The Financial Crisis and Federal Reserve Policy

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Second Edition

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To Sally, Liz, and Sophie

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Preface

Financial crises often ensue on the heels of extended periods of economic calm. It has been said that "stability breeds instability," a view borne out by the extraordinarily stable quarter century immediately preceding the Great Crisis of 2007–2009. In fact, economists refer to this benign period as "The Great Moderation." Of the dozen post–World War II recessions, the two experienced in this period were the mildest and briefest, and the longest continuous economic expansion in history extended from 1991 to 2001. In the two decades prior to the Great Crisis, the nation's unemployment rate was appreciably lower than in the previous twenty years, on average. Also, the inflation rate remained unusually low, averaging only 2.5 percent per year. By the year 2000, Federal Reserve chairman Alan Greenspan had been dubbed "The Maestro" for his ostensibly flawless orchestration of this new era of prosperity and unprecedented stability.

Unfortunately, as has often been the case in the past, this period of good times and heightened economic stability led to hubris. Lenders, borrowers, investors, regulatory authorities, the Federal Reserve, and others mistakenly assumed that esoteric instruments developed by a new breed of financial engineers had effectively reduced risk in financial markets and reallocated remaining risk to those most willing and able to incur it. This development, together with improved conduct of monetary policy, had rendered episodes of severe unemployment and high inflation obsolete—or so it was thought. Overconfidence lulled some economic actors into complacency and induced others to sharply increase risk-taking in pursuit of quick profits—both setting the stage for the catastrophe to come.

The decision to write this book was motivated by the simple fact that I am an economist and the financial crisis that began in 2007, together with its aftermath, constitutes the most important economic event of my lifetime—indeed of the past 75 years. This book, which aims to provide clear and straightforward answers to crucial questions surrounding the Great Crisis, is written for a broad audience of motivated readers, including those without formal training in economics. It should also be of considerable interest to students in the field, and to professional economists who are not specialists in the areas of finance and monetary economics.

Many important developments have occurred since the first edition of this book was published. The U.S. recovery from the severe 2007–2009 recession has turned out to be especially disappointing. For example, unemployment remained unacceptably high four years into the recovery, and recession-mandated austerity measures remain in place in numerous states and thousands of localities around the country. The federal government sequester has meant cuts in funding for Head Start and nutrition programs for children of low-income families. The European sovereign debt crisis, itself a direct result of the 2007–2009 Great Crisis, is not only causing misery for tens of millions of Europeans, but is also threatening to further impede the U.S. economic recovery as much of Europe slid into a double-dip, second recession in 2012 and 2013. The Federal Reserve has demonstrated its dedication to attacking the unemployment problem here by implementing an aggressive but controversial set of actions aimed at lowering long-term interest rates. This new edition includes three entirely new chapters—chapters 7, 8, and 12—covering the anemic recovery, the European debt crisis, and the Fed's conduct of unconventional monetary policy, respectively. In addition, all chapters in the first edition have been significantly updated to reflect new developments and information.

Key questions addressed in this book are the following:

- Why did the Great Crisis happen and why are financial crises recurring features of capitalism?
- Why did the crisis, which began in the United States, spread throughout the world?
- What were the channels through which the crisis spilled over to cause the recession that was the most severe of the numerous economic contractions since the Great Depression of the 1930s?
- Why are economic contractions associated with financial crises more severe than other recessions?
- Why was the recovery following the 2007–2009 Great Recession so weak?
- What actions did the Federal Reserve take to cut short the cascading events that in September 2008 were poised to result in Great Depression II?
- How did the Fed's performance during the Great Crisis compare with that in the Great Depression?
- What caused the ongoing European debt crisis?
- Were the Federal Reserve's unconventional monetary policies warranted?
- What problems are likely to confront the Federal Reserve as it conducts its "exit strategy" in coming years—that is, as it sells off the mortgage-related bonds and other assets it accumulated as it dramatically expanded its balance sheet to stem the contractionary forces of the Great Crisis?
- In what ways have the events of the past decade increased the prospects for substantially higher inflation in the years ahead?
- What financial reforms would increase the likelihood that future crises will be less frequent and less severe than the Great Crisis, and how well did the reform legislation enacted in 2010 (the Dodd-Frank Act) address the problems?

