

The Washington Post

The Radicalization of Ben Bernanke

Advertisement » Your Ad Here

He is throwing trillions of dollars at the financial crisis. What happens if his gambles don't pay off?

By Simon Johnson and James Kwak
Sunday, April 5, 2009; B01

Timothy Geithner and his predecessor Henry Paulson have been the public faces of the U.S. government's battle against the global economic crisis. But even as the secretaries of the Treasury have garnered the headlines -- as well as popular anger surrounding bank bailouts and corporate bonuses -- another official has quickly amassed great influence by committing trillions of dollars to keep markets afloat, radically redefining his institution and taking on serious risks as he seeks to rescue the American economy. Without a doubt, this crisis is now Ben Bernanke's war.

Bernanke has become the country's economist in chief, the banker for the United States and perhaps the world, and has employed every weapon in the Federal Reserve's arsenal. He has overseen the broadest use of the Fed's powers since World War II, and the regulation proposals working their way through Congress seem likely to empower the institution even further. Although his actions may be justified under today's circumstances, Bernanke's willingness to pump money into the economy risks unleashing the most serious bout of U.S. inflation since the early 1980s, in a nation already battered by rising unemployment and negative growth.

If he succeeds in restarting growth while avoiding high inflation, Bernanke may well become the most revered economist in modern history. But for the moment, he is operating in uncharted territory.

When he first joined the Federal Reserve's Board of Governors in 2002, and later when he became chairman in 2006, there was little reason to expect Bernanke to revolutionize central banking. After all, it was the Age of Greenspan the Triumphant. Almost two decades of sustained growth and low inflation had created the illusion of central banking as a precise science, with the Fed simply reading economic statistics and nudging short-term interest rates up or down to keep the American economy humming and inflation low.

Shortly after succeeding Alan Greenspan as Fed chairman, Bernanke [credited](#) his predecessor's monetary policy with helping to reduce wide swings in U.S. economic performance -- the so-called "Great Moderation" -- and revive the productivity of American workers. This apparent success also lent staying power to some of Greenspan's conviction that the Fed should regulate the banking system with a light touch, relying on the free market and private-sector incentives.

Bernanke initially maintained Greenspan's hands-off approach to the emerging housing bubble. As the financial crisis deepened in late 2007 and early 2008, however, the Fed began expanding its lending efforts to financial institutions that couldn't raise money in private markets. This was Bernanke's first departure from the Greenspan school, in which tweaking interest rates was the instrument that mattered.

Then, in 2008, Bernanke became sucked into the firestorms that threatened to engulf the financial sector: Bear Stearns, AIG, the money markets and Citigroup, among others. In these interventions, the Fed brought the money. It extended loans to newly created entities and accepted dodgy collateral in return; lent money directly to non-financial institutions; or guaranteed the value of toxic assets -- a series of reactive, chaotic and non-transparent transactions that seem to have enriched Wall Street and have attracted congressional concern.

The theory at the time was that the financial sector was facing a liquidity crisis, with banks unable to raise

enough money to pay off their short-term debts. In response, the Fed would provide enough cash for banks to "deleverage in a more orderly manner," as [Bernanke explained](#) last August. By late 2008, the Fed was providing \$1.5 trillion of liquidity to the economy through these programs -- an amount roughly equal to half of the 2008 federal budget -- prompting John Cassidy of the New Yorker, in a perceptive [essay](#), to note that Bernanke had begun to "intervene on Wall Street in ways never before contemplated by the Fed."

Since late last year, however, Bernanke has signaled that even these efforts are not enough. In a January speech, Bernanke acknowledged the limits of liquidity and outlined a broader strategy in which the Fed would do everything in its power to increase credit. And last month, in an extraordinary interview on "60 Minutes," Bernanke conveyed a powerful message with his words about the Fed "printing money" and with his body language, as he toured his home town in South Carolina and declared that he cares about Wall Street only because it affects Main Street -- in part attempting to defuse criticism that the Fed lending was mainly benefiting bankers.

Clearly, the Fed chairman recognizes the severity of the problem and has decided to do whatever it takes to prevent anything like the Great Depression from happening again. Given where we are today, that means printing money, even if that runs the risk of creating a serious inflation problem.

Shortly after joining the Fed in 2002, Bernanke gave a [speech](#) describing how the Fed could prevent deflation, i.e., a general decline in prices. The key theme was that, in a pinch, the Fed could simply print more dollars -- for example, by buying long-term bonds on the market -- which reduces the value of each dollar in circulation and therefore raises the dollar price of goods and services. "Under a paper-money system," Bernanke explained, "a determined government can always generate higher spending and hence positive inflation." In a time of economic overconfidence, the discussion seemed largely academic. But it is now clear that Bernanke intends to follow through on it.

