The Market Oracle

Ben Bernanke's Legacy: A Weak and Mediocre U.S. Economy

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John P. Cochran writes: As Chairman Bernanke's reign at the Fed comes to an end, the *Wall Street Journal* provides its assessment of "The Bernanke Legacy." Overall the *Journal* does a reasonable job on both Greenspan and Bernanke, especially compared to the "effusive praise from the usual suspects; supporters of monetary central planning. The *Journal* argues when accessing Bernanke's performance it is appropriate to review Bernanke's performance "before, during, and after the financial panic."

While most assessments of Bernanke's performance as a central banker focus on the "during" and "after" financial-crisis phases with much of the praise based on the "during" phase, the *Journal* joins the Austrians and John Taylor in unfavorable assessment of the more critical "before" period. It was this period when the Fed generated its second boom-bust cycle in the Greenspan-Bernanke era. In the *Journal*'s assessment, Bernanke, Greenspan, and the Fed deserve an "F." While this pre-crisis period mostly fell under the leadership of Alan Greenspan, the *Journal* highlights that Bernanke was the "leading intellectual force" behind the pre-crisis policies. As a result of these too loose, too long policies, just as the leadership of the Fed passed from Greenspan to Bernanke, the credit boom the Fed "did so much to create turned to mania, which turned to panic, which became a deep recession." The *Journal*'s description of Bernanke's role should be highlighted in any serious analysis of the Bernanke era:

His [Bernanke's] role goes back to 2002 when as a Fed Governor he gave a famous speech warning about deflation that didn't exist [and if it did exist should not have been feared].[1] He and Mr. Greenspan nonetheless followed the advice of Paul Krugman to promote a housing bubble to offset the dot-com crash.

As Fed transcripts show, Mr. Bernanke was the board's intellectual leader in its decision to cut the fed-funds rate to 1% in June 2003 and keep it there for a year. This was despite a rapidly accelerating economy (3.8% growth in 2004) and soaring commodity and real-estate prices. The Fed's multiyear policy of negative real interest rates produced a credit mania that led to the housing bubble and bust.

For some of the best analysis of the Fed's pre-crisis culpability one should turn to Roger Garrison's excellent analysis. In a 2009 *Cato Journal* paper, Garrison (2009, p. 187) characterizes Fed policy during the "Great Moderation as a "learning by doing policy" which, based on events post-2003, would be better classified as "so far so good" or "whistling in the dark." The actual result of this "learning by doing policy" is described by Garrison in "Natural Rates of Interest and Sustainable Growth":

In the earlier episode [dot.com boom-bust], the Federal Reserve moved to counter the upward pressure of interest rates, causing actual interest rates not to deviate greatly from the historical norm. In the later episode [housingbubble/boom-bust], the Federal Reserve moved to reinforce the downward pressure on interest rates, causing the actual interest rates to be exceedingly low relative to the historical norm. Although the judgment, made retrospectively by economists of virtually all stripes, that the Fed funds target rate was "too low for too long" between mid-2003 and mid-2004, it was almost surely too low for too long relative to the natural rate in both episodes. (p. 433)

Given this and other strong evidence of the Fed's role in creating the credit driven boom, the *Journal* faults "Mr. Bernanke's refusal to acknowledge that the Fed made any mistake in the mania years."

On the response to the crisis, the *Journal* refrains from the accolades of many who credit the Fed led by the leading scholar of the Great Depression from acting strongly to prevent another such calamity. According to the Fed worshipers, things might not be good, but without the unprecedented actions and bailouts things would have been catastrophic. The *Journal*'s more measured assessment:

Once the crisis hit, Mr. Bernanke and the Fed deserve the benefit of the doubt. From the safe distance of hindsight, it's easy to forget how rapid and widespread the financial panic was. The Fed had to offset the collapse in the velocity of money with an increase in its supply, and it did so with force and dispatch. One can disagree with the Fed's special guarantee programs, but we weren't sitting in the financial polar vortex at the time. It's hard to see how others would have done much better.

But discerning readers of Vern McKinley's *Financing Failure: A Century of Bailouts* might disagree. Fed actions, even when not verging on the illegal, were counter-productive, unnecessary, and contributed to action freezing policy uncertainty which contributed to the collapse of the velocity of money. McKinley describes much of what was done as "seat-of-the-pants decision-making" (pp. 305-306):

"Seat of the pants" is not a flattering description of the methods of the regulators, but its use is justified to describe the panic-driven actions during the 2000s crisis. It is only natural that under the deadline of time pressure judgment will be flawed, mistakes will be made and taxpayer exposure will be magnified, and that has clearly been the case. With the possible exception of the Lehman Brothers decision ... all of the major bailout decisions during the 2000s crisis were made under duress of panic over a very short period of time with very limited information at hand and with input of a limited number of objective parties involved in the decision making. Not surprisingly, these seat-of–the-pants responses did not instill confidence, and there was no clear evidence collected that the expected negative fallout would truly have occurred.

While a defense of some Fed action could be found in Hayek's 1970s discussion of "best" policy under bad institutions (a central bank) where he argued that during a crisis a central bank should act to prevent a secondary deflation, the Fed actions went clearly beyond such a recommendation. Better would have been an immediate policy to end the credit expansion in its tracks. The Fed's special guarantee programs and movement toward a mondustrial policy should be a great worry to anyone concerned about long-term prosperity and liberty. Whether any human running a central bank could have done better is an open question, but other monetary arrangements could clearly have led to better outcomes.

The *Journal*'s analysis of post-crisis policy, while not as harsh as it should be,[2] is critical. Despite an unprecedented expansion of the Fed's balance sheet, the "recovery is historically weak." At some point "a Fed chairman has to take some responsibility for the mediocre growth — and lack of real income growth — on his watch." Bernanke's policy is also rightly criticized because "The other great cost of these post-crisis policies is the intrusion of the Fed into politics and fiscal policy."

Because the ultimate outcome of this monetary cycle hinges on how, when, or if the Fed can unwind its unwieldy balance sheet, without further damage to the economy; most likely continuing stagnation or a return to stagflation, or less likely, but possible hyper-inflation or even a deflationary depression, the Bernanke legacy will ultimately depend on a Bernanke-Yellen legacy. Given, as the *Journal* points out, "Politicians — and even some conservative pundits — have adopted the Bernanke standard that the Fed's duty is to reduce unemployment and manage the business cycle," the prospect that this legacy will be viewed favorably is less and less likely. Perhaps if the editors joined Paul Krugman in reading and fully digesting Joe Salerno's "A Reformulation of Austrian Business Cycle Theory in Light of the Financial Crisis," they would correctly fail Bernanke and Fed policy before, during, and after the crisis.

But what should be the main lesson of a Greenspan-Bernanke legacy? Clearly, if there was no pre-crisis credit boom, there would have been no large financial crisis and thus no need for Bernanke or other human to have done better during and after. While Austrian analysis has often been criticized, incorrectly,[3] for not having policy recommendations on what to do during the crisis and recovery, it should be noted that if Austrian recommendations for eliminating central banks and allowing banking freedom had been followed, no such devastating crisis would have occurred and no heroic policy response would have been necessary in the resulting free and prosperous commonwealth.

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