THE HILL

Ben Bernanke and the art of central banking

George Selgin

October 9, 2015

Like any experienced Fed chairman, Ben Bernanke knows how to choose his words carefully. So the triumphalist headline, "How the Fed Saved the Economy," assigned to his Oct. 4 *Wall Street Journal* column, probably wasn't his doing. Still the question remains: did the Fed really save us? Bernanke suggests that it did. But the evidence he musters leaves plenty of room for doubt.

At 5.1 percent, Bernanke observes, the unemployment rate is "close to normal." One needn't delve into the statistic to doubt that a return to "close to normal" unemployment after six long years is much of an achievement. But delving in makes the achievement more doubtful still.

As Bernanke himself admits, "other indicators," including the labor force participation rate, suggest "that there is some distance left to go." That's putting things mildly: in fact, *two-thirds* of the decline in unemployment since 2009 is due, not to the unemployed finding jobs, but to their giving up. Bernanke presumably doesn't want us to thank the Fed for that.

The inflation rate, Bernanke informs us, is just 1.5 percent--somewhat below the Fed's 2 percent target, and nowhere near the hyperinflation some histrionic Fed critics warned against. But histrionics notwithstanding, the statistic is, once again, more proof of the Fed's failure than of its success: as everyone who has followed the Fed's efforts knows, inflation is low, not because the Fed has taken pains to keep it there, but despite the Fed's attempts, through several massive rounds of quantitative easing, to raise it.

The Fed's failure to achieve its inflation target casts doubt on the last bit of evidence Bernanke supplies as proof of the Fed's success: the fact that the U.S. output is now almost 9 percent above its pre-crisis peak, whereas output in Europe, where the ECB resisted quantitative easing until recently, is still below its pre-crisis level. But conflating the United States higher output with the Fed's resort to quantitative easing is one thing; establishing a causal link is quite another. In fact, empirical studies so far suggest that the output gains attributable to QE have been modest, if not negligible. Nor is this any surprise: instead of lending them, banks added almost all of the new dollars to their excess reserve holdings. That's why inflation is so obstinately low. It's also why the rise in output can't easily be credited to quantitative easing.

If the Fed may not have made as great a contribution to recovery as Bernanke suggests, did it not at least succeed in avoiding a deeper crisis? Here, again, there's plenty of room for doubt. When it rescued Bear Stearns in March 2008, the Fed justified the step, not by claiming that Bear, though illiquid, was solvent—as it ought to have been able to do according to the tried-and-true rules for last-resort lending—but by declaring Bear too "systematically important" to fail. That unwise pronouncement set the stage for Lehman's far more cataclysmic September failure, by leading it to assume that it, too, could count on being rescued.

In the meantime, the Fed lent heavily to other troubled financial institutions through its new Term Auction Facility. But because it "sterilized" these loans by selling off Treasury securities, that lending amounted to a transfer of liquid funds from healthy banks to less healthy ones. Here again, the Fed's procedures turned orthodox rules for last-resort lending, calling for central banks to leave insolvent firms to their fate, while lending generously to solvent ones, on their head. If the orthodox rules are sound—as Bernanke has repeatedly assured us—then the Fed's early response to the crisis under Bernanke's leadership wasn't.

During the depths of the Great Depression, British economist Ralph Hawtrey published a long essay on "The Art of Central Banking." Hawtrey had in mind the wisdom and foresight upon which central bankers must draw to successfully manage their way through crises—wisdom and foresight that Hawtrey found conspicuously lacking among the central bankers of his day. But central bankers also practice another sort of art. That's the art of spinning even their biggest failures into successes. That Bernanke has certainly mastered one of these two arts no one can doubt. But great care must be taken in deciding which.

George Selgin is director of the Center for Monetary and Financial Alternatives at the Cato Institute