After the double-digit inflation of the 1970s and early 1980s, why would anyone want to create inflation? Households and companies alike are trying to "deleverage," or pay down their debts. But deflation makes it harder to pay down debts, because debts are fixed in dollars and those dollars are becoming worth more and more. Moderate inflation in the neighborhood of 4 percent, by contrast, makes it easier for borrowers to manage their debt loads, and stimulates the economy.

In the past few months, Bernanke has expanded the central bank's role in two major ways. The Fed has committed over a trillion dollars for buying securities issued by federal housing agencies, and another trillion for other products such as student loans, credit card loans and auto loans. Not only is the Fed devoting enormous funds to restart the flow of credit, but it is deciding where and how to allocate the credit. This is a remarkable shift from the traditional, hands-off approach to central banking. Bernanke is now making the Fed a major banking player in its own right.

Then in March, the Fed said that it will begin buying long-term Treasury bonds on the open market, hoping to push down long-term interest rates (by increasing the amount of money available for long-term lending) and thereby stimulate borrowing. The implication is that the Fed will finance these purchases by creating money. Not only that, but Bernanke wants us to know exactly what the Fed is doing; he hopes to push up our expectations of future inflation, so that wages and prices will nudge upwards, not downwards.

In short, Bernanke is making the biggest bet placed by a U.S. central banker in decades, wagering that he can pull the economy out of a deep crisis by creating money without unleashing high and long-lasting inflation.

Will it work? In a normal advanced economy, creating hundreds of billions of dollars in new money would not foster runaway inflation. As long as the economy is underperforming -- for example, with high unemployment -- stimulating the economy will only cause that "slack" to be taken up, the theory goes. Only when unemployment is low again can workers demand higher wages, forcing companies to raise prices.

But is the United States really a normal advanced economy anymore? We seem to have taken on some features of so-called emerging markets, including a bloated (and contracting) financial sector, overly indebted consumers, and firms that are trying hard to save cash by investing less. In emerging markets there is no meaningful idea of "slack;" there can be high inflation even when the economy is contracting or when growth is considerably lower than in the recent past.

If the United States is indeed behaving more like an emerging market, inflation is far easier to manufacture. People quickly become dubious of the value of money and shift into goods and foreign currencies more readily. Large budget deficits also directly raise inflation expectations. This would help Bernanke avoid deflation, but there is a great danger that unstable inflation expectations will become self-fulfilling. We do not want to become more like Argentina in 2001-2002 or Russia in 1998, when currencies collapsed and inflation soared.

In his prime, former Fed chief Greenspan was considered one of the most powerful men in the world, simply by changing short-term interest rates in response to inflation. But the Great Moderation that he oversaw, it turns out, was an illusion, and Greenspan has admitted that his beliefs in a self-correcting free market were wrong.

Now Bernanke, the soft-spoken but authoritative academic, has redefined the Federal Reserve on the fly and exercised powers that Greenspan never dared touch. Bernanke's strategy is risky, and only time will determine whether he is being brave in averting a larger crisis, or reckless in unleashing inflation that could increase quickly and uncontrollably. Today, Bernanke's gamble looks like the worst possible alternative, apart from all the others.

Simon Johnson, a professor at MIT's Sloan School of Management and the former chief economist of the International Monetary Fund, and James Kwak, a student at Yale Law School, are co-founders of BaselineScenario.com, which tracks the global financial crisis.

Post a Comment

[View all comments](#) that have been posted about this article.

You must be logged in to leave a comment. [Login](#) | [Register](#)

Submit

Comments that include profanity or personal attacks or other inappropriate comments or material will be removed from the site. Additionally, entries that are unsigned or contain "signatures" by someone other than the actual author will be removed. Finally, we will take steps to block users who violate any of our posting standards, terms of use or privacy policies or any other policies governing this site. Please review the [full rules](#) governing commentaries and discussions. You are fully responsible for the content that you post.

© 2009 The Washington Post Company

Ads by Google

[The Truth on Wall Street](#)

Exposed: Greenspan & the Other 9 Culprits of the Financial Crisis.
www.WealthDaily.com/Wall_Street

[Compare the Acura MDX](#)

Special leasing available for well- qualified buyers. Learn more today.
www.acura.com

[Plan For Hyperinflation](#)

How to beat hyperinflation before It cripples the economy – Report
www.freeinvestingreports.com