BOOK REVIEWS – BOOK REVIEWS – BOOK REVIEWS

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The author of this book - Ben S. Bernanke - served as chairman of the Federal Reserve from 2006 to 2014. He carried therefore a main responsibility for US monetary policy and was a key political player during the global financial crisis 2007-2009.

Bernanke’s book has a clear structure. The text is divided in three parts: Part I – Prelude – deals with the author’s family background, his education at Harvard University and MIT, his academic career at Stanford University and Princeton University and his first years as a member of the Federal Reserve Board. Part II – The Crisis – gives a detailed account of events and meetings in the two dramatic years from the summer of 2007 to the autumn of 2009. In Part III – Aftermath – the author discusses the later development of unconventional monetary policies as Quantitative Easing and the efforts to build a new and more resilient financial system. An Epilogue with comments on the recent activities of the Fed under the leadership of his successor Janet Yellen concludes the book.

In part I of the book, he describes his modest Jewish background and his years as a student at Harvard University. He felt academically disadvantaged compared with classmates from elite prep schools. His response to the challenges at Harvard was hard work. In order to earn money, he and a roommate ran a small grill and sold burgers to other students. Bernanke followed courses in economics taught by prominent economists like Martin Feldstein and Dale Jorgenson. His hard thesis work was rewarded with a National Science Foundation fellowship, which could pay for tuition and expenses for the first three years of graduate school. He moved to MIT, where Stan Fischer most influenced the course of his studies. Fischer recommended to his students the 1963 book “A Monetary History of the United States, 1867-1960”, by Milton Friedman and Anna Schwartz. Bernanke was fascinated by the book’s historical approach. He decided that he in his academic career would focus on macroeconomics and monetary issues. After some years at Stanford University as assistant and associate professor, Bernanke was offered a full professorship at Princeton University, and in 1985 he and his wife Anna moved to New Jersey. Due to his research work on monetary policy, Bernanke was invited to make visits and presentations at the Board of Governors in Washington DC. In 2002, Glenn Hubbard, chairman of President Bush’s Council of Economic Advisers, called Bernanke on the phone and asked if he would be interested in coming to Washington to talk with the president about possibly serving on the Federal Reserve Board. In July 2002, the Senate Committee on Banking, Housing, and Urban Affairs approved the nomination. The author describes in detail how he got to know the members of the Federal Open Market Committee and other colleagues at the Federal Reserve. A chapter on Bernanke’s time as junior member of the Federal Reserve Board under Chairman Alan Greenspan has the charming headline: “In the Maestro’s orchestra”. The US macroeconomic performance was in this period by and large considered as satisfactory. At the Kansas
City Fed’s annual Jackson Hole symposium in August 2005, Greenspan’s last as chairman, he was hailed as the greatest central banker in history. Warnings that a crisis might be under way were, however, published already at that time by Robert Shiller, Yale University, and by Claudio Borio and William White, BIS. The financial crisis of 2007-2009 had several triggers as analyzed by the Financial Crisis Inquiry Commission. Bernanke’s chapter on “The Subprime Spark” is partly based on material from the Commission (p.586). The author admits that many at the Fed, including himself, underestimated the extent of the housing bubble and the risks it posed (p.90). He writes also that the remarkable economic stability of the latter part of the 1980s and the 1990s (“the Great Moderation”) likely bred complacency (p.92). There are also critical remarks on the US structure of financial regulation. The structure before the crisis is characterized as highly fragmented and full of gaps. No agency had responsibility for the system as a whole. The coordination of the work done by respectively the Office of the Comptroller of the Currency, the Federal Reserve, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission was very incomplete. In May 2005, Bernanke was confirmed as Chairman of the President’s Council of Economic Advisers (CEA). The CEA had been a stepping-stone to the Fed chairmanship for Greenspan, and speculation about Bernanke’s appointment started immediately. On October 24, President Bush nominated him. On February 1, 2006, Bernanke became the fourteenth Chairman of the Federal Reserve. At the swearing-in ceremony Alan Greenspan, Paul Volcker and President Bush attended. An early priority for the new Chairman was forging cordial working relationships with international policymakers. Mentioned are the Governors Mervyn King, Bank of England, Toshihiko Fukui, Bank of Japan and Jean-Claude Trichet, European Central Bank (p.118).

