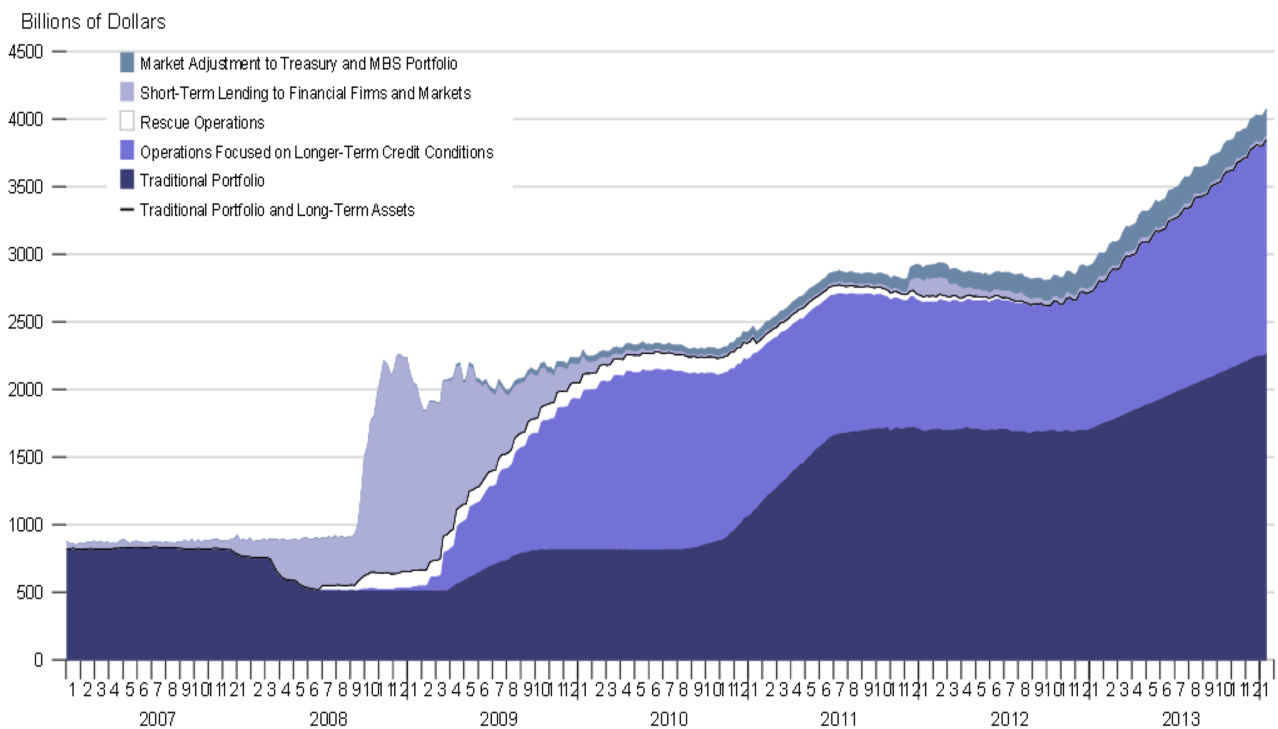
Now that Ben Bernanke is stepping down as chair of the Fed – and Janet Yellen is taking over as his replacement – it is appropriate to take note of his contributions in that role. The fact is that absent leadership at the Fed, the mortgage/financial crisis could have turned into something very much worse than it did. A different Fed chair might not have taken action. There were failures of policy, but these were primarily within the political system which, in its current polarized state, does not do well with emergencies. Because the Fed is partly insulated from the political system, it was able to do what needed to be done.



It is apparent from the chart above, that unusual steps were taken by the Fed. There were(very) large asset purchases that kept enough liquidity in the financial system to prevent a collapse. And there was a willingness to experiment so long as the overall economy remained weak.

