The Washington Post

For Obama, the Only Choice for the Fed

By Robert J. Samuelson
Wednesday, August 26, 2009

It would have been insane (not to be too subtle) for President Obama not to nominate Ben Bernanke to a second term as chairman of the Federal Reserve Board. The economics dictated it; the politics dictated it.

Imagine the fallout if Obama had instead selected White House economic counselor Lawrence Summers. The next-day stories would have been predictably critical. Was Obama trying to compromise the Fed's "independence"? Given Summers's reputation for abrasiveness, could he craft a consensus in the key 12-member Federal Open Market Committee? How would the economy respond, considering the strong support for Bernanke among economists, business executives and bankers?

Even naming someone less controversial than Summers -- say, Janet Yellen, president of the Federal Reserve Bank of San Francisco, or Princeton economist Alan Blinder, a former Fed vice chairman -- might "have rattled markets and unsettled the foreign investors," said the Wall Street Journal. Looking ahead, Obama surely anticipated what might have happened if the economy unexpectedly worsened. The shift from Bernanke might be blamed.

Frankly, only a fool wouldn't have reappointed Bernanke. Of course Bernanke has critics in Congress; but that is the fate of any Fed chairman during hard economic times. Beyond these political calculations, however, there was a larger reason to rename Bernanke: He deserved it.

We will never know whether the world might have suffered a depression if Bernanke's Fed had not responded so aggressively. But that is plausible.

Early this year, the Nobel Prize-winning economist and New York Times columnist Paul Krugman issued depression warnings. Bernanke admitted similar fears in interviews with David Wessel, economics editor of the Wall Street Journal and author of "In Fed We Trust." The fact that the global economy is no longer uncontrollably spiraling downward (for 2010, the Economist Intelligence Unit predicts growth of 2.7 percent for the world and 1.8 percent for the United States) was not a foregone conclusion. Nor was it ordained that the panic gripping financial markets just six months ago would subside. From recent lows in March, the U.S. stock market is now up roughly 50 percent.

It is not that Bernanke's performance was flawless. Far from it. He made two blunders.

First, he didn't see the crisis coming. Even after the March 2008 collapse of the investment bank Bear Stearns, he didn't foresee a widespread financial panic or a savage recession. In the summer of 2008, the economy was weakening but seemed -- to Bernanke and most economists -- to be suffering from inflationary "overheating." Consumer prices were increasing at a 5 percent annual rate; oil was peaking at $147 a barrel.

Second, along with then-Treasury Secretary Hank Paulson, Bernanke allowed Lehman Brothers to go bankrupt in September. Both have said they lacked the legal power to rescue Lehman and that no one wanted to buy it. Many observers (including me) find this defense to be self-serving. If Bernanke and Paulson had fully anticipated the consequences of Lehman's failure, they almost certainly would have found a way to save it. Once Lehman collapsed, the crisis got much worse. Banks retreated from lending to one another; investors wouldn't buy new bonds; banks, consumers and businesses hoarded cash. The economy contracted at a 5 to 6 percent annual rate.

Here is where Bernanke distinguished himself. A student of the Great Depression, and especially of the disastrous effects of bank failures, he went well beyond the standard response of lowering interest rates (the overnight federal funds rate dropped effectively to zero by December). The Fed created a dizzying array of "liquidity facilities" that substituted more than $1 trillion of Fed credit for retreating private credit. The Fed supported markets for mortgages, money market funds, commercial paper, auto loans and student loans. The strategy was, as Wessel says, to do "whatever it takes" to avoid a complete loss of credit and confidence -- a loss causing continuous drops in spending and asset prices (for stocks, bonds, homes) and culminating in depression.

Although there were other actors, the Fed's interventions were decisive in halting the panic. It is an open question whether any other Fed chairman -- someone without Bernanke's detailed knowledge of the Depression -- would have been so bold in supporting credit markets. Moreover, Bernanke's approach inspired similar moves abroad. After the 1997-98 Asian financial crisis, Time magazine ran a cover story called "The Committee to Save the World," featuring Summers, then-Fed Chairman Alan Greenspan and then-Treasury Secretary Robert Rubin. An updated version might have Bernanke on the cover under the headline: "The Man Who Saved the World."

But this is also Bernanke's burden. If the Fed doesn't withdraw all that extra credit quickly enough, it may spawn inflation. If it withdraws it too quickly, it may subvert recovery. Failure, either way, could mean that reappointment marks the zenith of Bernanke's prestige.

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