BOOK REVIEW

Ben S. Bernanke (2013). *The Federal Reserve and the Financial Crisis: Lectures by Ben S. Bernanke* (Princeton and Oxford: Princeton University Press), pp. 134, (h/b), ISBN 978-0-691-15873-0

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Introduction

What was the role played by the U.S. Federal Reserve in mitigating the financial crisis of 2008? That is the question which Ben Bernanke, the Chairman of the Fed, addresses in this series of four lectures at the George Washington University in March 2012. The first two lectures set out the basics of central banking and the history of the Fed in the United States. The third and fourth lectures discuss the events leading up to the financial crisis itself and its aftermath. These lectures were originally delivered as a part of a course at George Washington, and represent a series of attempts made by Ben Bernanke in recent years to reach out to a larger audience than that which is traditionally preoccupied with the structure and function of monetary policy. These lectures then should be of interest to anybody who is interested in learning about monetary policy, and the Fed's attempts to increase the levels of transparency in the conduct of monetary policy in the United States. Each of these four lectures is accompanied by a Q&A session with participating students, and can be read either as separate modules, or in a sequence of ascending difficulty, to help develop a more nuanced understanding of monetary policy, and how it can be used as a policy instrument to ensure macroeconomic stability in the broader economy. The video version of these lectures, accompanied by presentation slides, is also available online for those who might be interested. This book is the edited versions of these video lectures, to not only preserve as a permanent record, but to also serve, as a learning resource. The main sense of well-being that a reader will experience on reading this book relates not only to learning the rudiments of monetary history and monetary policy from a leading central banker, but to also learn from the policymaker who was responsible for much of it since 2006. Since many of the interventions that Bernanke made include a high level of co-ordination with the US Treasury – especially in determining the contribution that the Troubled Asset Relief Program (TARP) could make to alleviating the distress experienced by financial firms without their having to seek recourse to the so-called 'discount window' (and the stigma that brought with it) -- readers might want to read this book in conjunction with that of attempts made by the then Treasury Secretary, Hank Paulson, to explain the statutory significance of TARP in recapitalizing banks and troubled financial institutions (Paulson, 2010).

Another interesting aspect of this book -- as Bernanke's habitual readers will know -- is the rather unique opportunity that Bernanke had as an economic-historian-turned-policymaker to deploy his expertise on the Great Depression to stave off the possibility of yet another depression in the wake of the financial meltdown of 2008. It may therefore be a good idea if more of Bernanke's lectures and Congressional testimonies before the banking and finance committees in the House of Representatives and the Senate are made available to interested readers in a series of books like this since readers have been hitherto dependent on books 'about Bernanke' to understand his stance on the crisis (Harris, 2008; Van Overveldt, 2009; Wessel, 2009). Those attempting to read Bernanke for the first time should note that he is one of the most prolific speakers and writers on a whole range of issues in both monetary theory and monetary policy, and has taught economics in a number of leading American institutions like Stanford and Princeton before being appointed as a member of the Board of Governors, and subsequently, as Chairman of the Fed in 2006.

The main goal of this book, its strategic intent, is to impress upon the reader the fact that the Fed has not forgotten the lessons of the Great Depression, and the role that the Fed played inadvertently in creating the Depression – this is something Bernanke is known to have apologized for. This crisis then was a great way of institutionalizing the policy lessons from the Great Depression.

On Institutional Voids

Bernanke's remarks then should interest those who work in areas like institutional economics as well, since what is at stake here is the relationship between the problem of institutional memory and what, if anything, constitute effective interventions in the domains of economic policy and public policy (Khanna and Palepu, 2010). What Fed policy has, in effect, 'done' is to list and plug the gaps in the 'institutional voids' that emerged in the wake of the crisis. This is an interesting exercise that will bear serious study by policy makers in a number of areas in economic policy and public policy because Bernanke's interventions demonstrate that advanced economies are not void of voids. What is a chronic problem in emerging economies is, in fact, either an endemic problem or an intermittent problem in the more advanced economies if we consider the meltdown as a series of regulatory failures. There is something inadequate in what can be defined as an effective regulatory regime either because there is a lack of consensus on either the need for and/or the shape that regulatory intervention should take in an advanced financial economy. That is why Bernanke is interested in the role played by the Federal Deposit Insurance Corporation (the FDIC) in stemming the run on banks. Needless to say, this was one of the innovations that were introduced in the wake of the Great Depression by President Franklin D. Roosevelt in 1934. Not only was the role of the FDIC given a renewed sense of importance during the recent crisis, but deposit insurance on transaction accounts was not limited to a threshold amount like before. We can infer the success of the FDIC from the fact that, as Bernanke points out, 'the $250,000 deposit insurance limits were raised essentially to infinity for transaction accounts' (p.98). These discussions should interest those involved in studying the implications of regulations like the Dodd-Frank Act of 2010 because the scale and scope of regulation that anticipated problems in the future will have a lot to gain by deciding what, if anything, in US legislative history is worthy of being considered the most successful form or instance of regulation in the financial sector. I don't think it would be an exaggeration to say that Bernanke's candidate for this exalted status is the FDIC. This was one of the more important takeaways for this reviewer. Taking Bernanke's interventions as a policy maker and communicator of Fed policy seriously is tantamount, in my understanding, to be akin to going beyond ideological discussions on the pros and cons of regulatory policy to focusing on actual instances of success in regulation, and then asking seriously, from an empirical point of view, as to whether FDIC is a success; and, if yes, determine whether it can then serve as a prototype of successful regulation in the years to come. It simply doesn't make sense to do monetary policy without immersing oneself in monetary history (Moss, 2007).

