Federal Reserve Policy in the Current Economic Situation

Testimony of
Alan S. Blinder
Gordon S. Rentschler Memorial Professor of Economics and Public Affairs
Princeton University
to the
House Committee on Financial Services

February 26, 2009

Mr. Chairman, Ranking Member Bachus, members of the Committee, I'd like to start by saying that I have read Chairman Bernanke's prepared testimonies of February 10th and February 25th but have not had full benefit of the Q&A that followed each. Subject to that proviso, I agree with the Chairman on almost every particular. And I feel the country is fortunate to have someone as courageous, creative, and thoughtful as Ben Bernanke sitting in that chair in this perilous time. Since October, he has been doing an impossible job very well. Now to some particulars.

<u>Interest rates</u>

Regarding conventional monetary policy, the Fed got off to a rather slow start when the crisis first broke in the summer of 2007, but has more than made up for lost time. Specifically, I applaud the FOMC's decision to lower the federal funds rate to virtually zero in December and pledge to hold it there "for some time."[1] Indeed, it terms of its aggressiveness in cutting rates, the Fed has set an example for the world.

Nevertheless, the economic outlook is bleak, as Chairman Bernanke said yesterday. He made two points that I'd like to underscore. First, he strongly suggested that his own

[1] Ben S. Bernanke, Statement before the Committee on Financial Services, U.S. House of Representatives, February 25, 2009, p. 3. All Bernanke quotations in this testimony are from this source.

outlook for 2009 is worse than the FOMC's central tendency.[2] So is mine. The bottom end of the Committee's range is a 1¼ percent decline over the four quarters of 2009. I expect we'll lose that much ground in the first quarter alone, and I'll be thrilled if the next three quarters net to zero.

Second, he observed that, "If actions taken by the Administration, the Congress, and the Federal Reserve are successful in restoring some measure of financial stability—and only if that is the case, in my view--there is a reasonable prospect that the current recession will end in 2009…" (p. 7). Again, I agree—with emphasis on the "only if" part.

We are now fighting a two-front war and, like most two-front wars, you only win if you prevail on both fronts. Specifically, we must both restore aggregate demand and revive the financial system. The two interact, in both vicious and virtuous cycles. The vicious cycle is what we have experienced to date: first, the financial collapse dragged the real economy down, and now the recession is weakening the financial sector further. But that same interaction can operate as a virtuous cycle: A stronger economy will reduce loan losses, and a stronger financial system will help the economy recover.

Quantitative easing

Let me now turn to *unconventional* monetary policy, which is far more important these days. Here, the Fed has been terrifically creative. I want, in particular, to praise its moving away—to the maximum extent possible, which is not 100%—from the institution-by-institution approach to the market-by-market approach. The former is a series of *ad hoc* rescue operations for (or decisions not to rescue) troubled institutions. These rescue operations, while sometimes necessary, take us nowhere toward a cure and leave markets wondering about the rules of the game. The market-by-market approach,

[2] In his words (p. 7): "I believe that, overall, the downside risks probably outweigh those on the upside."

by contrast, seeks to revive moribund markets, and operates within a set of relatively well-defined rules. Using this approach, the Fed is now supplying the commodity that is in shortest supply these days: the willingness to bear credit risk.

Under normal circumstances, of course, the private sector, not the government, should bear such risks. One day, we will get back to that. But for now, risk premiums in most financial markets are wildly high, and some markets have almost ceased to function. As long as such abnormal conditions persist, the government is right to step in to provide the risk-bearing services that no one else seems willing to provide. The central idea behind the TALF, for example, is for the Fed to nurse one moribund market after another back to health—as it has already done with commercial paper—and then withdraw.

I think that's the right thing to do, and I'd like to contrast it with the idea of buying longer-term Treasury notes and bonds. To be sure, buying long bonds would be on anybody's list of possible quantitative easings, once the federal funds rate is driven to zero. And Chairman Bernanke has mentioned doing precisely that, though not in yesterday's testimony. I must say, however, that I don't understand what purpose would be served by buying long-term Treasuries now. Today's problem is *not* that the yield curve is too steeply sloped; in fact, a steep yield curve probably helps recapitalize banks. The problem, as I have just mentioned, is that various risk premiums are way too high. And I don't see how buying *riskless* Treasury bonds will help that.

Before closing, I'd like to touch briefly on two other issues.

<u>Transparency</u>

First, I applaud Chairman Bernanke's forthright new position on Federal Reserve transparency. He said, "The presumption of the committee will be that the public has a right to know, and that the nondisclosure of information must be affirmatively justified by clearly articulated criteria for confidentiality… (p. 6)" As you may know, this has been my position on Federal Reserve transparency for many years. I think it is the right one, and I am delighted to see the FOMC embrace it—permanently, I hope.

Nationalization

Finally, there has been much talk in recent weeks about nationalizing banks--talk that has not been very helpful, in my view. While I recognize the possibility that some U.S. banks might eventually have to be nationalized, restructured, and then either re-privatized or euthanized, we are not there yet. This seems also to be Chairman Bernanke's position.

My problems with rushing to nationalization can be summarized in four words: *We are not Sweden*. By that, I mean four things:

First, Sweden had a handful of banks, while we have over 8,500. Where to draw the line on nationalization is a real problem since, e.g., nationalizing Bank A but not Bank B will disadvantage Bank B when the two banks compete for funds in the marketplace. For this reason, nationalizing some banks will weaken others. And I don't think anyone contemplates nationalizing all 8,500 banks. Nor should they.

Second, and related, if we began a bank-by-bank nationalization process that wipes out existing shareholders, speculators would start attacking those banks deemed most likely to be nationalized, thus destroying their share values and ballooning their CDSs. Such market reactions could create a vicious cycle of self-fulfilling prophecies.

Third, the nationalization and denationalization process in Sweden was amazingly free of political interference. You ladies and gentlemen can judge better than I, but as a citizen, I'm dubious that that would happen here.

And finally, even though I’m an economist, I wouldn’t entirely dismiss the notion that nationalization is “un-American,” by which I mean that it runs against deeply ingrained political and economic traditions. If so, the act of nationalization might actually undermine rather than enhance confidence.