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Did Bernanke save us from another Great Depression?

Not exactly.

By George Selgin

ATHENS, GA.

The recession is probably over. So said Ben Bernanke this week. His timing is exquisite. President Obama has reappointed him to be Fed chairman, and he can now head into his Senate confirmation hearings this fall with the reputation that he nipped another Great Depression in the bud.

But did he?

Trying to challenge Mr. Bernanke's job performance is like trying to convince your average ancient Greek that Zeus was a bumbling weakling. That's because the mystique surrounding the Fed's ordinary actions – let alone its recent, extraordinary ones – is thicker than the fog at Mt. Olympus's summit. People entertain perfectly absurd beliefs concerning what the Fed can – and what it can't – do; and while some like to blame the Fed for every economic hiccup, others are no less convinced that the economy would drop dead were it not for its constant care.

One doesn't usually turn to old TV shows for economic insights. Yet the best way to put the Fed's role in the recent crisis in perspective is by recalling an episode of "The Beverly Hillbillies" – the one in which Granny convinces everyone that a spoonful of her medicine can cure the common cold. Sure enough, it can: It just takes between a week and 10 days.

Recessions don't peter out in 10 days, of course. But they do eventually end, with or without central bankers' help. According to the National Bureau of Economic Research, the US went through 32 recessions between 1854 and 2001, the average duration of which was about 17 months – or a few months shorter than the current recession, so far.

Even a severe downturn can be followed by rapid recovery without aggressive central bank intervention. In the 1921 recession, wholesale prices, industrial production, and manufacturing employment all fell by 30 percent or more within a year. Yet by early 1922, the US economy had recovered fully from its mid-1921 low. What's more, it did so with no help from the Fed, which was determined to let the recession take its course, so as to hasten the restoration of the prewar gold standard.

Bernanke, in contrast, has been praised for taking bold, innovative measures to tame a supposedly unprecedented economic collapse. But his innovations included errors of both commission and omission that almost certainly deepened the recent downturn, making it last that much longer.

Until the late summer of 2008, the Fed responded to what was really a solvency crisis as if it were a liquidity crisis, establishing the Term Auction Facility in December 2007 and dramatically lowering its

interest rate target. Yet while it was taking these steps, the evidence pointed not to a liquidity shortage, but to fears of counterparty exposure to losses on mortgage-backed securities, as the cause of the credit squeeze. The Fed's actions, both on its own and in conjunction with the US Treasury, did nothing to allay those fears.

On the contrary: they compounded them by throwing good money after bad, rewarding imprudent financial firms at the expense of their more prudent rivals, including prospective buyers, while unsettling financial markets all the more by suggesting that even Bernanke himself was tossing in the towel on old-fashioned monetary policy.

Starting in the late summer of 2008, the Fed erred the other way. Thanks partly to its (and the Treasury's) previous missteps, including scare tactics used to cow Congress into approving the Treasury's bailout plan, a genuine liquidity crisis had taken hold by then. Yet the Fed resisted a much-needed loosening of monetary policy until early October. Then, although it finally took steps to aggressively expand bank reserve credits, it undermined the potential stimulus effect of doing so by starting a new policy of paying interest on bank reserves. In short, the Fed behaved much as it had back in 1936-37 when, fearing inflation (of all things), it decided to double bank reserve requirements, plunging the US back into the Great Depression from which it was struggling to emerge.

In many ways, Bernanke was dealt a tough hand when he became chairman. The Fed made lots of mistakes earlier this decade – primarily, holding interest rates too low for too long – that weren't entirely his fault.

But when the crisis hit during his watch, he faced a choice: He could have stuck to orthodox rules that would have helped sever the link between the housing market collapse and recession, by keeping Fed firmly focused on the goal of preserving the overall availability of liquidity to the banking system. Instead, he took the lead in developing wasteful, ad-hoc handouts to individual banks that often didn't need or weren't worthy of them. A strict focus on its traditional duty of maintaining sound banks' access to funds would also have kept the Fed from actually undermining bank solvency by subsidizing imprudent firms.

If Congress really wants to encourage Bernanke to successfully combat future recessions, it needs to take steps to force him to stick to traditional monetary policy procedures, instead of congratulating him for innovations that may well have done more harm than good. After all, no one congratulates Granny, and she never did anyone any harm.

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