Accord of 1951 to set interest rates. This, needless to say, was the relevant precedent in monetary history when the then Chancellor of the Exchequer Gordon Brown freed the bank of England to set its own interest rates in 1997.

Examples of Causality

Another relevant example of the causality problem that Bernanke discusses is the question of when exactly the crisis began. Was it the reduction in interest rates by the Fed in 2001 that should be defined as the cause of the bubble in the housing markets in the US? A theoretical approach might lead to the identification of that event as the 'cause'. But a historical approach with a more nuanced approach to housing prices and data might lead it back, as Robert J. Shiller (2005; 2009b; 2012) does, to as early as 1998 (p.53). Here is a third example of how theory and history disagree on what causality is. This is probably the most important question a central banker like Bernanke can wrestle with from the Fed. What actually causes inflation? Should he take a theoretical approach like Milton Friedman and conclude that inflation is always a monetary phenomenon (Malabre Jr. 1994)? Or should he work with historically resonant counter-examples like the Yom Kippur War and the increase in oil prices announced by OPEC in 1973? What is at stake in Bernanke's well-chosen examples is not just how we 'define' inflation, but how we intervene in the economy. This is all the more of significance since laypeople are confused when they are told both in economics courses and in the business media that they must differentiate between core and headline forms of inflation, and that they must remember to exclude food and energy prices from the former. But, for most people, inflation is inflation, and they do not see the wisdom, if any, of differentiating between forms of inflation, and expect the Fed to succeed in containing inflation even if it appears that not all forms of inflation are monetary unless we want to define away inflation rather than define inflation as a prelude to an effective monetary policy intervention. So there is a difference between saying that the Fed can only intervene within monetary forms of inflation by tweaking the money supply, and expecting it to take policy responsibility for any and all forms of inflation whatsoever.

Juxtaposition as Method

I restrict my discussion to only three examples here where the notion of causality becomes problematic on whether the policy maker is dependent on theoretical assumptions or historical data about what is 'cause' and what is 'effect'. Further complications are also created by the presence of 'lag-variables' that introduce a delay in the temporal dimension that separates cause and effect, and thereby prevent a policy maker from demonstrating a neat spatial representation of 'what causes what', and how 'cause and effect' relate to each other. These then are some of the important problems in the methodology of economics that Bernanke touches upon in these lectures. His goal is not to take sides between the ideological pressures exerted by those who have an epistemological preference for either theory or history, but to demonstrate – not unlike a deconstructionist -- the interdependence between theory and history in uncovering the essential forms of causal over-determination in monetary policy. Bernanke however does this without using big words like 'epistemology' lest he scare away readers who lack a background in philosophy; he prefers instead to simply juxtapose theoretical definitions with historical data in order to let the reader feel the 'push-and-pull' of theory and history respectively. This is Bernanke's way of giving the reader a feel for the difficulties of making economic policy when there is in fact no consensus within the economics profession on what, if anything, are the suitable remedies for a financial crisis, and where -- truth be told -- the financial crisis is but an epistemological mask for the crisis of the economics profession. Bernanke's greatness as a policy maker is amply demonstrated in his willingness to take responsibility not only for the role that the Fed played in creating the Great Depression (the main learning from his study of the history of central banking), but also in his willingness to apply the historical data to understand how it will play out in the broader economy.

The obsession with 'fine tuning' the federal funds rate itself is testimony to the fact that the Fed doesn't believe in making a fetish of the funds rate, but regards it instead as an ongoing policy mechanism or tool (to calibrate the broader economy, which itself is but a means, in the attempt to ensure greater macroeconomic stability).

Conclusion

It is this rare combination of theoretical rigor with flexibility at the level of policy that has made it possible for Bernanke to find a unique niche for himself in the history of central banking. Bernanke's intellectual honesty, I think, can be gauged from the fact that while he admits that the Fed did not seeing the crisis coming (either during the Great Depression or in the wake of the Great Moderation), it was not found wanting once it realized the need to take action. The expansion of the Fed's balance sheet is also bound to be another object of concern for most readers: it may take them by surprise to realize that the Fed does not have either an arbitrary or irresponsible banking policy, but that, in fact, as Bernanke points out, the Fed's lending policy is to take further Walter Bagehot's dictum from as early as his book Lombard Street (1873) where the English journalist emphasized the following: during a financial crisis a central bank must lend copiously, ensure that borrowing institutions have sufficient collateral, and that they borrow at a higher interest rate. So even if a number of financial institutions could not turn in a huge profit, the Fed, in fact, has done so, and the better part of the moneys borrowed from the Fed have, in fact, not only been returned to the Fed, but have made the Fed a more profitable institution: a lender of last resort that, if challenged, can provide a justification of its lending practices. It is time then that lay people go beyond the simplistic notion of the Fed as an arbitrary institution that bails out whoever it chooses to bail out at the taxpayer's expense. Bernanke also discusses the relevant provisions in the Dodd-Frank Act that have either strengthened or weakened its powers to intervene in the next crisis, and the actual criteria of evaluation for why the Fed saved Bearns Sterns, for instance through the offices of JP Morgan, but not Lehman Brothers, and the provisions that have been put in place within the regulatory structure to solve the 'too big to fail' problem should there be need to fold up such firms in the future with a minimal fallout for the financial system as a whole. This is a book that just about anybody can use as both a concise introduction to and as an insightful evaluation of the financial crisis of 2008. Needless to say, this is not only the latest but the most effective of Ben Bernanke's recent forays in explaining Fed policy to a 'broader readership' (a term that I invoke as an educator's analogue to Bernanke's preoccupation with the implications of monetary policy for the broader economy). It won't surprise me then to see this book on the shelves of not only central bankers in the near future, but as one of the best introductions available on 'the federal reserve and the financial crisis'.

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