BOOK REVIEWS

In Fed We Trust: Ben Bernanke's War on the Great Panic
David Wessel
New York: Crown/Random House, 2009, 323 pp.

David Wessel is a fine journalist; *In Fed We Trust* is a fine book. It belongs on the shelf of every student of the 2007–09 financial crisis. It is, as well, a good read for recreational observers of the economic scene. Wessel focuses on Fed Chairman Ben S. Bernanke, but he discusses the role of all the other key players as well. The biographical information on Bernanke is interesting, as are Wessel's comments on the policy approaches and personalities of the other policymakers.

Future research will deepen our understanding of the crisis, its course, and the responses of the Federal Reserve and Treasury Department. A researcher in the future will want to have the book close at hand as a reference source. Wessel's first and last chapters are reflective and insightfully so. Those with a professional interest in the financial crisis will also want to read *The Road Ahead for the Fed*, edited by John D. Ciorciari and John B. Taylor (2009). This book of 12 essays was put together in the first quarter of 2009 and published July 17, 2009. The essays reflect thinking about the Fed's handling of the crisis while markets were still in considerable turmoil. The two books were written about the same time—*In Fed We Trust* went on sale August 4, 2009.

My principal reflection on the book, besides my admiration, is that Wessel does not adequately question whether the Fed's bold, new, and very large credit programs were in fact effective. Targeted lend-

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ing programs, such as Fed purchases of commercial paper issued by nonbanks, was a complete departure from past practice, except for some small programs in the 1930s. I would not have expected Wessel to present research to address the issue, but he should have raised the question: How different would the course of the crisis have been if the Fed had increased the monetary base the old-fashioned way—that is, entirely by lending through the discount window and purchasing government securities?

Wessel seems dismissive of the criticisms of Bernanke's approach within the Fed. Rather than outlining the nature of the disputes, Wessel refers to "the resentment of flyover-state Fed bank presidents toward the power of Washington and New York" (p. 244). Later he writes, "Targeted lending meant deciding in which markets the Fed would be intervening, a practice that ran up against the hard-line ideologies of some regional presidents" (p. 254). But these criticisms cannot be so easily dismissed. Despite Fed denials, targeted lending *is* a form of credit allocation, and the issues are not primarily ideological.

One issue is whether Fed allocation of credit was more effective in dealing with the crisis than market allocation. A second issue is whether Congress will accept the Fed's choices and its decisions with regard to such matters as disclosure of the identity of firms receiving assistance. As of this writing, in December 2009, these issues are very alive in Congress and may lead to important legislation changing the structure of the Federal Reserve System. These same concerns are apparent in the essays in the Ciorciari-Taylor volume.

If the Fed had purchased Treasury securities instead of providing targeted credit, what would those receiving the cash have done with it? They could not in the aggregate have parked the cash in Treasuries, because the volume of outstanding Treasuries was fixed. Indeed, if the Fed had been buying Treasuries to the same degree it expanded its balance sheet through targeted lending (in excess of $1 trillion between mid-September and mid-December 2008), availability of Treasuries in the market would have been that much lower. Some of the holders of cash following sales of Treasuries to the Fed might have purchased mortgage-backed securities, for example, instead of Treasury bonds. After all, once Fannie Mae and Freddie Mac were taken over by the government in early September 2008, the credit risk on Treasuries and agency MBSs was the same. This is the type of question that Wessel does not explore, or even raise.

The same issue arises with respect to the banking system as a whole. Wessel says (p. 232) that Bernanke and Treasury Secretary Paulson feared that the entire American banking system was at risk of a run. But where would those conducting a run park their cash? Some might have gone into currency, but that would be impractical for those withdrawing millions of dollars. Efforts to park funds in gold would push up the gold price but not expand the total number of ounces of gold available. And those selling gold would have to park their cash somewhere. Would the funds have gone to European banks? Most of them were also shaky.

The logic is that those looking for a place to park cash would have chosen highly rated commercial paper and other such assets, because they had no other place to go. On this argument, the Fed could have supported the commercial paper market and other relatively safe asset markets by buying Treasuries—it did not have to buy commercial paper directly. Note also that the Fed did not support lower-rated commercial paper; it only purchased A1/P1 rated paper. Thus, the Fed's credit programs had no direct effect relieving the financial stress felt by weaker firms.

The Fed's balance sheet and measures of the money stock were roughly constant between March and September 2008—between the bailout of Bear Stearns and the failure of Lehman Brothers. As measured by monetary aggregates, monetary policy was tight rather than easy during this period, despite the invention and expansion of new Federal Reserve credit programs.

