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On the Issues

Stern Lessons on Fed Policies and Actions

How fragile is our financial system? What are the implications of the Fed's actions on Bear Stearns? Do we need new ways of thinking about the risks the system entails? In recent articles, four AEI scholars have looked closely at the evidence of what went wrong and what is ahead.

Our Overextended Fed

By Vincent R. Reinhart

In the past few weeks, the Federal Reserve has fundamentally redefined the role of a central bank in a market economy. Almost half of our nation's central bank balance sheet—more than $400 billion—is exposed to credit risk through new lending facilities. It has also entered an open-ended commitment to use its discount window to backstop major securities firms. These efforts will influence the depth of the recession that the U.S. economy has likely already entered and will leave a durable imprint on the financial landscape for many years to come.

We are in the midst of the worst financial crisis since the 1930s. The large, complex financial institutions at the center of the global financial system need more capital. Until they get that capital, those firms will keep their risk-taking operations shuttered.

As a result, the market for securities using mortgage-related collateral has vanished. It also means that opportunities for new lending will be few and far between. Thus, we have entered one of those rare episodes in which balance-sheet constraints put a brake on spending. This is piled on top of an economy already reeling from the significant wealth loss associated with the decline in the prices of homes and equities and the retrenchment of builders who have realized that the run in residential construction was overdone.

The desire on the part of policymakers to draw a line defending the existing structure of the financial system is understandable. But one can wonder if the trenches the Federal Reserve has dug are this generation's Maginot Line—ineffective in defense and costly in the long run.

The Federal Reserve put its balance sheet in harm's way to give assurance to Bear Stearns's creditors and extended that protection to the other primary dealers. In doing so, the board of governors of the Federal Reserve had to determine unanimously (since they had only five members at the time) that these were "unusual and exigent" circumstances and that failure to lend to Bear would have adverse consequences for the U.S. economy. The signaling aspect of that decision cannot help but have adverse consequences for investors' willingness to take on risk.

Moreover, the implicit declaration that a midsize investment bank was systematically important puts any firm at least as big as Bear in the cross hairs of speculators. In coming days, how can the Federal Reserve turn away another like-sized entity—primary dealer or not—that is suddenly in the marketplace's disfavor for having used leverage to borrow at short-term maturities to fund longer-term obligations?

In such circumstances, the Federal Reserve's $900 billion balance sheet will not look that big. And the Federal Reserve will have ceded control of its balance sheet to the needs of private sector entities.

More seriously, the Federal Reserve's action can only be viewed as rewarding bad behavior. Remember that Bear opened this financial crisis when it revealed problems with its sponsored hedge funds last June. That it did not spend the next nine months resolving its problematic positions and getting sufficient capital did not prevent it from getting a "get out of jail free" card from the Federal Reserve.

The decision on Monday by executives at JPMorgan Chase to sweeten its takeover bid to $10 per share showed how valuable that Federal Reserve intervention was to the owners of Bear Stearns. Consider the alternative: Officials from the Federal Reserve could have commiserated with the mendicants from Bear and pointed to the door. The Federal Reserve could have then offered its balance sheet to any financial institution willing to assume the portfolio of risky obligations from the defunct Bear to ensure that the financial system continued to function smoothly. True, the Federal Reserve would have been exposed to credit risk, as it is now, but bad behavior would have been punished.

At the same time, showing its ingenuity in a different form, the Fed could have begun purchasing the debt of the government-sponsored enterprises and, more importantly, their mortgage-backed securities. The evident support to the prices of mortgage-related securities would have cushioned the market blow of Bear's failure. And Bear's failure would have provided a useful encouragement to those firms in the core of our financial system to get more capital.

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The recent actions by the Federal Reserve are only buying time before that infusion of capital to those firms, which might come from the domestic private sector, from abroad, or ultimately from the government. The pity is that some of those actions taken in the heat of our ongoing crisis—importantly including the extension of credit to an investment bank—will have long-lasting consequences.

Vincent R. Reinhart is a resident scholar at AEI. A version of this article appeared in the *Wall Street Journal* on March 26, 2008.

Fed Still Keeps Us Guessing with Rescue of Bear

By Amity Shlaes

More government is the remedy that Congress is reaching for as it moves to evaluate the Bear Stearns disaster. Yet as the story of another banking catastrophe reminds us, government involvement can also be a curse. What is especially problematic is when the role of public officials and institutions is unclear.

In 1913, Congress was busy creating a central bank for the United States, the Federal Reserve Board, to serve as lender of last resort. The Fed was supposed to provide an additional source of liquidity to banks that formerly relied on state-level networks alone, such as the New York Clearing House.

