MONETARY POLICY AND FINANCIAL STABILITY UNDER GREENSPAN AND BERNANKE

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Abstract

This paper is intended to examine the link between monetary policy and financial stability. We begin with a general discussion in the form of a literature review. No doubt, proper regulation and effective supervision are crucial to keeping the financial system stable. We claim that financial deregulation has undermined these conditions. Under such circumstances monetary policy may particularly easily create conditions which are propitious to the development of financial imbalances. Monetary policy may be a reason for asset price booms (and bust) and financial distress even though goods and services prices remain stable. This suggests a need for activist policy targeted at financial stability which we discuss in the second part of the paper. It shows that policy oriented at contradicting asset price inflation has not been generally accepted. In particular, under "Greenspan's doctrine" any activist policy promoting financial stability as a goal independent from price stability has been refuted. This leads us to a closer look at the Fed's monetary policy under Greenspan in the third part of the paper. We claim that this policy was successful in many respects but it failed to recognize the risks of financial instability and eventually it became pro-cyclical. In this sense the present financial and economic crisis is a part of Greenspan's legacy. In the fourth part of the paper we analyze the Fed's policy in face of the crisis under the current Chairman Ben Bernanke. This policy is based on very aggressive injection of liquidity on the scale never experienced before which creates risks for healthy financial foundation of the economy. The last part of the paper offers short conclusions.

***Keywords**: Federal Reserve, Monetary Policy, financial crisis, asset price inflation*

***JEL codes:** E02, E32, E44, E52, E61, G18*

1. Monetary Policy and Financial Stability

Price stability (low inflation) and to a degree high employment or economic growth are fairly uncontroversial goals of monetary policy. It is not so easy when it comes to financial stability (stability of financial markets and institutions). Before we discuss whether a central bank should include financial stability among its monetary policy goals we will consider reasons for a financial crisis, in particular we will check whether a monetary policy itself can be conducive to financial distress.

The substance of any financial crisis is an immense and rapid decline in the value of a category of assets. Such an explanation, however trivial, is in contradiction to the efficient market hypothesis. It is not the purpose of this paper to discredit the hypothesis; it is clear that in spite of its formal elegance it proved to be misleading in the perception of the functioning of financial markets. This is a matter of fact. However, an explanation why markets are not efficient and "irrational exuberance" or "speculative manias" happen is not so trivial any more. This is, first of all, subject to the behavioral theory of finance. Leaving apart academic theories let's take here for granted that investors not necessarily make rational decisions and that markets are not always, if ever, effective. Asset price bubbles are a phenomenon difficult to deny. Instead of analyzing in what regard human beings are not perfectly rational let's try to identify factors that lead to a build-up of financial imbalances.

Firstly, it is useful to notice that speculative manias took place under the gold standard, too; consider the "tulip mania" in Holland in the 17th century or the collapse of the East India Company in England. It proves that an active interest rate policy of a modern central bank is not a necessary condition for a crisis. However, it does not say that monetary policy can't be a sufficient factor to bring about financial distress.

Secondly, the risk of a financial crisis can be diminished by proper regulation of the financial market. Generally, the need for regulatory restrictions is not questioned. However, regulation restraining some activities creates incentives to look for loopholes. A good example is given by Engdahl[1] "The original intent of the Basle Accord was to force banks to reduce lending risk. The actual effect for US banks was just the opposite. They soon discovered a gaping

[1]ENGDAHL, F.W. (2008 V), *The Financial Tsunami*, Part V, Speculative Onslaught. Crisis of the World Financial System: The Financial Predators Had a Ball, www.globalresearch.ca, access 24.04.2008

loophole – off-balance-sheet transactions, notably derivation positions and securitization." As an effect of securitization "the lending bank now no longer had to worry if the loan would ever be repaid."

Regulation not only creates incentives for financial institutions to look for loopholes but it also makes regulators wonder about the trade-off between making markets safer or making them more effective and credit less expensive. A devoted advocate of financial liberalization was Greenspan as the governor of the Fed. In particular, Greenspan's opinion presented in 1987 to the US House of Representatives Committee on Banking clearly shows what was his choice concerning the trade-off: "…repeal of Glass-Steagall would provide significant public benefits consistent with a manageable increase in risk".[2] Greenspan repeated this mantra until final repeal of the act in 1999.

The Glass-Steagall Act of 1933 was intended, broadly speaking, to restrict commercial banks from speculative investing in risky assets and from resulting conflicts of interest which lay behind the crash of 1929. Another example of liberalization of the financial market in the US is the decision by the Fed in 1974 to lower to 50% the margin requirements for the purchase of stocks on credit (Regulation T) - the requirement had been at 100% since 1934. Even in the face of the dot.com bubble Greenspan repeatedly refused to change the stock margin requirements, although "influential observers, including financier George Soros and Stanley Fisher, deputy director at the IMF, advocated that the FED let the air out of the credit boom by raising margin requirements".[3] These remarks, far from an extensive discussion of financial regulation and liberalization, only illustrate the role which proper regulation plays in restricting a conflict of interest, excessive accumulation of risks and immoderate credit supply. Without doubt, were good regulation in place, any financial crisis would be less probable or less severe.