This book seeks to provide insight into these important questions. Intensive study of the Great Crisis is warranted by its enormous costs. The Congressional Budget Office has estimated that the loss of national output in the period extending from the end of 2007 through the end of 2012 has been in the range of 4 to 6 percent of potential GDP. In an economy with a potential GDP of $16,000 billion per year, this adds up to a loss of output and income over the five-year period of the order of magnitude of $4,000 billion, or some $12,000 per capita. And these continuing losses are diminishing only slowly as the nation's output gap declines at an exceptionally meager pace.

Of course, these costs have not been shared equally across the population. They have been concentrated disproportionately among the more than eight million people thrown out of work. Especially damaging is the fact that the percentage of the labor force in long-term unemployment—those continuously out of work for 27 or more weeks—was five times higher by October 2010 than its average in the 20-year period ending in 2007. Such long-term unemployment remains abnormally high and is particularly debilitating and costly inasmuch as skills and motivation of the affected workers tends inevitably to atrophy over time. Many individuals of middle age and older, thrown out of work through no fault of their own, may never recover from the debacle.

Yet the costs of the Great Crisis were hardly limited to those denied jobs. Few Americans were not significantly impacted in one way or another. For example, many families whose breadwinners retained their jobs nonetheless lost their homes. The median U.S. family's principal source of wealth has traditionally been its equity in the family home. The unprecedented drop in house prices wiped out $7 trillion of this wealth. The decline in stock prices (which have since recovered) in conjunction with the contraction in housing equity, meant that millions of Americans approaching retirement were forced to postpone their decision. And many of those recently retired either re-entered the work force or faced sharply reduced economic circumstances.

The cost to cities and states has been without precedent in modern times. Nearly all 50 states suffered a significant contraction in tax revenues, necessitating imposition of austerity programs. Tens of thousands of school teachers have been let go, with adverse implications for the long-term well-being of their young students. Prisons have released thousands of inmates owing to lack of funds to continue their incarceration. Roads and water systems have deteriorated. Essential services to some of the nation's most vulnerable citizens have been terminated.

Unlike states, the federal government is normally unconstrained in its expenditures by the revenues at hand. Nevertheless, the severe drop in federal tax receipts, combined with stimulus programs aimed at reducing the severity of the economic contraction, sharply boosted the federal deficit in the United States and many other countries. By 2009, the U.S. deficit exceeded 10 percent of GDP, a level unprecedented except in times of all-out war. Four years later the deficit/GDP ratio remained above 4 percent. The fear that foreign investors might lose confidence in the U.S. commitment to fiscal responsibility was sufficiently palpable to prevent the implementation of urgently needed fiscal stimulus as the fragile economic recovery showed clear signs of needing a policy-assisted boost.

Early chapters of this work discuss the types of financial crises that have occurred in various nations over the centuries and provide a framework that explains the forces that periodically combine to produce bubbles in credit and asset prices whose inevitable collapse initiates financial crisis. To place in context and shed light on the recent Great Crisis, previous U.S. crises are analyzed, including the Savings and Loan crisis of the late 1980s, the Great Depression, and the Panic of 1907—which directly led to the creation of the Federal Reserve System.

