I. Introduction

Federal Reserve policy in the Great Depression of the early 1930s was analyzed in chapter 8 and was found to be very poorly conceived and conducted. Serious errors committed by the Fed include permitting bank reserves to decline significantly during banking panics, sharply raising interest rates in 1931 after Britain abandoned the gold standard, sterilizing gold inflows that would otherwise have expanded bank reserves and the monetary base, abruptly reversing course in mid-1932 after implementing a short-lived expansionary policy of open market security purchases, and doubling reserve requirements in 1936 and 1937. In this chapter, the Fed's policy during the Great Crisis of 2007–2009 and its aftermath is analyzed.

In many ways the challenges that confronted the Federal Reserve during the Great Crisis were more daunting than those of the 1930s. The recent crisis had the potential to do even more damage to the nation's economy. First, the series of financial innovations that gave us collateralized debt obligations, credit default swaps, and other poorly understood and dangerous instruments did not have an analogous counterpart in the 1930s. And a regulatory framework appropriate for the new financial technology was not in place. Second, the rapid expansion of the largely unregulated shadow banking system made the recent crisis more complicated and challenging. Third, given that two bubbles burst (housing and stock markets) at the beginning of the recent crisis, and that ownership of stocks and houses was more widespread in 2007 than in 1929, the pervasiveness of loss of wealth was relatively greater. Fourth, given the globalization movement of recent decades, the degree of interconnectedness among nations is much
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greater today than in earlier times. For example, U.S. imports increased from less than 4 percent of GDP in the late 1920s to more than 15 percent in recent years. The influence of declining economic activity in the United States on other nations (and the reverse feedback on the United States) is stronger today than in earlier times. And capital flows across nations loom much larger today. This meant that it was even more essential in the Great Crisis for central banks around the world to coordinate their responses.

Federal Reserve chairman Bernanke admits that he and his Federal Reserve colleagues were blindsided by the crisis, underestimating the interconnectedness and fragility of the various elements of the financial system. Nevertheless, the creativity and forcefulness with which the Bernanke-led Federal Reserve reacted to the crisis once it reached full force in fall 2008 stands in contrast to the passive Fed behavior in the Great Depression. In September 2007, two months before the Great Recession officially began, the Fed began reducing interest rates. While hindsight indicates the Fed should have reacted more strongly in the months immediately preceding the September 2008 Lehman Brothers collapse, it did then unleash an unprecedented number and variety of initiatives to prevent a meltdown of the financial system and an economic contraction that could potentially have been more severe than the catastrophe of the early 1930s.

One of the early signs of the financial tsunami that was to wreak havoc on economies throughout the world and challenge the most creative of central bankers occurred on August 9, 2007. On that date BNP Paribas, a Paris-based bank and one of the world's largest, announced that it was freezing three of its investment funds to forestall an impending run by shareholders. Within a week, several other European banks followed BNP Paribas' example. These banks moved to prevent shareholders from withdrawing their accounts because the banks could not place a specific value on the subprime mortgage-backed securities (MBS) owned by their investment funds. It was not clear whether these funds were solvent because trading in the mortgage-backed bonds had ceased, making it impossible to know the value of the bonds.

BNP Paribas may not have been in appreciably different straits than many other large banks. Rather, it was simply the first to publicly acknowledge the uncertain value of its MBS. Market observers quickly recognized that this meant that it was impossible to know whether several of the largest U.S. banks that held large portfolios of mortgage-related instruments were solvent. Among other things, this meant that banks that normally engaged routinely in lending to other banks in the interbank markets perceived that such loans were now quite risky because their prospective counterparties—other banks seeking to