Part II of the book deals with the financial crisis. On 9 August 2007 BNP Paribas, France’s largest bank, barred investors from withdrawing money from three of its investment funds that held securities backed by US subprime mortgages. Investor distrust of subprime-backed securities was so great that potential buyers had withdrawn from the market entirely (p.134). A wave of panicky selling in markets around the world followed. Until then, Bernanke and others at the Fed thought that subprime problems were unlikely to cause major economic damage (p.136). The author describes the new situation as a “Catch-22”: Investors were unwilling to buy securities they knew little about. But without market trading, there was no means to determine what the securities were worth (p.143). The Fed decided to increase liquidity in different ways. That included the supply of short-term funding to the shadow banking system. In November 2007, several large US banks announced that they were writing down their subprime holdings (p.179). In March 2008, the Fed decided to lend USD 30 billion in taxpayer funds to prevent the failure of the Bear Stearns Companies, the nation’s fifth-largest Wall Street investment bank (p.198). The author describes in great detail the deliberations that preceded that decision. The Board also approved an important new lending facility – the Primary Dealer Credit Facility – which allowed primary dealers to borrow from the Fed, just as commercial banks had always been able to (p.220). Ultimately, JPMorgan acquired Bear Stearns. The Bear rescue was heavily criticized. Bernanke defended the rescue arguing that the Fed had the protection of the financial system and the protection of the American economy in mind (p.224). During the summer of 2008, the Fed subjected the investment banks Goldman Sachs, Morgan Stanley, Merrill Lynch and Lehman Brothers to stress tests (p.253). The tests showed that none of them passed the test if exposed to circumstances like those Bear Stearns faced in March.

Concerns about the situation of Lehman now filled the media. Lehman was 50 percent bigger than Bear and its derivatives “book” was twice the size that Bear’s had been (p.259). The Fed hoped to find a solution for Lehman based on involvement of private financial institutions in the US and abroad. Financial Times and Wall Street Journal warned about the moral hazard implications of a new rescue plan. “We will have a new de facto federal policy of underwriting Wall Street that will encourage even more reckless risk-taking” (p.261). Bernanke’s view in September 2008 was that he was absolutely convinced that invoking moral hazard in the middle of a major financial crisis was misguided and dangerous. However, one by one the big financial institutions stepped back from participating in a rescue operation for Lehman. Bank of America reported that the Lehman assets in their view were worth USD 60-70
billion less than their official valuation, and Barlay’s option for Lehman was stopped by the UK Financial Services Authority and the concern for a possible involvement of British taxpayers (p.266). The Fed’s rescue strategy was based on finding a buyer. Without a buyer, and with no authority to inject fresh capital or guarantee Lehman’s assets, the Fed had no means of saving the firm (p.268). Lehman’s bankruptcy filing, at 1.45 a.m. Monday, September 15, 2008 reverberated through financial markets – at first abroad, then in the United States. Investors fled to the safety of US Treasury securities and banks hoarded cash. The huge insurance company AIG – with trillion-dollar insurance operations spanning 130 countries – was the next cause of concern. The company was so large and interconnected with the rest of the financial system that the ramifications of its failure would be massive, if hard to predict (p.276). AIG was about the size of Lehman and Bear Stearns combined. Its failure would create chaos and reduce confidence in the rest of the insurance industry. Bernanke saw no alternative to providing a loan of up to USD 85 billion against collateral in the going-concern value of specific AIG businesses (p.283). The AIG board accepted reluctantly the Fed’s offer. Bernanke admits (p.286) that he did not feel much sympathy for AIG. It got itself into trouble. After serious losses and restructurings, the US Government (the Fed and the Treasury combined) would make investments and loan commitments totaling USD 182 billion to prevent AIG from failing (p.286). Because Lehman failed but AIG was saved, serious questions persisted. Bernanke defends the Fed’s different decisions in the two cases. He does not want the notion that Lehman’s failure could have been avoided, and that its failure was consequently a policy choice, to become the received wisdom, for the simple reason that it is not true (p.291).