Moreover, proper regulation must be accompanied by effective supervision. It was clearly missing in the case of the huge sale of non-delivery forward currency contracts by Russian banks before the Russian crisis in 1998 or in the case of the Madoff affair when the Securities and Exchange Commission did not undertake necessary activities. It is true that financial markets

[2]ENGDAHL, F.W. (2008 III), *The Financial Tsunami*, Part III, Greenspan's Grand Design, www.financialsense.com/editorials/engdahl/2008, access 24.04.2008
[3]ENGDAHL, F.W. (2008 III), *The Financial Tsunami*, Part III, Greenspan's Grand Design, www.financialsense.com/editorials/engdahl/2008, access 24.04.2008

become more and more complicated and difficult to control (especially when loosely regulated). This observation may result in defeatist attitudes. Greenspan said: "It is, thus, all the more important to recognize that twenty-first century financial regulation is going to increasingly have to rely on private counterparty surveillance to achieve safety and soundness. There is no credible way to envision most government financial regulation being other than oversight of the process. As the complexity of financial intermediation on a worldwide scale continues to increase, the conventional regulatory examination process will become obsolete – at least for the more complex banking systems."[4]

For the time being let's accept two broad statements. Firstly, market participants are sometimes prone to speculative manias which lead to build-up of asset price bubbles. Secondly, proper regulation and supervision may reduce the risk and severity of a financial crisis. Given that, it is more important whether there are any economic, in particular monetary, conditions which would be favourable to financial imbalances.

The financial crisis is triggered by a factor or an event that Minsky called a displacement. A displacement occurs when investors get excited about something—an invention, such as railroads or the internet, or a war, or a major change of economic policy. It also might be a change in the way the financial market operates; an invention of new financial instruments or changes in the regulatory framework.

Minsky[5] points out that "the relations upon which the monetary authorities base their operations are predicted upon the assumption that a given set of institutions and usages exist. If the operations of the authorities have side effects in that they induce changes in financial institutions and usages, then the relations shift. As a result, the side effects of monetary operation can be quite different from those desired".

In fact, Minsky[6] not only points out at a spectacular event being a displacement but also at "prosperity" being a product of expansionary policy as a milieu where lending booms and speculation thrive. This is an important aspect of his financial instability hypothesis. "The first theorem of the financial instability hypothesis is that the economy has financing regimes under

[4] ENGDAHL, F. W. (2008 IV), *The Financial Tsunami, Part IV, Financial Crisis: Asset Securatization – The Last Tango*, www.globalresearch.ca, access 12.04.2008
[5] MINSKY, H., *Can "It" Happen Again?, Essays on Instability and Finance*, M.E. Sharpe, 1982:162
[6] MINSKY, H., *The Financial Instability Hypothesis*, The Jerome Levy Economics Institute of Bard College, Working Paper no. 74, 1992:7

which it is stable and financing regimes in which it is unstable. The second theorem of the financial instability hypothesis is that over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system."

It seems that both factors – a displacement and prosperity – matter. In the case of the dot.com bubble, for example, it was the development of new technologies which made investors exited but it was also a time of "prosperity" – a long period of low interest rates and credit boom.

These remarks are not very far from a statement that monetary policy may create conditions which are propitious to the development of financial imbalances. This idea is openly expressed by White[7] "(…) persistently easy monetary conditions can lead to the cumulative build-up over time of significant deviations from historical norms – whether in terms of debt levels, saving ratios, asset prices or other indicators of "imbalances" The historical record indicates that mean reversion is a common outcome, with associated negative implications for future aggregate demand."

The same idea is presented by Borio and Lowe[8] "(…) low and possibly falling inflation together with a high degree of credibility of monetary policy would give little reason for the authorities to tighten policy if they respond only to clear signs of inflationary pressures. Paradoxically, (…) endogenous responses to credible monetary policy increase the probability that latent inflation pressures manifest themselves in the development of imbalances in the financial system, rather than immediate upward pressure on higher goods and services price inflation. Failure to respond to these imbalances, either using monetary policy or another policy instrument, may ultimately increase the risk of both financial instability and subsequently deflation." It seems that the earlier mentioned "side effects of monetary operation" by Minsky have very much in common with "endogenous responses to credible monetary policy" by Borio and Lowe.

The suggestion by Borio and Lowe that monetary policy may be a reason for financial distress and that it should respond to imbalances even though goods and services prices remain

[7]WHITE, W.R. 2006:1, *Procyclicality in the financial system: do we need a new macrofinancial stabilization framework?* BIS Working Paper no 193.
[8]BORIO, C., LOWE, P. 2002:22, *Asset prices, financial and monetary stability: exploring the nexus*, BIS Working Paper no 114.

stable is a good starting point to the next part of the paper, which presents this issue in more detail.