The new material in the book—information beyond that reported in the daily press—comes from the extensive interviews Wessel conducted. These are not listed, but most appear to be with policymakers and their senior staff. (For example, Wessel interviewed me in July 2008 after I had retired in March of that year as president of the Federal Reserve Bank of St. Louis.) It appears that there were relatively few interviews with senior executives and directors of the major private firms involved, such as Lehman Brothers and AIG. Wessel tells the story of the financial crisis primarily from the policymakers' perspective.

A theme throughout the book is "whatever it takes." That is also the title of the introductory chapter. Starting with the Term Auction Facility (TAF) in December 2007, in which the Fed auctioned funds to commercial banks, the Fed began to construct ad hoc lending facilities to provide assistance to one sector or market after another.

The special facilities, which need to be distinguished from the emergency bailouts, deserve and will in time receive careful study as to their effectiveness. Wessel notes that some, including me, were skeptical about the effectiveness of the TAF, but he also says that the "TAF was widely seen as a success."

Liquidity or Solvency?

From the beginning of the crisis in August 2007, most Fed policymakers viewed the matter as a liquidity problem. I have come to believe that their diagnosis was wrong or at least very incomplete. Liquidity became a problem for firms and entities of doubtful solvency. The threat of insolvency was the fundamental reason the market cut off financing to the Bear Stearns hedge funds that failed in July 2007 and the Citigroup SIVs (structured investment vehicles) the following month. Wessel notes the difficulty of distinguishing a liquidity from a solvency issue but does not make enough of it.

The bailouts began with Bear Sterns in March 2008, in the form of an assisted merger with JP Morgan Chase. Perhaps we will eventually know whether Bear was solvent at the time of the bailout, but the Fed has already written down the value of the Bear assets it took onto its own balance sheet. Lehman Brothers was permitted to fail in September 2008; the day after Lehman filed for bankruptcy the Fed bailed out AIG.

Wessel is appropriately critical of the Fed for not understanding the implications for systemic financial stability of the house price bubble and the mortgage finance abuses. But how much good would it have done if the Fed had expressed its concerns vigorously? Alan Greenspan's famous "irrational exuberance" speech had only a momentary effect on the bubble in dot-com stocks in the late 1990s. Greenspan's campaign to reform Fannie Mae and Freddie Mac came to nothing. National policy pushed by Congress and the Bush administration was to increase the percentage of households owning houses.

That said, the fundamental problem was that the private sector generated poorly underwritten mortgages. Portfolio managers then stuffed collateralized debt obligations backed by these mortgages into weak portfolios financed with little equity and lots of short-term debt. Wessel does not pursue this argument to its logical conclusion: perhaps as early as the beginning of 2006—the very beginning of

Bernanke's term as Fed chairman—the die had been cast. As mortgagors defaulted and mortgage credit dried up in subsequent quarters, a substantial decline in house prices was inevitable, a decline that would put many commercial and investment bank portfolios under water. As house prices fell, losses would not be confined to subprime mortgage paper but would extend to prime mortgages and the mortgage-backed securities issued against them.

In all its special facilities, other than those involving bailouts, the Fed took collateral but did not accept credit risk. Indeed, the Fed continuously emphasized that it did not take credit risk because the Federal Reserve Act permits the Fed to make loans only against good collateral. If the Fed takes the best collateral, other creditors must have a weaker position in the event of bankruptcy. Recognizing the weaker position, other creditors might reduce their exposure. Thus, the logic of this argument is that targeted Fed lending does less to ease credit stringency than might appear. What really matters is not the targeted lending per se but the implied Fed guarantee—the extension of implicit too-big-to-fail protection to firms qualifying for the Fed's credit programs.

The Fed obviously had to stretch the definition of "good collateral" to conduct the Bear Stearns and AIG bailouts. Until the crisis reached its acute stage, with the Lehman failure, the Fed apparently did not appreciate the depth of the solvency issue. Only after Lehman did the Fed join with Treasury in advocating legislation, the Troubled Asset Relief Program (TARP).

Another of Wessel's themes concerns the "theater" of dealing with the crisis, an issue Wessel says was constantly emphasized by Timothy Geithner, president of the New York Fed and later Secretary of Treasury in the Obama administration. Wessel does not suggest, however, the Geithner had a clear idea of a consistent policy strategy. The absence of a clear strategy was painfully evident as Treasury Secretary Henry Paulson launched the TARP just a few days after the Lehman bankruptcy. The original idea to buy toxic assets was unworkable, which should have been clear to Treasury at the outset.

The House of Representatives rejected the poorly crafted and poorly explained TARP bill the first time around, which surely increased market concerns that the Fed and Treasury did not have a coherent plan to deal with the crisis. John Taylor (2009) argues persuasively that it was the lack of a coherent plan rather than the

Lehman failure itself that led to the acute stage of the crisis in October 2008. Taylor's interpretation is based on the spread between 3-month LIBOR and the overnight index swap (OIS) rate, which rose only modestly when Lehman filed for bankruptcy. The spread did not widen dramatically until the botched TARP plan was announced on the Friday after the Lehman bankruptcy (Taylor 2009: 27–30).

