Ben S Bernanke: Economic policy – lessons from history

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, at the 43rd Annual Alexander Hamilton Awards Dinner, Center for the Study of the Presidency and Congress, Washington DC, 8 April 2010.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Good evening. It is a great pleasure to share a meal with the Center for the Study of the Presidency and Congress, and especially with the Center's fellows. Doubtless your participation in the fellowship program as undergraduate and graduate students – writing and thinking about leadership, governance, and public policy – will prove immensely valuable as you develop your own intellectual and leadership skills and embark on careers that I hope will include a period of public service.

I must begin this evening by expressing my appreciation to the Center and to Ambassador Abshire for selecting me as this year's recipient of the Hamilton Award. I'm truly honored to join the ranks of such past Center honorees as Sandra Day O'Connor, Robert Rubin, Al Gore, and Gerald Ford. Thank you also, Chairman Volcker, for your very kind introduction. As you all know, the award is named after Alexander Hamilton, who of course is best known as our nation's first Secretary of the Treasury. From my perspective, at least equally important is that Hamilton, as the founder of the First Bank of the United States, was, in a sense, also our nation's first central banker.

These days central banking is my line of work as well. Before that, I was an academic economist and economic historian, with a particular interest in the causes of the Great Depression. So, given my background and the Center's abiding interest in applying the lessons of history to today's critical issues, I thought that I would speak to you about the parallels – and differences – between that crisis and the more recent one, particularly regarding the responses of policymakers. I draw four relevant lessons from the financial collapse of the 1930s; I will first list these lessons, then briefly elaborate. First, economic prosperity depends on financial stability; second, policymakers must respond forcefully, creatively, and decisively to severe financial crises; third, crises that are international in scope require an international response; and fourth, unfortunately, history is never a perfect guide.

The first lesson – economic prosperity depends on financial stability – seems obvious, but this connection was not always well understood. After the stock market crash of 1929, many thought a financial and economic crisis was necessary – even desirable – to wring out speculative excesses that had built up in the 1920s. Remarkably, despite the fact that the Federal Reserve had been founded to mitigate financial panics, the central bank made essentially no effort to prevent the wave of bank failures that paralyzed the financial system at the start of 1930s. Indeed, the Treasury Secretary at the time, Andrew Mellon, believed in the tonic effects of weeding out weak banks and famously advised President Herbert Hoover, "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate … It will purge the rottenness out of the system."[1]

Economists themselves have not always fully appreciated the importance of a healthy financial system for economic growth or the role of financial conditions in short-term economic dynamics. Even after the Depression, some economists found it useful to think of

[1] See Herbert Hoover (1952), *The Memoirs of Herbert Hoover*, vol. 3: *The Great Depression, 1929–1941* (New York: Macmillan), p. 30.

the financial system as a "veil," which helped allocate the returns to physical assets but did little to affect so-called real economic outcomes. In contrast, more recent work on the subject, to which I contributed, showed that the health of the financial system and the performance of the broader economy are closely interrelated, both in the short run and in the long run. Indeed, in a historical context, some of my own research on the Great Depression showed that countries such as the United States that, for institutional or other reasons, suffered severe banking problems, had significantly worse depressions than countries in which the banking system was more stable, such as Great Britain.[2]

The lesson has been learned. In the current episode, in contrast to the 1930s, policymakers around the world worked assiduously to stabilize the financial system. As a result, although the economic consequences of the financial crisis have been painfully severe, the world was spared an even worse cataclysm that could have rivaled or surpassed the Great Depression.

That lesson brings me to the second one – policymakers must respond forcefully, creatively, and decisively to severe financial crises. Early in the Depression, policymakers' responses ran the gamut from passivity to timidity. They were insufficiently willing to challenge the orthodoxies of their day – such as the liquidationist doctrine of Mellon and others, or the rigid adherence to the variant of the gold standard adopted after World War I. A key turning point, in the United States, came with Franklin Roosevelt's commitment to bold experimentation after his inauguration in 1933. Some of his experiments failed or were counterproductive, but his decisions to declare a bank holiday upon taking office in March 1933 and to sever the link between the dollar and gold helped arrest the descent of the U.S. financial system and set off a strong, albeit incomplete, recovery.

In the Depression, effective policy responses came only after three to four years of financial crisis and economic contraction. In our own time, policymakers acted sooner and with greater force than in the 1930s. For example, in October 2008, just weeks after the sharp intensification of the crisis, the Congress authorized the Troubled Asset Relief Program (TARP) to support stabilization of the financial system. It was far from perfect legislation, but it was essential for preventing an imminent financial collapse. For its part, the Federal Open Market Committee, the monetary policymaking arm of the Federal Reserve, sharply and proactively cut its target for short-term interest rates from the fall of 2007 through 2008. After the target could go no lower, the Committee embarked on an unprecedented (for the United States) program of long-term securities purchases, recently completed, to support private credit markets, including the mortgage market.

Also, in the spring of 2009, the Federal Reserve led the Supervisory Capital Assessment Program, known as the bank stress test.[3] In some ways, its effect was similar to Roosevelt's national bank holiday. During the holiday in 1933, banks temporarily shut their doors. Examiners were dispatched to evaluate them, and banks that were declared sound reopened to renewed depositor confidence. In the 2009 stress tests, multidisciplinary teams of examiners, economists, financial experts, and other specialists calculated how much capital 19 of the nation's largest bank holding companies would need to remain healthy and continue lending during a hypothetical worse-than-expected economic scenario. The Treasury Department committed to supplying additional capital as necessary from the TARP.