2. Can the Fed's monetary policy contradict asset price booms?

The opinion that monetary policy should consider financial stability as a target independent from price stability and that failure to respond to financial imbalances may be a reason for a crisis is not generally accepted at all. In particular, it does not seem to have been shared by the Fed policymakers. A contradictory view that central banks should restrict from manipulating asset prices used to be called "Greenspan's doctrine". This is well expressed by Bernanke and Gertler[9] "In brief, it is that flexible inflation-targeting provides an effective, unified framework for achieving both general macroeconomic stability and financial stability. Given a strong commitment to stabilizing expected inflation, it is neither necessary nor desirable for monetary policy to respond to changes in asset prices, except to the extent that they help to forecast inflationary or deflationary pressures." Bernanke and Gertler[10] justify this opinion claiming that "a key advantage of the inflation-targeting framework is that it induces policymakers to automatically adjust interest rates in a stabilizing direction in the face of asset price instability or other financial disturbances. The logic is straightforward; since asset price increases stimulate aggregate demand and asset price declines reduce it, the strong focus of inflation targeters on stabilizing aggregate demand will result in "leaning against the wind" – raising interest rates as asset prices rise and reducing them when they fall." This straightforward logic is, however, only a pure academic speculation which not necessarily - and not in fact - has much to do with the reality. It is not only against other professional opinions – such as that by Borio and Lowe above – but it is first of all in a sharp contradiction to the experience of many cases of a financial distress, including the present crisis.

Moreover, this false opinion is a corner-stone of a formal model presented by Bernanke and Gertler[11] which "scientifically" justifies no need to react in an independent manner to financial market imbalances. "Greenspan has (...) safely retired, written his memoirs and handed

[9]BERNANKE, B., GERTLER, M. (2000:45), *Monetary Policy and Asset Price Volatility*, NBER Working Paper 7559.
[10]BERNANKE, B., GERTLER, M. (2000:14), *Monetary Policy and Asset Price Volatility*, NBER Working Paper 7559.
[11]BERNANKE, B., GERTLER, M. (2000:14), *Monetary Policy and Asset Price Volatility*, NBER Working Paper 7559.

the control (and blame) of the mess to a young ex-Princeton professor, Ben Bernanke. As a Princeton graduate, I can only say I would never trust monetary policy for the world's most powerful central bank in the hands of a Princeton economics professor. Keep them in their ivy-covered towers."[12]

Another argument against activist policy targeted at financial stability is alleged impossibility to differentiate between a bubble and fundamentally sound growth of asset prices. Bernanke and Gertler argue that "because "fundamental discount rate" is not directly observable, it is in general impossible to know whether there is a non-fundamental component in the current stock price." [13]

Similar opinion on the role of monetary policy to prevent asset bubbles and financial instability is presented by Bordo et al who write "that a monetary regime that produces aggregate price stability will, as a by-product, tend to promote stability of the financial system". [14]

In these days such opinions seem to be without doubt negatively verified by the experience of the present crisis and the economic situation in the years and months preceding. However, this experience is not unique at all. Also recommendations for monetary policy to counter build-up of financial imbalances are not a recent idea. Borio and Lowe maintained that "in principle, safeguards in the financial sphere, in the form of prudential regulation and supervision, might be sufficient to prevent financial distress. In practice, however, they may be less than fully satisfactory. If the imbalances are large enough, the end-result could be a severe recession coupled with price deflation. While such imbalances can be difficult to identify ex ante, the results presented in this paper provide some evidence that useful measures can be developed. This suggests that, despite the difficulties involved, a monetary policy response to imbalances as they build up may be both possible and appropriate in some circumstances." [15]

[12] GREENSPAN, A., "The Age of Turbulence: Adventures in a New World", Penguin, 2007.
[13] BERNANKE, B., M. GERTLER (2000:7), *Monetary Policy and Asset Price Volatility*, NBER Working Paper 7559.
[14]BORDO, M., M. DUEKER, D. Wheelock 2000:27 *Aggregate price shocks and financial instability: an historical analysis*, NBER Working Paper 7652.
[15]BORIO, C., P. LOWE 2002:1, *Asset prices, financial and monetary stability: exploring the nexus*, BIS Working Paper no 114.

Looking at the problem from a specific perspective also White[16] gives his support to monetary policy which reacts to symptoms of financial imbalances. White argues that price stabilization which tries to avoid periods of deflation (what is characteristic for definitions of price stability as a central bank's target) sometimes may be too expansionary and it may lead to an asset price bubble. This may happen in a situation of "good deflation" when prices decrease as an effect of some positive supply shocks such as rapid growth of productivity or – as recently – globalization. However, it is interesting in this context to ask to what degree monetary policy should be more accommodative in case of "bad deflation" – one induced by a financial crisis and falling demand - without risking it may turn out to have been too easy.