Defining "chutzpah" for those not yet familiar with the concept, a group of Jewish small-timers in New York called a bank they were chartering that same year "Bank of United States." Observers made their irritation known. It started with the name's odd article-less-ness. "Bank of United States," instead of "Bank of the United States," sounded illiterate.

Worse, though, was the sense that such a name would trick gullible immigrants into believing their deposits were government backed. The founders were recalling the Fed's predecessors, the First and Second Banks of the United States. "Such an honored name

should not be dragged in the mud on the Lower East Side of the city," an opponent told the *New York Times*.

The Bank of United States confounded the critics by keeping its name and proving a success story. It identified markets that more traditional banks ignored—the garment trade, for example—and profited from that insight. Its branches proliferated. Its immigrant depositors thrived. Its shares were traded on the Curb. And its executives likely believed they were making headway in penetrating that old New York establishment. On July 12, 1930, a Bank of United States baseball team even trounced Chase National Bank 5–1 in a game at Ebbets Field in Brooklyn—the team's fifth consecutive win.

Several vulnerabilities, however, were emerging. As with Bear Stearns, real estate or related instruments were a problem, with the bank overinvesting. Bear lacked access to the Fed's discount window; similarly, Bank of United States was shut out of a source of liquidity because it was not a member of the clearinghouse.

A year into the Depression, in the autumn of 1930, the runs on the bank began, and in December, the Bank of United States closed its doors. There were late-night merger efforts. Manufacturers' Trust—one of the multiple banks in the DNA of today's JPMorgan Chase—was a possible partner. In the end, the clearinghouse banks turned their backs on the newcomer. The Fed was missing in action.

"Let it fail, draw a ring around it so that the infection will not spread," a clearinghouse member argued, as economist Allan H. Meltzer points out in his *History of the Federal Reserve*, volume two of which appears later this year.

Shareholders bore the consequences. *Time* magazine's editors wrote one day about the time of the closing that "if the Bronx merchant who had tried to sell his Bank of United States stock the day before had succeeded, he would have received $11 1/2 a share. After the closing, he would have been lucky to get more than $3. Last year this stock sold at $240."

As with Bear, there was the question of whether the failure had to happen at all. Joseph Broderick, the New York state superintendent of banks, pleaded with banking executives to help the Bank of United States. Broderick's account of his argument caught the eye of Milton Friedman and Anna Schwartz, who reprinted it in their own monetary history.

"I said it had thousands of small borrowers, that it financed small merchants, especially Jewish merchants, and that its closing might, and probably would, result in widespread bankruptcy among those it served," Broderick said, according to the book. "I warned that its closing would result in the closing of at least 10 other banks in the city and that it might even affect the savings banks."

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Broderick pointed out that they were rescuing other troubled banks—why not this one? "I asked them if their decision to drop the plan was still final. They told me it was. Then I warned them that they were making the most colossal mistake in the banking history of New York." The liquidation of the bank lasted fourteen years, even longer than the Depression.

It would be wrong to push this analogy too far. Bigotry was part of the 1930 story. It is not today. Bank of United States was operating amid deflation. Bear Stearns is operating amid probable inflation.

Several Bank of United States executives were sent up to Sing Sing Prison, convicted of misdirecting funds. No one is charging, let alone convicting, Bear executives yet. The Bank of United States did not come back. Bear may.

Still, one similarity remains: the arbitrary quality of the actions by government and fellow banks. The cocky immigrants who gave Bank of United States its name were culpable. But so was the young Fed, which was still defining what was and what was not "last resort."

"There's never been clarity on that, and there isn't now," says Meltzer of the Fed's role in crises. And the Fed keeps changing the rules. This time, the discount window was available to commercial banks but not to Bear.

Knowledge of this probably emboldened Jamie Dimon of JPMorgan Chase as he closed in. In the past, as now, the very institutions that are meant to prevent instability helped to cause it.

Amity Shlaes, an AEI adjunct fellow, is the author of *The Forgotten Man: A New History of the Great Depression*, which she wrote with assistance from AEI's National Research Initiative program. She is a contributing editor to *The American* and has given two Bradley lectures at AEI about her book.
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Fighting Recession with Panic

By John L. Chapman

After a weekend in which the collapse of Bear Stearns, the fifth largest investment bank in the United States, prompted the Federal Reserve to make an unprecedented loan to JPMorgan Chase, the Fed's Open Market Committee holds its regular six-week review meeting today. There is wide anticipation that interest rates will be cut yet again, amid signs that the U.S. economy is slowing after several years of respectable growth, technology-led productivity gains, a booming stock market, low unemployment, expanding international trade, and low inflation. But can economists at the Federal Reserve Board and the U.S. Treasury prevent a recession?