In late September, the Fed presented a Troubled Asset Relief Program (TARP) for the Senate Banking Committee. The program was greeted with deep skepticism. Many legislators raised the issue of compensation packages in financial institutions that benefited from taxpayer dollars (p.319). The proposed crisis measures became an issue in the ongoing presidential election campaign between John McCain and Barack Obama. After difficult negotiations, the negotiators in Congress approved a proposal for TARP legislation implying a disbursement in two USD 350 billion tranches. The political deal also required Treasury to develop a plan to help mortgage borrowers in trouble. The FOMC approved a more than doubling of the Fed’s swap lines with major foreign central banks to USD 620 billion. On September 29, however, The House of Representatives defeated the bill (p.334). Bernanke writes that he felt like he had been hit by a truck, and so did the stock market. The Dow Jones Industrial average plunged down 7 percent. After a sweetening of the bill by including an increase in deposit insurance from USD 100,000 to USD 250,000 both the Senate and the House passed the bill in early October. Notwithstanding the enactment of TARP, confidence in financial markets and institutions had nearly evaporated. The economic effects of the crisis spread rapidly, without regard for national borders. In October, the Eurozone countries agreed to implement capital injections and guarantees for their banks. At the end of 2008, the US Treasury’s investments in banks under the TARP program were approaching USD 200 billion. Bernanke writes (p.357) that he had no doubt that the TARP, together with all the other measures, had prevented a financial meltdown. In late November 2008, the Fed declared that they planned to buy up to USD 500 billion in mortgage-backed securities guaranteed by Fannie, Freddie, and the Government National Mortgage Association. The Fed also announced plans to buy up to USD 100 billion of the debt issued by Fannie, Freddie, and other government-sponsored enterprises to finance their own portfolios. In December 2008 Treasury agreed with President Bush to use TARP funds for the automakers GM and Chrysler (Ford decided not to participate). On January 20, 2009 President Obama was inaugurated. The new administration presented a major fiscal package, the American Recovery and Reinvestment Act of 2009. Plans for reducing mortgage foreclosures followed. The Fed’s new lending programs improved short-term funding markets. Capital injections from the TARP program and the positive results of stress tests gradually improved confidence in the banking system (p.397).

Bernanke concludes Part II of the book by summarizing the Fed’s response to the crisis (p.409). The response had four elements: 1) lower interest rates to support the economy, 2) emergency liquidity lending aimed at stabilizing the financial system, 3) rescues (coordinated
when possible with the Treasury and the FDIC) to prevent the disorderly failure of major financial institutions, and 4) the stress-test disclosures of banks’ condition. In his view, the Fed bore for much of the panic alone the burden of battling the crisis (p.410).

Part III of the book opens with a discussion of quantitative easing QE. The Fed’s large-scale asset purchases described above were called quantitative easing or QE by market observers. The monetary policy goal was to bring down longer-term interest rates, which might stimulate spending on housing and business capital investments. The following chapter deals with plans for reforming the US financial system. A Treasury report had as its goal to create a “three peaks” regulatory structure (p.436). The first peak should be a single “prudential” regulator focused on ensuring the safety and soundness of individual financial institutions. The second peak should be a new “conduct of business” agency charged with protecting consumers and investors. The third peak should be an agency responsible for the stability of the financial system as a whole. This broad role should fall to the Fed, which should monitor the financial system and address any vulnerabilities found. In contrast to the structure-simplifying Treasury-plan, a proposal from another part of the Obama administration left the existing set of regulators largely intact. The Basel 2 agreement with bank capital requirements had never been fully implemented in the United States. In December 2010, the Basel 3 accord was released. Its recommendations concerning tougher capital requirements were taken into consideration in the reform negotiations between the Senate and the House in Washington. The final bill left the US regulatory bureaucracy relatively intact (p.463).

The author refers several times to the cooperation between the US and European countries. At a meeting in the FOMC in April 2010 there were concerns that the weak European development might pose risks to the United States, but those risks had not materialized (p.482). Bernanke’s last month in office was January 2014. The first steps in slowing the Fed’s securities purchases had then been taken. But the delicate task of normalizing monetary policy would fall to Janet Yellen and her colleagues (p.561).

An interesting feature of Bernanke’s book is that he writes personal characteristics of many of the politicians, CEOs and central bankers he met and cooperated with. SUERF-readers will probably read with special interest his description of the ECB Presidents Jean-Claude Trichet and Mario Draghi. The author finds Trichet shrewd and diplomatic but too willing to accept the moralistic approach to macroeconomic policy advocated by many northern Europeans (p.524). Draghi is described as soft-spoken, bespectacled and scholarly (p.525). Bernanke quotes - with some admiration - Draghi’s speech on July 26, 2012, which included the famous sentence: “the ECB will do whatever it takes to preserve the euro” (p.525). He also writes in plain words that the reason why the earlier Bundesbank President Axel Weber (former member of the SUERF Council of Management) left the running for the ECB presidency was that he was a staunch opponent of ECB’s bond-buying program (p.524).

Bernanke’s book is a unique source of knowledge on the handling of the financial crisis of 2007-2009. The text reflects the author’s experience as a professor of economics and gives a detailed account of the interplay during the crisis between powerful politicians, leaders of large financial institutions, and central bankers all over the world. Complex financial topics are dealt with pedagogically and in a fluent language. The book has an excellent index, and also rich references to websites, which give access to the huge Federal Reserve World. Time invested in reading this book will give SUERF readers a high return.