In spite of its clear commitment to price stability ECB was in favor of a monetary policy reactive to financial imbalances. The reaction postulated should follow a strategy of leaning against the wind where "the central bank would adopt a somewhat tighter policy stance in the face of an inflating asset market than it would otherwise allow if confronted with a similar macroeconomic outlook under more normal market conditions. In this way a central bank would, already at an earlier stage of market dynamics, err on the side of caution in trying to avoid feeding the bubble with an accommodative policy. It would thus tolerate a certain deviation from its price stability objective in the shorter term in exchange for enhanced prospects of preserving price and economic stability in the future."[17] Such policy should also help avoid too late reaction which would only "prick the bubble" and thus would trigger a crisis.

3. Greenspan's legacy

In 1998 unemployment in the U.S. reached a 24-year low, inflation hit an 11-year low and consumer confidence was the highest it had been in 30 years. In fact during the 18-year mandate of Greenspan (1987-2006) at the head of the Fed, the U.S. benefited from low inflation and suffered only two recessions. Inflation had not exceeded 5% since 1991.

Greenspan has managed to keep inflation low despite the stock market crash of 1987, several international crisis in the 1990s, a three-year bear market after the burst of the Dotcom bubble in 2000 and a terrorist attack on the world trade centers in New York in September 2001.

[16]WHITE, W. R. 2006:1, *Procyclicality in the financial system: do we need a new macrofinancial stabilization framework?* BIS Working Paper no 193

[17] ECB (2005), *Asset price bubbles and monetary policy*, Monthly Bulletin, April 2005:58

According to Martin Wolf[18], associate editor and chief economics commentator at the Financial Times, Greenspan "has become an almost legendary figure". And that is because Greenspan succeeded in keeping inflation low when it had broken out all over the world. He also did so after succeeding the successful Paul Volcker who, before Greenspan, crushed inflation too.

According to Martin Wolf other reasons also helped the Chairman of the Board of Governors in keeping inflation low with a stable growth: "The monetarist counter revolution, the pain caused by the inflationary excesses of the 1970s, globalization and the weakening of trade union power". Wolf also made a comparison between Greenspan and the "father of Macroeconomics" John Maynard Keynes and asserted that both trust their own judgment and that both believe in "discretionary policymaking" and in the "wisdom of managing the long run by treating it as a series of short runs".

In the Jackson Hole 2005 symposium, Greenspan stated that his own approach to monetary policy was the following: "Maximum sustainable economic growth...with price stability pursued as necessary condition to promote that goal."[19] In fact, to Martin Wolf, Greenspan's focus on "maximum growth" along with his will to discover the "economy's speed limit" by trial and error is also one of the reasons behind his success. Moreover, Wolf asserted that Alan Greenspan rejects "monetary targeting" because the relationship between money and spending broke up in the 1980's and early 1990's.

In 1996, the Fed Chairman warned of "Irrational Exuberance" and the idea of bubbles in the economy. Greenspan argued that it is impossible to know whether a bubble is occurring and that the right solution resides in a flexible economy.[20]

A concern about Greenspan's approach to asset price bubbles is that the Fed was indifferent when prices were going up and intervened in an aggressive way when they were falling. According to Wolf, this policy encouraged investors to take excessive risks. He asserted that Greenspan or the Fed should have warned people of the risks they incur in excessive speculation, "rather than act as a cheerleader for U.S. productivity". In fact during the Dotcom

[18] WOLF, M. associate editor and chief economics commentator at the Financial Times; *"The Lessons and challenges for Greenspan's Fed replacement*", FT Wednesday October 19 2005.
[19] www.federalreserve.gov
[20] WOLF, M. associate editor and chief economics commentator at the Financial Times; *"The Lessons and challenges for Greenspan's Fed replacement"*, FT Wednesday October 19 2005.

bubble, Greenspan believed that increasing share prices was a sign of confidence in the growth of American corporations.[21]

Finally, according to Martin Wolf, three lessons should be drawn from the Greenspan era: The first is that it is hard for a central bank, especially the Fed as it is the most important of all, to decide on its monetary policy as it is hard to have a clear understanding of what's clearly going on in an economy, especially in asset prices.[22] This has been clearly demonstrated during the excessive speculation of investors from 1996 to 2000 when no one believed that asset prices were overpriced and did not reflect at all their intrinsic values.

The second is that "giving so much discretion to an institution dominated by one person is risky" [23] In fact it is not until 1994 that the Fed moved towards more transparency and openness to the public. It is in 1994 that it began to reveal the FOMC directives after each FOMC meeting. It is also not until 1999, that it began to announce the "bias" toward which monetary policy was likely to go. Furthermore, it is not until 2002 that the Fed began to report to the press the vote on the federal funds rate target during the FOMC meetings.

