Bernanke Keeps His Balance On A Tightrope

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Central-bank watchers have been debating whether Ben Bernanke, head of the U.S. Federal Reserve, has been doing the right thing in response to the slowing U.S. economy and the sub-prime mortgage mess currently wreaking havoc in the financial markets. On one side are those who think he is not worried enough about inflation and is far too soft when it comes to "bailing out" institutions that should be allowed to fail after making excessively risky bets. On the other side are those who think he should do anything possible to keep financial markets operating smoothly so as to avoid the next Great Depression. As is often the case in issues of economic policy, the truth is somewhere in between, and we should be thankful that Bernanke is able to find that messy middle ground.

Bernanke's two academic specialities have shaped his views on the economy and monetary policy. First, he studied the causes of the Great Depression, emphasizing how problems in financial markets contributed to the record-breaking economic collapse. Though he is too young to have lived through that dire economic episode, the mistakes made then by policy makers are for Bernanke "professionally" personal. More than most Fed Chairmen, he does not want to be the one who presides over the Second Great Depression.

Then there is his research on inflation-targeting systems, like the one adopted by the Bank of Canada in 1991. These systems are very successful in "anchoring" expectations and thus in keeping actual inflation low and stable. Bernanke's argument that the Fed should also adopt such a system reflects his deep concern regarding the dangers of high inflation, including the considerable cost involved in bringing it down when it gets too high.

These two areas of expertise give Bernanke the ability to find the middle ground in today's messy economic environment. He is surely concerned about America's rising inflation, and often makes exactly this point. Yet he is also concerned about the smooth functioning of the financial markets, and he knows all too well that when these markets cease to operate smoothly, outright declines in output, employment and living standards may follow. His policy actions over the past few months have been designed to provide enough liquidity to keep financial markets functioning, but not enough to create a serious long-run inflation problem.

Some still believe that he went too far in providing loans to J.P. Morgan to purchase Bear Stearns, the large Wall Street firm on the brink of collapse a few weeks ago. But here again we see his balanced approach in action. Bernanke is well aware of the problem of "moral hazard" created when governments stand ready to bail out bankrupt firms, thus leading the firms to make

riskier investments in the first place. And like most economists, he believes that an important part of a free-market system is that individuals or firms who make risky decisions should bear the burden of those decisions, even if bankruptcy is the outcome.

Yet Bernanke also knows that financial markets are not like the markets for shoes or spaghetti or sports cars. Financial firms are interconnected through their transactions and their holdings to other financial firms, and when one firm fails there is a chance that it will bring down others. If only a few small firms go down, the system can easily survive. But if large financial firms fail, there is a chance that other large ones will fail, thus threatening the entire system.

That Bernanke chose to do anything in the Bear Stearns situation shows that he clearly cares about stable markets and is worried about the possibility of systemic failure. Yet the precise form of the Fed intervention also shows that he is not prepared to simply "bail out" firms in trouble. The Federal Reserve extended a loan to J.P. Morgan so that it could purchase the near-bankrupt Bear Stearns. The collateral assets accepted by the Fed are certainly not of the quality that central banks usually accept, but over the long term Bernanke argues these assets are likely to pay off fully.

The logic of the Fed's action was basically this: if we act now to facilitate the purchase of Bear Stearns, the financial markets are less likely to collapse and the economy is more likely to muddle along and eventually recover fully. In this case, the collateral assets will eventually pay off, and everything will turn out well—for the economy and also for the Fed. The alternative is that we do nothing, the financial markets are more likely to collapse and the economy to go through a serious recession. The Fed will be less on the hook for these assets, but the economy will be in a mess.

Though Bernanke is clearly taking a calculated risk, the risks associated with doing nothing are probably worse. And risks are standard fare in monetary policy. We should take comfort in the fact that the person in charge of the Fed deeply understands the various risks at play and continues to find that messy middle ground.

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