Chapter 4 analyzes the developments that led to the twin bubbles in house prices and the volume of credit extended to homebuyers and other borrowers. This chapter discusses the role played by the forces of "animal spirits" and the myopic belief that, unlike the price of stocks, oil, or gold, house prices are inflexible on the downside—they just cannot fall. Important contributing forces in the inflation of the twin bubbles include imprudent and reckless behavior on the part of both lenders and borrowers, absence of reasonable oversight by regulatory authorities, incompetent and perhaps fraudulent analysis of mortgage-backed securities by ratings agencies, and an almost unbounded supply of credit available to the housing sector. This explosion of credit resulted from a combination of forces. Among these were the securitization of mortgages into marketable bonds and related esoteric instruments, the rapidly emerging and largely unregulated shadow banking system, the search for investment outlets in the United States for funds accumulated by China and other countries that had amassed vast holdings of dollars through persistent trade surpluses vis-à-vis the United States, and extraordinarily easy monetary policy maintained by the Federal Reserve.

Chapter 5 outlines the chain of events that transpired after housing prices began declining in mid-2006 and the volume of credit began contracting. It demonstrates how the vicious cycle of falling house prices, mortgage foreclosures, and forced home sales begat a cascading series of destructive events. This process culminated in the demise of such icons of the financial world as Lehman Brothers and Merrill Lynch, a run on the nation's money market funds and various shadow-banking institutions, and the insolvency and government takeover of Fannie Mae and Freddie Mac, the nation's government-sponsored but privately owned housing agencies. Chapter 6 details the numerous avenues through which the crisis led to severe contractions in consumption, investment, and other forms of expenditures, thereby accounting for the deepest and longest recession since the Great Depression. New chapter 7 explains why the economic recovery that followed the Great Recession has been one of the most anemic in U.S. history.

Relative to other books about the Great Crisis, a distinguishing feature of this work is its extensive analysis of Federal Reserve policy. This is warranted in part because of the central responsibility accorded the Federal Reserve historically in dealing with financial crises. In part, it is warranted because the extraordinary and heroic actions taken by the Federal Reserve that very likely prevented a massive economic collapse were crowded out in the contemporary media reports and subsequent analyses by attacks focused principally on banks, the "government," and other alleged villains. An in-depth analysis of the Federal Reserve's response to the Great Crisis is presented and contrasted with Fed behavior in the Great Depression. To facilitate this objective, Chapter 9 provides a broad sketch of the framework of Federal Reserve monetary control, explains how the Fed is able to determine short-term interest rates and the trend growth rate of the nation's money supply, and outlines the tools the Fed uses to exert this control.

Chapter 10 discusses the events of the Great Depression of the early 1930s and analyzes the forces that account for the 30 percent contraction in the money supply from 1929 to 1933. Economists believe this development was instrumental in the onset of severe price level deflation that was the signature characteristic and predominant force accounting for the severity and duration of the Great Depression. The chapter discusses several crucial policy mistakes made by the Fed and looks into the mindset of Federal Reserve officials that might account for these costly mistakes. This chapter is of special interest given that Ben Bernanke, who became Federal Reserve chairman in 2006 and presided over the Fed during and after the Great Crisis, earned his reputation as an economist of the first rank in large part through his research into the Great Depression and the role of the Federal Reserve therein.

Chapter 11 explains the actions taken by the Fed to prevent the Great Crisis from degenerating into Great Depression II. As banks and other economic agents became engulfed in fear with the demise of Lehman Brothers in the fall of 2008, the money multiplier that links the monetary base to the nation's money stock declined even more precipitously than in the Great Depression. The Fed compensated by dramatically expanding its balance sheet, first through innovative lending programs to entities being shut off from normal sources of credit, and shortly thereafter through massive acquisition of mortgage-backed bonds and other securities. These actions by the Fed produced sufficiently rapid increases in bank reserves and base money to prevent the money supply from declining and ushering in a potentially devastating episode of price-level deflation.

Chapter 12 examines the Fed's unconventional monetary policies that commenced in 2008 and continue as of this writing (mid-2013). These unconventional policies include large-scale purchases of long-term bonds and communication initiatives ("forward guidance" in Fedspeak) designed to push down mortgage and other long-term rates to extraordinarily low levels in the interest of reviving construction and other forms of investment spending.

