Lessons from the Fed's Monetary Policy*

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Ben S. Bernanke:
The 21st Century Monetary Policy: The Federal Reserve from the Great Inflation to COVID-19
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Ben Bernanke received the (shared) Nobel Prize in 2022 for his research on banking and financial crises. His voluminous book, which is briefly described in this article, is partly a summary of his work, but also a search for answers to the question of what has changed in the world. It analyses how the Federal Reserve's activities will transform in the 21st century as a result of these changes.

Bernanke's 8-year term as Chairman lasted until 2014 and coincided with the international financial crisis. Prior to this, he was an outstanding academic and researcher. Starting from 2002, however, he was a senior Fed official. More important than his academic work is his professional achievement in steering the US economy through the biggest financial crisis in a century, in 2008–2009. He averted the collapse of the international financial system and developed the methods that, as the title of his book suggests, may become the tools of the Federal Reserve System in the 21st century.

The book assumes knowledge of how the Fed came into being, its legal basis, its role in the US financial institutional system, how this role changed after the collapse of the gold standard, and the role of the US dollar as the global currency in the world today. The work deals with the above only tangentially and *focuses on the role of the Fed in the US domestic economy*.

As is well known, the Fed is essentially a mixed public-private institution. It is structured like a joint-stock company, but its statutes were approved and can be amended by Congress. It is not "owned" by the state, but rather by private banks which subscribe its shares. These shares are special, non-negotiable securities,

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in exchange for which holders are entitled to a statutory, 6-per cent dividend on their capital contributions and receive free services from the Fed. (One not too well-known fact is that only 38 per cent of US banks are covered by the Fed. Non-member banks are only allowed to operate in the private sector and cannot conduct any transactions with the government. Only the Fed can do this. Non-Fed banks have a separate clearing centre; the Fed provides this service free of charge to member banks.) The Fed's governing body, the Board of Governors (the Board), its Chairperson and Vice Chairperson are appointed by Congress. Members are appointed for 14 years. The chairperson may be elected only from among the members, but s/he and her or his deputy may be appointed for a term of only four years, or possibly, with extension, for another four years. The long-term appointment of board members is a guarantee of independence from political "winds". Which is obviously not perfect, because cooperation with the government in power is necessary. The Fed had a dual mandate (until adoption of the Dodd-Frank Act). Its main objective was to ensure the stability of the value of money, which was ultimately aimed at keeping inflation low. This task was supplemented in the 1970s by the provision of an adequate level of employment. *Finally, after the financial crisis of 2007–2008*, *the Dodd-Frank Act added a third mandate: supervision of the stability of the financial system*.

Of course, inflation is of fundamental importance to government, which is an elected body; after all, it is a broad economic phenomenon that affects voters first and foremost. Inflation "eats away" at the real value of the incomes of small people. But it is not only for them that low inflation is important: it is also important for the capital-owning classes, as this is how their accumulated wealth retains its value. Which aspect is more important to the Fed is open to debate. Many have raised the question of which of the two core tasks it has focused on over the past half century. In this book, Bernanke admits that for a long period of time, the preference was to keep inflation low.

As we know, and the author deals with this in detail, the Philips curve expresses the relationship between inflation and employment. For a relatively long time, it seemed to hold that employment could be expanded at the "cost" of some inflation. As the book points out, this has changed today, and monetary policy has had to change accordingly.

Inflation is not only caused by excess demand due to money abundance: there is also cost inflation. (There is not only demand-pull inflation, but also cost-push inflation.) The two will merge if wage demands are strengthened by price increases. For companies, an increase in wage costs causes cost inflation in the same manner as unexpected increases in energy or material costs. The explosion in energy prices in the 1970s led to *stagflation* in America. Trade union wage demands put pressure on businesses, and as a result growth changed to stagnation. Bernanke's book describes how Volcker, the Fed chairman at the time, broke this down by drastically raising interest rates. Bernanke does not say much about the international implications of this, even though we know that it had consequences outside the US. Developing countries became heavily indebted as their dollar loans became much more expensive. (We Hungarians suffered the same...)

The author also points out that the drastic signs of the crisis soon forced interest rates to be cut, as many sectors of the US economy went bankrupt. After the easing, the recovery started, and we know that under Greenspan, interest rates stayed very low for a long time. (Today, it is considered to have been perhaps too low.) In any case, the US entered a prosperous period. The functioning of the economy was positive, partly due to the resulting developments in the labour market. With unemployment relatively low, Bernanke *described* the labour market *as healthy*.

Here, the reviewer allows herself some critical remarks. Bernanke says nothing about what many US economists, such as Nobel Prize winner J. Stiglitz, sharply criticised that real wages had not risen since Volcker. However, the US economy had been growing steadily. Question: where did the new value generated flow to? Answer: obviously to the owners of the capital, it could not go anywhere else. Previously, workers and capitalists had shared proportionally in the surplus from productivity growth. But for more than 40 years, it has been flowing *only to the rich*, widening income inequalities that are now a source of serious social problems.

But in connection with this statement, we must also quote a third Nobel Prize winner, Angus Deaton, who together with his wife wrote a high-impact book in 2020 entitled *Deaths of Despair*. In their work, they showed the tragic proportions of the suicide rates in America due to alcoholism, drugs and hopelessness, especially among the white working male population... Obviously, because of the increased number of job losses or the fear of losing one's job. The phenomenon also caught the attention of Obama and Trump. Can the labour market then be called "healthy"?