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[2] See Ben S. Bernanke and Harold James (1991), "The Gold Standard, Deflation, and Financial Crisis in the Great Depression: An International Comparison," in R. Glenn Hubbard, *Financial Markets and Financial Crises* (Chicago: University of Chicago Press for NBER).

The historical linkages between financial stability and economic performance have been explored in great detail in recent work. For example, see Carmen M. Reinhart and Kenneth S. Rogoff (2009), *This Time is Different: Eight Centuries of Financial Folly* (Princeton and Oxford: Princeton University Press).

[3] See Ben S. Bernanke (2009), "The Supervisory Capital Assessment Program," speech delivered at the Federal Reserve Bank of Atlanta 2009 Financial Markets Conference, Jekyll Island, Ga., May 11.

Critics had warned that the stress test could backfire, but as it turned out, the release of the results last May helped restore confidence in banks, and many institutions have since been able to raise capital from investors and repay the capital the government had injected.

Then as now, the financial and economic crisis was global, underscoring the third lesson: International crises require an international response. Contemporary Americans' impressions of the Depression have been shaped by iconic photos of bread lines, hungry Dust Bowl migrants, and the milling crowds on Wall Street on Black Monday. We think of it as an American episode. We forget it was a truly global event. But the depth of the Depression in Germany exceeded that even of the United States, and the failure in 1931 of a large Austrian bank, Credit Anstalt, was an important trigger of a wave of bank failures that affected many countries, including the United States. Unfortunately, authorities then were ill-positioned to coordinate an effective international response, as years of bitter wrangling over World War I international debts and reparations had all but destroyed the mutual trust upon which coordination depends.

In the recent episode, policymakers, bankers, and business people recognized that the world's economies and financial systems would sink or swim together. I recall talking with bankers and business people while attending an international meeting in Brazil. They told me that, in September 2008, what had been a healthy pace of business activity and lending in Brazil suddenly plummeted. They described the impact of the crisis as being like that of a "cold wind" that appeared out of nowhere. Similar stories, I am sure, can be told in many other countries. Because the world's policymakers understood the potentially devastating effect of the financial crisis for the global economy, they and we worked urgently to stabilize the situation. In October 2008, in an unprecedented display of coordination, six central banks – the Federal Reserve, European Central Bank, Bank of England, Swiss National Bank, Bank of Canada, and the central bank of Sweden – acted together to cut short-term interest rates. A few days later, after watershed meetings in Washington of finance ministers and central bank governors, many countries, including the United States, announced comprehensive plans to stabilize their banking systems. And at the Federal Reserve, because we were well aware that turmoil in dollar funding markets overseas hurts our own financial markets, we also established temporary liquidity swap lines that enabled 14 central banks around the world to calm their markets by lending dollars in their jurisdictions.

I'll conclude with the cautionary fourth lesson – history is never a perfect guide. It is a principle acknowledged by the words etched on the wall of the Center's conference room, attributed to Mark Twain, "History does not repeat itself, but it can rhyme." As an example, bank runs in many countries, including the United States, were common in the Depression. In the most recent crisis, retail runs – depositors lining up in the streets – were thankfully rare because of deposit insurance and other changes in our financial system.[4] Although ordinary small depositors by and large did not run, we nevertheless experienced the equivalent of runs on the network of nonbank financial institutions that has come to be called the shadow banking system. In the shadow banking system, loans, instead of being held on the books of banks as was virtually always the case in the 1930s, were packaged together in complex ways and sold to investors. Many of these complex securities were held in off-balance-sheet vehicles financed by short-term funding. When the housing slump shook investors' faith in the values of the loans underlying the securities, short-term funding dried up quickly, threatening the banks and other financial institutions that explicitly or implicitly stood behind the off-balance-sheet vehicles. This was a new type of run, analogous in many ways to the bank runs of the 1930s, but in a form which was not well anticipated by financial institutions or regulators. In an additional variation on the theme of the bank run, in September 2008

[4] Exceptions that come to mind are the runs on Great Britain's Northern Rock in September 2007 and California's IndyMac Bank in July 2008.

money market mutual funds saw massive outflows after one prominent fund suffered losses related to the failure of Lehman Brothers.

The Federal Reserve, with its discount window, was well positioned to provide liquidity to banks by making short-term, collateralized loans. (The discount window was the tool the Federal Reserve could have used, had it chosen, to stem the banking panics of the 1930s.) However, our traditional tools, developed in an earlier era, were of little use in addressing panic in the shadow banking system or in the money market mutual fund industry. So, we engaged in what I call “blue sky thinking” – generating many ideas. Most were discarded, but, crucially, some led to the development of new ways for the Federal Reserve to fulfill the traditional stabilization function of central banks. Using emergency authority last employed during the Depression, we created an array of new facilities to provide backstop liquidity to the financial system (and, as a byproduct, coined many new acronyms). Thus, we were able to help restore the flow of credit to American families and businesses by shoring up important financial markets, such as those for commercial paper and securities backed by consumer loans.

Undoubtedly, researchers and scholars will devote considerable energy in the years ahead to expanding and refining the lessons this most recent crisis has provided us. I hope that some of you might contribute to that endeavor. I congratulate the Center fellows whose work is also being recognized this evening and thank you, once again, for honoring me with the Hamilton Award.