Finally, transparency matters. It is not until 2004 that the Fed began to release the minutes of the FOMC meeting after 3 weeks while it was 6 weeks before that date.[24] Even today the Fed is not fully transparent as it does not publish its forecast of the economy nor its target inflation rate as other central banks do. [25]

Clearly, the U.S. economy relies a great deal on the movements of interest rates. The Federal Reserve, responsible for the manipulation of national interest rates, must analyze the current state of the economy and make adjustments that will lead to stable growth and consumer confidence in the nation's financial health. However, as the post 9/11 actions of the Fed show, excessive low interest can fuel too much spending, high consumer debt, low savings, and now combined with a declining dollar and the sub-prime crisis, have a serious consequence—namely stagflation.[26] Factors indicating decline include high oil prices, rising healthcare costs, lingering

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[21] VALDEZ. S, "*An introduction to Global Financial Markets*",4th edition, Palgrave, 2003:191.
[22] WOLF, M. associate editor and chief economics commentator at the Financial Times; *"The Lessons and challenges for Greenspan's Fed replacement"*, FT Wednesday October 19 2005.
[23] WOLF, M. associate editor and chief economics commentator at the Financial Times; *"The Lessons and challenges for Greenspan's Fed replacement"*, FT Wednesday October 19 2005.
[24] MISHKIN,F., EAKINS,S., "*Financial Markets & Institutions*", 5th edition, Pearson (2006), p168.
[25] MISHKIN,F., EAKINS,S., "*Financial Markets & Institutions*", 5th edition, Pearson (2006), p168.
[26] EISENBERG, D. "Greenspans's Deficits." Time, May 2, 2005. p. 44.

fears of terrorism, and an increasing government debt that leaves too much of America's fate in foreign hands.[27]

Overall, the Federal Reserve did a good job of sustaining the U.S. economy after 9/11. Indeed, the purpose of the Federal Reserve is not necessarily to prevent cyclical downturns, but to shield the U.S. economy from sinking too far into the depths of cycles or, conversely, overheating to the point of excessive inflation. The Federal Reserve can also not be blamed for the escalating trade deficit that the federal government accrues by pursuing foreign military operations—it simply must take that into account when fine-tuning the economy. Perhaps more important than measured steps to preserve the U.S. economy would be to end the growing deficits and create a sense of balance in budgetary and trade matters. In the end, the Federal Reserve's actions on interest rates have both positive and negative effects—both micro- and macro- issues must be included when formulating policy in order to achieve success in the U.S. economy.

The Fed is one of the most prestigious institutions in the world. In fact it is not by pure accident that after the terrorist attack on the world trade centre in September 2001, an institution like the Fed, within few hours of the attack, can make the following announcement: "The Federal Reserve System is open and operating".[28]

This message of the Fed to the financial system as a whole was clear: "We are here" and has directly been translated into real actions. The Fed provided $45 billion to banks through the discount window; two hundred times more than the amount provided the week before. The terrorist attacks of September 11th, 2001 on New York City and Washington D.C. were immediately detrimental to the U.S. economy. For example, when the New York Stock Exchange reopened on September 17th, the market fell 684.81 points, and by September 21st had fallen to a level of 8,235.81, compared to 9,605.51 a mere eleven days earlier on September 10th.[29] In New York City alone, physical, economic, and psychological damage estimates range into the hundreds of billions. The tragic loss of life left an indelible mark on American society, and the new psychological vulnerability of the nation's financial heart left consumers and producers alike uncertain of both the near and long term future. The "[American] economy's

[27] MCLEAN, V. *Give the Economy a Break*. USA Today. September 22, 2004, A19..
[28] MISHKIN, F., EAKINS, S. *Financial Markets & Institutions.* 5th edition, Pearson (2006), p. 189.
[29] PETRUNO, T. *Right Response to September 11th Remains Unclear.* LA Times. September 8, 2002.

success is tied to confidence,"[30] so consequently the Federal Reserve acted to eliminate uncertainty and create a new sense of confidence in the economy's psyche.

In the days following the terrorist attacks, the Federal Reserve injected $45 billion in emergency funds into the economy.[31] The logic behind this was to counteract the natural fear of spending consumers and businesses would exhibit after a destructive shock to the economy. For example, despite "patriotic buying" the stock market still plummeted as investors sold on airlines, New York based corporations, and other firms affected by the attacks, as evidenced above. As confidence decreased, Greenspan and the Fed decided to slash already falling interest rates. Before the terrorist attacks, the Fed had already cut interest rates seven times during 2001 in response to the earlier bursting of the Internet bubble and various other factors. On October 3rd, the Fed cut benchmark interest rates one-half percent for the second time since the attack, down to a level of 2.5%, the lowest since 1962; the discount rate for banks also fell one-half percent to 2%.[32]

By December 12th, the Fed cut the rates yet again to a level of 1.75%, for a grand total of eleven cuts and a 4.75 point drop in interest rates for the entire year.[33] These moves were "intended to reduce borrowing costs across the economy, helping to stimulate more economic activity among consumers and businesses," and banks responded by cutting their lending rates at the same rate as the Fed did with each respective cut.[34]