Let us start by going back to the summer of 1929. Following the 1921 recession, real GDP growth had averaged 4.8 percent per year, and the consumer price level had been virtually unchanged (meaning there was no inflation). By the end of the decade, unemployment stood at just over 3 percent. Massive changes in transportation and communications technologies had fed an industrialization that had radically increased productivity, and as a result, real wages and corporate profits exploded: the stock market index grew by more than 23 percent per year during the 1920s, reaching an all-time high on September 3, 1929.

On that fateful day, however, no one could have guessed that the Dow Jones Industrial Average would not see this level again *for a quarter century*—not until late 1954—or that unemployment would triple in one year's time. By 1933, unemployment stood at 24.9 percent, real GDP had declined by a fourth, and rising protectionism had cut world trade in half.

Federal Reserve Chairman Ben Bernanke knows this history well: he is perhaps the world's foremost living authority on the Great Depression. Bernanke has asserted that such a catastrophe could not happen again because our understanding of trade and fiscal and monetary policy tools is far superior today. For example, Bernanke argues that a passive Fed was too restrictive in terms of money supply growth back then. As a result, 40 percent of all U.S. banks failed in the 1930s, contributing significantly to the contraction. This would never happen today.

Perhaps with that history in mind, the Fed has responded proactively to news of falling home prices, a credit crunch, two consecutive months of job losses to begin 2008, and now an insolvent Wall Street firm. Indeed, it has cut benchmark interest rates repeatedly and announced a $400 billion monetary infusion to shore up the credit markets. With many economists now expecting a recession this year, the Fed has moved aggressively to pump more liquidity into the U.S. banking system.

Bernanke also endorsed the Economic Stimulus Act of 2008, which was signed into law on February 13. This stimulus bill calls for $168 billion to be funneled into the economy, primarily via tax "rebates" (which include some outright transfers) to an estimated 128 million Americans in lower- and middle-income tax brackets. Another $50 billion is allocated for business tax breaks. Meanwhile, separate legislation has been proposed to aid troubled mortgage lenders.

Can the combination of monetary easing and fiscal stimulus serve to jump-start a sagging economy? The 1920s and 1930s provide us with two big lessons to consider.

Lesson 1: Recessions Are Often a Case of Monetary Mismanagement.

The 1920s were a time of significant growth in the money supply. This did not show up in consumer prices only because of technology-induced productivity gains throughout the economy—that is, the increasing supply of goods and services kept prices low. But monetary ease resulted in artificially lower interest rates, which led to a boom in capital investment. This led to a quintupling of the stock market in eight years and highly leveraged asset prices: between the end of 1927 and October 1929, broker loans for equity purchases increased by 92 percent. Clearly the 1929 crash was the bursting of an asset bubble driven by easy credit.

This storyline parallels the current era. Over the past decade, the "Money of Zero Maturity" money supply, which measures the most liquid funds available for spending, grew from $3.5 trillion to $8.2 trillion, which translates into an average annual growth rate of 8.8 percent. Tremendous gains in productivity—as well as heightened global competition—have kept pressure on consumer prices. Following the 2001 recession, however,

artificially low interest rates induced easy credit and a boom in housing and highly leveraged home buying. As in the 1930s, the deleveraging and liquidation of irresponsible capital investment will cause economic pain.

Unlike in the 1930s, however, the U.S. dollar is now (and has long been) the de facto international reserve currency, a role formerly held by gold. This has led to strong demand for dollar-denominated instruments and effectively has allowed the United States to borrow, run fiscal deficits, and "export" inflation abroad. This game can work as long as the U.S. economy is growing and the Fed is seen as a force for anti-inflation stability. But when the economy slows and the Fed becomes an engine of easy money, the U.S. dollar will weaken, which only exacerbates inflation.

Such is the case today. Consumer prices have spiked dramatically in the last twelve months, rising by 4.5 percent. We are now on the precipice of a new era of stagflation: a time of slow growth *and* inflation, with sharply higher interest rates.

Lesson 2: Fiscal Measures Designed to Promote Growth without Inducing Increased Production Are Doomed to Fail.

In the 1930s, economist John Maynard Keynes advocated "building pyramids and digging holes in the ground," if need be, to stimulate spending. But America's economic slump persisted because government itself can never *create* wealth; it is purely an agent of *redistribution*.

That basic fact seems lost on advocates of the 2008 stimulus bill. The tax "rebates" are not being distributed pro rata to all taxpayers but instead via a redistributive formula to lower- and middle-income households, some of whom paid no federal income taxes in 2007. This will merely redistribute wealth from current and future taxpayers to rebate recipients. Additionally, the tax rebate funds will be borrowed in the current year, thereby expanding the fiscal deficit and, at the margin, crowding out job-creating investment. This all serves to increase downward pressure on the dollar. It does nothing to encourage the entrepreneurship and capital formation so necessary to GDP expansion and real wage growth.

