Chapter 11


I. Introduction

Federal Reserve policy in the Great Depression of the early 1930s was analyzed in chapter 10 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 conduct of Fed policy during the Great Crisis of 2007–2009 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 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 inter-
connectedness 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 started,
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 unprec-
edented 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 cen-
tral 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 sharehold-
ers. 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 sol-
vent. Among other things, this meant that banks that normally engaged rou-
tinely 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 borrow—might be unable to make good on the loans. Hence,
the critically important interbank markets began to shut down.

Acutely aware of the implications of the BNP Paribas announcement for
the demand for liquidity in financial markets, the Federal Reserve immedi-
ately issued a statement indicating that it stood ready to provide liquidity
through the discount window. One week later, the Fed announced it was
lowering its discount rate to reduce the normal spread between the discount
rate and the federal funds rate (FFR) target from 1 to 0.5 percentage points.
When banks still balked at using the discount window to obtain liquidity,
the Fed in December 2007 initiated a new auction-loan program designed to
encourage banks to avail themselves of credit through the Federal Reserve.