The official recession of the American economy had actually began in March 2001 and lasted only one quarter—the fourth quarter of 2001 (after the terrorist attacks) actually displayed a 1.4% growth rate.[35] Clearly, the dramatic decrease of interest rates did serve to inspire spending in a time of confusion, and also allowed Congress and the President to agree on a federal recovery package for the future. Indeed, by early 2002 experts heralded the onset of economic recovery. However, interest rates continued to plummet up through 2004—down to an absolute low of 1%. While this is a tactic meant to keep spending up, there are negatives worth

[30] EISENBERG, D. Greenspans's Deficits. *Time Magazine* May 2, 2005. p. 44.
[31] ANONYMOUS. A Tribute to an Unlikely Hero of 9/11. *Chicago Defender*. April 18, 2002. p. 9.
[32]STEVENSON, R. Fed Cuts Its Benchmark Rate to 2.5%, Hitting 39-Year Low. *New York Times*. October 3, 2001. A1.
[33]STEVENSON, R. With the Economy Still Fragile the Fed Again Cuts Rates. *NewYork Times*. December 12, 2001.
[34]STEVENSON, R. With the Economy Still Fragile the Fed Again Cuts Rates. *NewYork Times*. December 12, 2001.
[35] STEVENSON, R. Fed Chief Sees Decline Over; House Passes Recovery Bill. *New York Times*. March 8, 2002.

mentioning. Savings accounts, especially for retirees and baby boomers, returned very little. Consumers accumulated a high debt on credit cards and mortgages, and the federal government became more reliant on foreign capital because of a growing trade and budget deficit. Only in late 2004 did the Fed begin to raise interest rates again, up to 2.25% by the end of that year.[36] Raising interest rates increases savings returns but also premiums on mortgage, loan, and credit payments.

Greenspan's Fed was to hold rates at 1 per cent from 2003 to June 2004, long after the dotcom bubble was over. It is clear that monetary policy was too accommodative. Rates of 1 per cent were bound to encourage all kinds of risky behaviour. Greenspan's book[37] tried to clear his name by blaming the bubble on an Asian savings glut, which purportedly created stimulus beyond the control of the Fed by driving down global bond rates.

The Federal Reserve and Greenspan's[38] leadership of it does bear part of the blame for the subprime collapse and the wider damage to which it has led. As is becoming ever more apparent, many of the lending practices in the mortgage market during these years, especially in the subprime market, involved carelessness, deception, or both. Many people borrowed who had no prospect of servicing the loans they took out; they were hoping either to resell the house at a higher price, or to refinance it and draw on the appreciated value to make their payments. Some borrowers were apparently induced to buy houses they could not afford, or to take out loans they should not have been granted, by irresponsible brokers and other agents keen to make commissions on transactions despite knowing they were inappropriate.

Many of the banks that packaged these loans into securities also put them into complex investment "vehicles" that they did not understand, and sold them to investors who understood even less about them. The credit rating agencies, on which investors normally rely to inform them of such risks, were at best useless. Today the wreckage, consisting of abandoned houses, defaulted loans, displaced homeowners, banks making good on the billions of dollars of losses they had guaranteed, and uninsured investors marking down their portfolios, can be seen everywhere. With respect to the housing bubble, the Fed asserts its innocence. It says that

[36] "Interest Rates and Deficits." *The New York Times*. Late edition. December 18, 2004.
[37] GREENSPAN, A., *The Age of Turbulence: Adventures in a New World*, Penguin, 2007.
[38] GREENSPAN, A., *The Age of Turbulence: Adventures in a New World,* Penguin, 2007.

monetary policy was appropriate. It also takes the position that while, ex post, it is clear that supervision and regulation was too lax, no one saw the housing and credit bubble forming.

Consequently, they cannot be blamed. The assertion that the stance of monetary policy was appropriate given the measured inflation rate just assumes away the problem. If policy contributed to the bubble, then it was inappropriate regardless of the inflation rate. Contrary to the Fed position, people did see the housing and credit bubbles forming, although they were in the minority. Most importantly, the Fed as the central bank and the principle banking regulator alone had the responsibility of forestalling systemic risks. Even if no one else saw the bubble forming, the Fed should have. Saying no one else saw the crisis brewing is no defence.

4. The Bernanke monetary policy reaction to the financial crisis

There are two aspects of a major financial crisis; firstly, a fast and deep fall in asset prices and, secondly, financial instability – a risk of a breakdown of the financial system due to bankruptcy of financial institutions of the systemic importance or disorganization of an important segments of the financial market. A general outcome is usually a credit crunch and economic stagnation or recession. It is widely accepted that central bank's role is not to exert an impact on asset prices but to protect the financial system and the financial market from a systemic collapse and to prompt economic recovery. According to Mishkin and White "financial instability is the key problem facing the policymaker and not stock market crashes, even if they reflect the bursting of an asset price bubble. If the balance sheets of financial institutions are initially strong, then a stock market crash (bursting of a bubble) is unlikely to lead to financial instability. In this case, the effect of a stock market crash on the economy will operate through the usual wealth and cost of capital channels, only requiring the monetary policymakers to respond to the standard effects of stock market decline on aggregate demand." [39]

The problem is, however, that asset price bubbles are typically accompanied by excessive lending and leverage, risky investment and weak balance sheets of financial and non-financial, debtor institutions.