Wessel does not comment on the importance of almost continuously rising energy prices to July 2008. These increases raised inflation concerns in the markets and in the Federal Open Market Committee. Although the FOMC had reduced its fed funds interest rate target in several steps from 5.25 percent in August 2007 to 2 percent in April 2008, policy statements continued to express inflation concerns until the statement issued October 8, 2008. For example, even in its policy statement of September 16, 2008, the day after Lehman filed for bankruptcy, the FOMC said, "The downside risks to growth and the upside risks to inflation are both of significant concern to the Committee." Inflation concerns were understandable given that oil prices reached a peak of over $140 per barrel in July and were still above $100 per barrel through most of September.

In his interviews, Wessel obtained a large amount of confidential information. FOMC proceedings are supposed to be confidential until the transcript is released with a five-year lag, but some participants and/or staff obviously talked quite freely with Wessel about what went on. Chapter 13 is devoted primarily to the very contentious FOMC meeting of December 15–16, 2008. The meeting was so contentious, Wessel reveals, that the Committee had great difficulty in crafting its policy statement and almost missed the traditional statement release time of 2:15 PM. It was at this meeting that the FOMC adopted a target fed funds rate of 0–0.25 percent.

What Are "Unusual and Exigent Circumstances?"

The Federal Reserve relied on Section 13(3) of the Federal Reserve Act as its legal justification for its lending to nonbanks. That section permits the Fed to make such loans under "unusual and exigent circumstances." Wessel emphasized that the Fed's extensive lending raised concerns in Congress:

> At one point, Barney Frank recalled, he asked Bernanke: "Do you have $80 billion?" And Bernanke replied: "Well, we have $800 billion," a reference to the value—then—

> of the Fed's assets. "And that's when many of us, for the first time, understood the full scope of this ["unusual and exigent"] statute."
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> For many members of Congress, the Fed's ability to come up with $85 billion overnight led to the realization that the Fed increasingly was acting like a fourth branch of government. Most politicians, indeed, most American citizens, had a vague idea that the Fed could move some interest rates up or down. But they had no idea that the Fed could—with the push of a button on a computer keyboard—create that much money from nothing and without seeking the approval of Congress or the president [197–98].

The issue, of course, is that Article I, Section 9 of the Constitution says: "No money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law." According to Wessel, Bernanke and Paulson made the judgment that the Fed had to use Section 13(3) because Congress would not do what had to be done. Only after the Lehman failure in mid-September 2008 did Bernanke and Paulson believe there was enough political support for Congress to act. Were Bernanke and Paulson correct that Congress would not do what had to be done?

In fact, Congress had acted in July 2008. The Housing and Economic Recovery Act of 2008, enacted at the end of that month, provided funds for Treasury to support Fannie Mae and Freddie Mac if necessary only about two weeks after Paulson had made the request. That authority was used in early September to put the two firms into conservatorship and federal control. Similarly, after Lehman, Congress passed the TARP, which President Bush signed into law on October 3, about two weeks after Paulson proposed it. Later, Congress passed the Obama administration stimulus bill in February 2009, less than a month after President Obama was inaugurated. Thus, recent evidence indicates Congress can act quickly when it believes there is a strong case. Nevertheless, on October 7, 2008, just a few days after the quick congressional action on TARP, the Fed created the Commercial Paper Funding Facility using the authority of Section 13(3).

As Wessel notes, the Bernanke-Paulson judgment that Congress could not act may have been correct, but they did not try to get legislation to authorize the credit programs the Fed believed were necessary. If the programs had been legislated, the Federal Reserve might have avoided congressional concerns that the Fed had overstepped its authority.

Wessel does not distinguish between the emergency bailouts of Bear Stearns and AIG in March and September 2008, respectively, and the other lending programs the Fed also justified under Section 13(3). It was indeed impossible for Congress to act to authorize the emergency bailouts (whatever their wisdom) because the Fed and Treasury had to make the decision over the span of a few hours. But the other programs could have been submitted to Congress for authorizing legislation.

In early 2009, long before the financial crisis seemed resolved, George Shultz (2009) worried that the Fed's entanglements with the Treasury would compromise monetary policy independence. Shultz notes how long and painful the process was for the Fed to regain independence after World War II.

Given subsequent congressional proposals to rein in the Fed, Shultz's fears were clearly justified. As of December 2009, it is not clear if and how Congress will amend the Federal Reserve Act. Clearly, given the draft bills being considered at this time there is a risk that monetary policy independence will be compromised. Many across the political spectrum will want to restrict Fed powers under Section 13(3), but we can hope that doing so does not compromise Fed independence in determining monetary policy. If that happens, it will be one of the legacies of how Ben Bernanke handled the financial crisis.

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