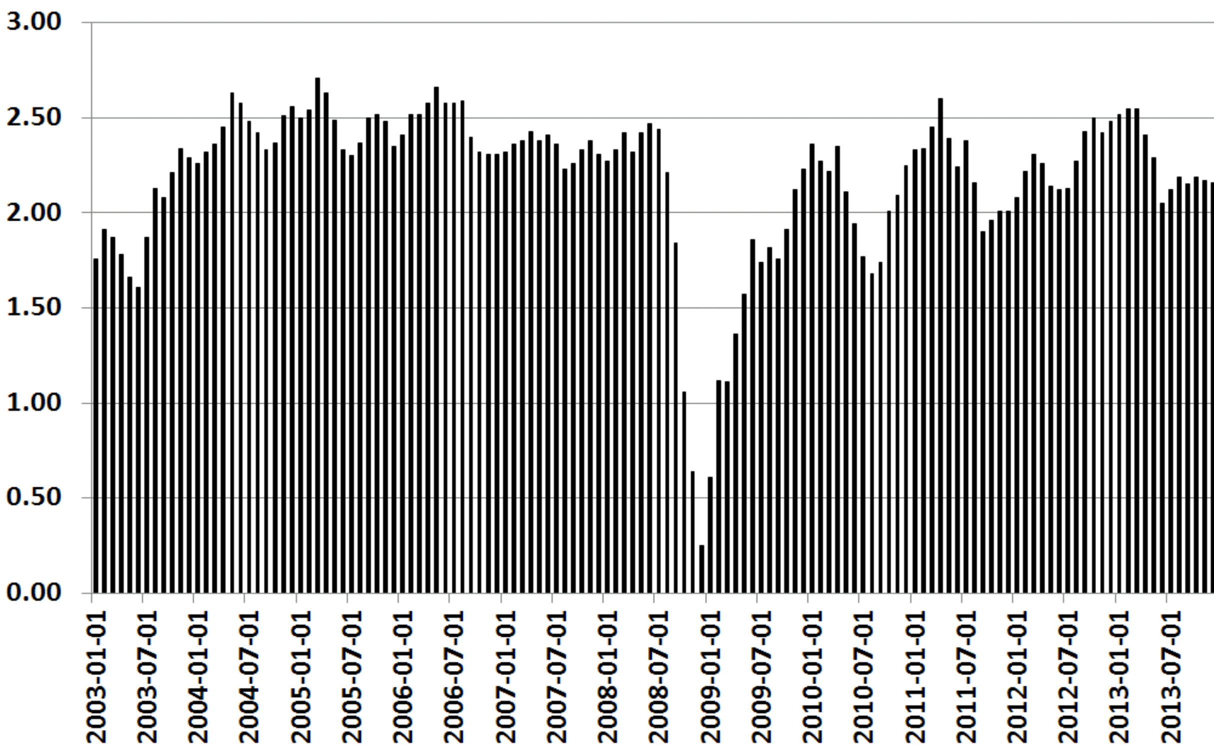
So what about the standard complaints. One complaint is that the Fed bailed out financial institutions that were culpable in the crisis and did not directly help, say, homeowners with under-water mortgages (mortgages which exceeded the value of the home after home prices dropped). The fact is that there was no way (legally) that the Fed could have extended aid directly to homeowners. Such a step could

have been taken by Congress and, to a limited extent, there was such aid. But arguably the homeowner programs were not sufficint. That was a political failure.

Similarly, there really was no direct way the Fed could punish institutions. In the end, institutions don't take actions; those that manage them do. It is legitimate to complain that there should have been prosecutions of such managers. But that complaint ultimately needs to go to the Department of Justice where prosecutions originate.

In the end, letting large financial institutions fail would have invited a cascade of such failures with the kinds of consequences that emerged in the Great Depression. However bad the Great Recession was, the Great Depression was orders of magnitude worse. Bernanke, as a student of the Great Depression, avoided repeating the errors of the 1930s.

A second complaint is that the Fed, by buying up assets and increasing the money supply (by whatever definition you think captures "money"), will let loose a wave of inflation. But so far there has been no Great Inflation. The odd thing is that those who seem most worried about inflation due to Fed actions are the same people who "believe" in markets. And we know that financial markets are not expecting a Great Inflation. The yield spread between conventional Treasury securities and inflation-adjusted Treasuries (TIPs) is a proxy for financial market expectations. And, as the chart below shows, market forecasts of inflation are about where they were before the Great Recession developed, maybe a little lower.



The current expectation, and explicit policy of the Fed, is that now that unemployment rates have fallen, it will begin to taper off its unusual asset purchases. Those who fear inflation believe that the Fed will eventually have to undo all its extraordinary purchases. But that isn't clear. Maybe financial markets are projecting the Fed will completely unwind what it did. Or maybe they just think that under Janet Yellen, the Fed will continue its pragmatic policy of trying to adjust to economic conditions. You may have learned that inflation is caused by "too much money chasing too few goods." Nowadays, however, exactly what is meant by "money" is unclear.

In any event, what it appears Bernanke did – beyond the specific policies adopted – was to embed the idea that the Fed wasn't just another bank. Yes, the Fed is a "central bank." But central banks, since they create reserve money to buy assets, are not just anointed commercial banks (although in some countries, they started out that way). So the concerns about the "quality" of Fed asset purchases and whether the Fed could go "bankrupt" if it bought poor quality assets were simply based on a lack of understanding. Similarly, demands in Congress to "audit" the Fed – to look for what, exactly? – in the same way you might audit a commercial bank, are also misplaced. I suspect that a better understanding – at least by some in Congress – was ultimately behind the relatively smooth confirmation of Yellen, who was billed as a protégé of Bernanke.

Future historians will ultimately decide whether Bernanke was the hero of the Great Recession. But it's unclear who else would be in the running for that title if it isn't him.