[39] MISHKIN, F. S., WHITE, E. N. *U.S. Stock Market Crashes and Their Aftermath: Implications for Monetary Policy*, Asset Price Bubbles Conference, Federal Reserve Bank of Chicago and The World Bank, Chicago, Illinois, April 23, 2002:16.

It is thus typical that bursting of an asset price bubble demands some involvement of the central bank beyond its commitment to maintain price stability or its intent to bar aggregate demand from falling. In such a juncture the central bank acts as a lender of last resort. Although this role of a central bank is essentially uncontroversial, during serious crises it can be addressed towards many financial institutions, take huge amounts of bail-out and become eventually a vast infusion of liquidity to the economy, without much respect to considerations other than avoiding the pending financial catastrophe. Such activity is certainly beyond monetary policymaker's response to "the standard effects of stock market decline on aggregate demand." Unfortunately, these efforts may not be very effective in promoting economic recovery, even when they take the form of quantitative easing, as in Japan.

In ECB's opinion[40] "one argument in favour of a policy of "leaning against the wind" is symmetry". This is most welcome as a postulate but when it comes to a crisis it seems there is no much room for symmetry. Moreover, even when anti-bubble tightening of the monetary policy would be accepted in principle, the monetary policymaker may be reluctant to raise interest rates. "In any event, any asset price "misalignments" are difficult to identify and cannot be effectively resisted since that would require interest rate increases that would be destructive elsewhere in the economy. Conversely, any slowdown in economic activity associated with an asset price "bust" can be effectively resisted through an easing of monetary policy. This could impart a degree of asymmetry to the conduct of domestic monetary policy in the face of such disturbances."[41] This quotation clearly presents why monetary policy tends to be asymmetric. We would only add and repeat that easing would rather not be very effective in promoting economic growth; the central bank, however, supplies abundant liquidity also for the reasons of financial stability.

What might be longer-term results of such loosening of monetary policy? A good answer to this question is given by White[42] who claims that "lower interest rates can enhance "search for yield". This will particularly be the case for financial institutions (like insurance companies and defined benefit pension funds) that must hit predetermined hurdle rates. This both induces investors to purchase increasingly risky assets, and to use increased leverage to raise rates of

[40] ECB (2005), *Asset price bubbles and monetary policy*, Monthly Bulletin, April 2005:58.
[41] WHITE, W.R. (2006), *Is price stability enough?* BIS Working Paper no 205:11.
[42] WHITE, W.R. (2006), *Is price stability enough?* BIS Working Paper no 205:13-14.

return on equity. Such behaviour becomes manifest in reductions in risk premia on lower-rated paper and sovereigns, and on the increased availability of low cost finance to support venture capital investments and to purchase asset-backed securities. On the one hand, this encourages aggregate spending and investment as desired. On the other hand, should certain sectors be particularly favourably affected (...) this could set the scene for another burst of credit-fuelled misallocations further down the line."

The way the present crisis is managed is based on liquidity injection on the scale not seen ever before. Only between August and November 2008 the Fed's balance grew from 900 billion US Dollars to 2.2 trillion US Dollars. Also in November 2008 the Fed announced new projects which are to boost the monetary base by another 800 billion US Dollars; the Fed decided to buy up to 100 billion US Dollars of debt directly issued by mortgage lenders Fannie Mae and Freddie Mac and 500 billion US Dollars of their mortgage-backed securities (MBSs) and it created Term Asset-Backed Securities Loan Facilities (TALF) of 200 billion US Dollars which is to lend against a collateral of ABS (asset-backed securities) backed by newly originated consumer and small business loans. In February 2009 the amount of TALF resources was increased to 1 trillion US Dollars. TALF is to realize the aims of Troubled Asset Relief Program (TARP) passed earlier last year by Congress – the money was, however, used mainly to bail-out troubled financial institutions. Press comments are not necessarily enthusiastic; "Under the guise of successive new programmes, each with a less memorable acronym than the last, the Fed is substituting its balance-sheet for that of the contracting private financial system to keep the American economy from being starved of credit." "The MBS purchases are significant; for the first time they turn the Fed into a direct lender to consumers. Many homeowners, though they do not know it, will be sending their monthly mortgage payments to the Fed." [43]

On March 18th, 2009 the FED announced that it would purchase 300 billion US Dollars in Treasury debt (what is monetization of huge public deficits and raises questions about future independence of the FED), it would boost its purchases of MBSs to 1.25 trillion US Dollars from previously declared 500 billion US Dollars and it would buy 200 billion US Dollars of debt issued by Fannie Mae and Freddie Mac and not 100 billion US Dollars as announced in

[43] Economist (2008), *Plan C*, November 27th, 2008.