Chapter 13 analyzes the tools the Federal Reserve is poised to deploy as the economic recovery becomes sufficiently robust for the Fed to initiate its "exit strategy," intended to prevent the enormous quantity of funds it injected into the banking system during and after the crisis from unleashing an inflationary increase in bank lending. In this endeavor, the Fed is entering uncharted waters. The chapter examines the political and economic forces that will challenge Fed policymakers as they attempt to navigate the recovery from the Great Recession without experiencing a damaging episode of appreciably higher inflation.

One of the crucial developments that necessitated this new edition involves the profoundly damaging European debt crisis, which has occupied much of the world's economic headlines since spring 2010. Chapter 8 examines the causes of this crisis and evaluates the impact of austerity measures imposed by the European authorities on such nations as Greece, Ireland, Spain, Cyprus, Italy, and Portugal with the intention of reducing their budget deficits and rendering them more competitive in world markets. Massive unemployment in these nations has resulted in nearly unprecedented civil unrest in much of Europe, and the fate of the single-currency euro zone hangs in the balance.

Finally, Chapter 14 examines the way in which a series of socially perverse incentives joined forces to contribute to a pattern of behavior that brought on the Great Crisis. It explains why, pending correction of these misaligned incentives through legislation and other means, economists believe that recurring severe financial crises are inevitable.

In sum, this work aims to provide a comprehensive perspective on the Great Crisis. It is hoped that the dedicated reader will emerge with a substantially firmer grasp of the causes and consequences of the Great Crisis, the role of monetary policy in minimizing its consequences, and the financial reforms that would reduce our vulnerability to future damaging crises. If so, the effort expended in writing this book will have been worthwhile.

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Abbreviated Terms

AIG	American International Group
AMLF	Asset-Backed Commercial Paper and Money Market Mutual Fund Facility
ARM	Adjustable-Rate Mortgage
ARRA	American Reinvestment and Recovery Act
ATM	Automatic Teller Machine
CBO	Congressional Budget Office
CDO	Collateralized Debt Obligation
CDS	Credit Default Swap
CEO	Chief Executive Officer
CMBS	Commercial Mortgage-Backed Security
CPFF	Commercial Paper Funding Facility
CPI	Consumer Price Index
CRA	Community Reinvestment Act
DDO	Demand Deposits and Other Checkable Deposits
ECB	European Central Bank
EU	European Union
FDIC	Federal Deposit Insurance Corporation
FDR	Franklin Delano Roosevelt
FFR	Federal Funds Rate
FOMC	Federal Open Market Committee
FRED	Federal Reserve Economic Database
FRN	Federal Reserve Notes
GDP	Gross Domestic Product
GSE	Government-Sponsored Enterprise
HUD	Department of Housing and Urban Development
IMF	International Monetary Fund
IT	Inflation Targeting
LIBOR	London Interbank Borrowing Rate
MBS	Mortgage-Backed Security
MMMF	Money Market Mutual Fund
NAFTA	North American Free Trade Agreement
NAIRU	Non-Accelerating Inflation Rate of Unemployment

NASDAQ	National Association of Securities Dealers Automated Quotations
NBER	National Bureau of Economic Research
NINJA	No Income, No Job or Assets (loans)
NRSRO	Nationally Recognized Statistical Rating Organization
PCE	Personal Consumption Expenditures
PDCF	Primary Dealer Credit Facility
PIIGS	Portugal, Ireland, Italy, Greece, Spain
PPI	Producer Price Index
QE	Quantitative Easing
RGDP	Real Gross Domestic Product
S&L	Savings and Loan Association
S&P	Standard and Poor's
SEC	Securities and Exchange Commission
SIV	Structured Investment Vehicle
SWPs	Liquidy Swap Lines
TAF	Term Auction Facility
TALF	Term Asset-Backed Loan Facility
TARP	Troubled Assets Relief Program