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A society becomes wealthier when more goods are produced per unit of resource input. Increased consumption is thus an *effect* of increasing wealth and not a *cause*, as Keynes argued. Incentives to produce are optimized when monetary policy yields a currency that maintains its value. Stable money promotes saving, capital formation, trade, and entrepreneurial risk-taking, all of which spur job creation and economic growth.

In short, government fosters economic growth when its policy mix includes low taxes on capital, income, and profits; sensible regulation and low barriers to trade; and stable money. Therefore, the stimulus bill, the Fed's recent monetary easing, and the growing threats of trade protectionism are all unhelpful errors that portend harder economic times ahead.

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That '70s Show

By Allan H. Meltzer

Is the Federal Reserve an independent monetary authority or a handmaiden beholden to political and market players? Has it reverted to its mistaken behavior of the 1970s? Recent actions and public commitments, including Fed Chairman Ben Bernanke's testimony to Congress yesterday—in which he warned of a steeper decline and suggested that more rate cuts lie ahead—leave little doubt on both counts.

An independent central bank is supposed to maintain the value of the currency and prevent inflation. In the 1970s and again now, Federal Reserve officials repeatedly promised themselves and each other that

they would lower inflation. But as soon as the unemployment rate ticked up a bit, the promises were forgotten.

People soon recognized that avoiding possible recession overwhelmed any concern about inflation. Many concluded that inflation would increase over time and that the Fed would do little more than talk. Prices and wages fell very little in recessions. The result was inflation and stagnant growth: stagflation.

It is beginning to happen again. Unlike the response of wages and prices in the low inflation 1990s, expectations of rising inflation now delay or stop price and wage adjustment, inhibiting growth.

One lesson of the inflationary 1970s: a country that will not accept the possibility of a small recession will end up having a big one when the politicians at last respond to the public's complaints about inflation. Instead of paying the relatively small cost of a possible recession, the public pays the much larger cost of sustained inflation and a deeper recession. And enduring the deeper recession is the only way to convince the public that the Fed has at last decided to slow inflation.

Economic forecasts are not very accurate; still, the International Monetary Fund, the Congressional Budget Office, and even the Federal Reserve do not forecast recession in 2008. The Fed thinks that the unemployment rate may rise to 5.3 percent, below the postwar average. In any event, it cannot do much to change economic activity or unemployment experienced in the next few months, and the Fed anticipates stronger growth in the second half of the year. Why the haste to cut interest rates drastically?

The freezing up of short-term financial markets called for more borrowing. The Fed's response was creative and correct. It recognized that its responsibility as lender of last resort required bold action to maintain the payments system, and it delivered.

But the rush to bring real short-term interest rates to negative values is an unseemly and dangerous response to pressures from Wall Street, Congress, and the administration. The Federal Reserve became "independent" in 1913 so that it could resist pressures of that kind. And in the postwar years, although it often failed to do so, it was expected to safeguard the purchasing power of our money and maintain economic growth.

For Wall Street, the pressure for lower interest rates is based on a hope that bond and mortgage yields will decline and their losses will be limited. Often long-term rates fall when the Fed lowers short-term rates—and since bond and mortgage prices rise when their rates fall, the losses of investors in these instruments will be reduced. For Congress and the administration, there is a need to show "concern" by doing something in an election year. These are not the concerns that should influence an independent central bank.

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Surely Bernanke and his colleagues remember what happened in the 1970s. They console themselves with the belief that they will respond to any inflation that occurs by promptly raising interest rates. That repeats the commitments made repeatedly in the 1970s, which the Fed was unwilling to keep. The blunt fact is that there is rarely a popular time to raise interest rates. And with the growing streak of populism in the country, it will become more difficult.

The Fed's recent behavior is in sharp contrast to the European Central Bank, which keeps its eye on both objectives: growth and low inflation. It does not shift back and forth from one to the other. The Fed should do the same. In the 1970s, because the Fed shifted from one goal to the other and back again, it achieved neither. Both inflation and unemployment rose on average, then fell together in the 1980s—after the Fed controlled inflation.

After 1985, Fed policy kept inflation and unemployment low. The result was twenty years of growth and three of the longest peacetime expansions punctuated by short recessions.

We should not throw this policy away. Federal Reserve independence is a valuable right that should not be discarded. The Fed should insist on its obligation to prevent inflation and sustain growth, not sacrifice inflation to lower unemployment before the election.

Allan H. Meltzer is a visiting scholar at AEI. A version of this article appeared in the *Wall Street Journal* on February 28, 2008.