November 2008. In fact, it is difficult to follow new programmes which are to revive lending in the American economy. These steps taken by the Fed are very unconventional central banking, to say the least; they are examples of quantitative easing after nominal Fed funds rate has been cut virtually to zero. Money is for nothing, and the Fed is "pushing the string" now.

Some other central banks are also eager to get credit flowing with the use of quantitative easing. The Bank of England announced on March 5th, 2009 that it would buy government securities and private assets for 75 billion pounds (105 billion US Dollars).

The present activities of the Fed and the American Treasury are aimed at absorbing troubled assets from the private financial sector, helping financial institutions to reduce their leverage, restoring confidence, reducing premia and yields and making credit flow again. To a degree they are successful – yields and premia have declined and there is more confidence. What concerns the "strategic" aims, these activities do not seem to be very effective. Money is sticking in financial institutions instead of fuelling new lending and boosting the economy. "But precious little of (...) additional liquidity is finding its way through to households and corporate borrowers. In fact, most of it is now sloshing around the banking system like so much excess ballast. Banks have increased their reserve holdings on deposit with the Fed from $8 billion to $494 billion. This is $488 billion more than the Fed estimates they would ordinarily need for payment clearing and prudential purposes." [44]

The fact that this money remains idle may reflect an approach to the economy of households, firms and – eventually – financial institutions more realistic than that of the central bank. If the economy has been choked with cheap and too easily accessible credit it does not seem that even more credit is a solution. Of course, preventing the financial system from a collapse and viable firms from bankruptcy due to the credit crunch, although not without costs, is a reasonable policy. It is also true that negative market sentiment may be self-fulfilling. When most of the agents decide rightly to cut their excessive spending it reduces future incomes and – if we still believe in rational expectations – make agents to economize even harder. This is a non-optimal Nash – and Keynes – equilibrium. It is thus advisable that the economic policy try to

[44]KEMP, J. (2008), *TARP and Fed facilities unravel*, http://blogs.reuters.com?great-debate/2008/11/13/tarp-and-fed-facilities-unravel, access 8. 02. 2009.

change these pessimistic sentiments. It may use fiscal instruments for that purpose and a reasonably easy monetary stance might help as well. Restrictive monetary policy would aggravate problems. With regard to the Great Depression this last statement is subject to Friedman-Schwartz hypothesis which claims that the depression was so deep and long because monetary policy was not accommodative enough. Having said this we are still convinced that flooding the economy with money, bailing-out fraudulent and irresponsible financial institutions, their managers and stock-holders, keeping alive "zombie" firms and offering more credit to "ninja"(no income, no job, no assets) households is not the right policy. Hopefully, financial institutions and firms are now more cautious than some central bankers and hopefully they are afraid to lose more money even though it is virtually for nothing - but still to be repaid. One may expect, also households should realize their true creditworthiness.

What is going to happen with this enormous amount of high-powered, idle money when the economic situation calms down? Is it going to fuel another "search for yield" and boost another bubble? Or probably in a changed environment it is going to spur goods and services inflation. In theory, this money could be also "mopped" back by the central bank. In practice, it is now difficult to imagine. This monetary hangover becomes a reason for anxiety which is also expressed in the press: "Having expanded its balance-sheet so rapidly, the Fed may not have the foresight or courage to shrink it fast enough once the crisis passes, and the extra liquidity could fuel an overheating economy." [45]

5. Conclusions

The Fed is the most influential central bank – and possibly financial institution - in the world. However, its monetary policy remains discretionary, not fully transparent and concentrated in the hands of its chairman. The Chairman's views and actions determine the monetary policy of the bank. This is particularly clear in the case of Greenspan's tenure which is described with terms such as "Greenspan era" or "Greenspan's doctrine". Greenspan's monetary policy was successful with respect to low inflation, economic growth and quick reaction to shocks, in particular 11 September 2001. However, it refused to take the responsibility of financial stability comprehensively. In fact, it restricted itself only to reaction to any financial

[45] Economist (2008), *Plan C*, November 27th, 2008.

distress emerging. Moreover, the Fed used to continue lax monetary policy for too long, it thus fuelled next bubbles and any eventual change of its monetary policy stance was a bit of a pricking of a bubble. This policy was clearly asymmetric and not very consistent. In doing so the Fed boosted moral hazard, excessive and too risky investment and high indebtedness.

The reaction of Bernanke's Fed to the present financial crisis is canonical in terms of Greenspan's doctrine. The main difference is that the scale of its accommodative steps is enormous even by previous standards. However it is difficult to dare run a novel policy during a major crisis, it is more and more clear that the Fed lacks intellectual courage to give up old mistakes and instead it tries even harder to run the same boom and bust policy.

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