Of course, inflation is not only, and not even primarily, influenced by the Fed's actions. It has a real economic basis. With the advance of globalisation, cheap labour appeared on the world market in large masses, and this depressed wage demands. China's transition to a market economy was a crucial step, as there was significant foreign investment in the Far East and outsourcing in the US made everyone worried about their jobs. The author does not really address this in his book either.

It should be noted that Bernanke does not even give too much thought to the significance of the collapse of the Soviet empire for the economic situation in the developed West. Eastern Europeans represented a well-trained, but cheap workforce. The income flowing from this region brought windfall profits for the

Western countries. And for America, it was also accompanied by a reduction in military spending (although this may not have been such a positive phenomenon for those with a stake in the defence industry). But the unipolar world economy certainly benefited the US politically and economically, at least in terms of economic growth. Low-wage workers in developing and emerging countries *limited the wage demands of American workers*. This led to a situation where workers' real wages did not increase. This was not so tragic for them because low inflation allowed them to expand their consumption with cheap credit and to even start buying their own homes. The US mortgage market boomed! This was a consequence of the big interest rate moderation. But when workers in this "healthy" labour market lost their jobs and could no longer afford their loans (mortgages), the market collapsed. Of course, other factors also played a role in the outbreak of the crisis. Financial innovations proliferated – which Bernanke admits were not brought under real control – and transparency was severely damaged. In the various "repackaged" securities, the buyer's or seller's side and position were not visible at all, and distrust rose exponentially. The liquidity crisis erupted and soon took otherwise solvent financial institutions with it.

The question arises for everyone: how did the supervisory authorities not recognise the dangerous situation? It is important to understand that the US has a very fragmented institutional oversight of the financial sector. Banks are also supervised by the Comptroller of the Currency, the Fed, and the FDIC. The securities market is supervised by the Securities and Exchange Commission, the SEC. (The FDIC and SEC were created in the wake of the 1929 crisis.) The supervisory authority for the securities market was not responsible for macro-prudential supervision, and it did not have the powers and tools to regulate the market properly. And the Fed only supervised the banks. In the end, it managed to avoid the collapse of the financial institutions by multiplying the money available almost without limit. It not only saved commercial banks, but investment banks too! This task, as Bernanke writes, was not very popular with the public. Legislative action always had to contend with public aversion to banks, which obviously influenced Congress's decisions.

The Fed's crisis management was based on the addition of a paragraph (Section 13/3) to the Fed's charter during the Great Depression of 1929–1933, which allowed the *Fed to provide funds to non-banks* in the event of a serious and urgent problem. The paragraph was "dormant" for 70 years, and then "deployed" during the 2007–2008 crisis. Among the huge companies that were bailed out in 2008 were Bear Stearns and AIG... The institutions that received loans had to provide collateral to the Fed, and they repaid the loans once the crisis was over. Thus, taxpayers did not suffer a loss; but the public still found the bailouts difficult to accept. The Dodd-Frank Act therefore clarified the conditions for its application: individual bailouts are no longer allowed, but the Fed is allowed to help troubled groups. The law, as noted above, essentially added a third important issue to the Fed's core responsibilities: the supervision of financial stability. But this cannot be ensured if only the supervision of banks, in the strict sense, falls within the Fed's remit... Because *the institutional composition of the financial sector itself has fundamentally changed*.

Why? This is because over the past twenty years changes have taken place, and for a long time neither society nor the experts grasped the essence of these changes. The Fed's attention used to be focused on banks, which converted short-term funds into long-term loans, not realising that this function had been taken over by the so-called *shadow banks* by the end of the 20th century. These are investment banks, insurance companies and other institutions: venture funds, mortgage lenders, etc., and they represent a very large share of financing around the world... (According to the Financial Stability Board (FSB), they accounted for 49.2 per cent of all financial assets in 2021, and thus ignoring them is a fatal mistake!) Unfortunately, until the summer of 2023, this area was not really regulated in the US, although the role of shadow banking is very large there. It is therefore important for financial stability that the Fed has a way to engage with this sector. In other words, the application of Section 13/3, which is considered exceptional, is becoming increasingly necessary.

For a long time, the main way to fight the crisis was to raise money supply by cutting interest rates, but when the lowest limit of interest rates was reached, *new types of instruments had to be used*. The Fed was not willing to stimulate using negative interest rates (as Switzerland, the ECB and Japan did). The new tool was *quantitative easing*. The book deals in detail with this instrument, which involves the Fed influencing money supply and interest rates on long-term bonds by selling and buying securities with different structures. It operates in a more sophisticated way than the Bank of Japan, which bases it actions on a mechanical quantitative monetary theory. However, the Fed was far less selective in these operations than the ECB, for example, which in some cases explicitly sought to help specific countries. Not always by increasing the money supply, but also by simply changing the maturity composition, the Fed was able to influence the evolution of long-term government bond rates, which was crucial for economic growth. Bernanke describes in detail the types of securities purchased: which government securities were covered, the timing, and the conditions under which they were used. It was debated whether the open market operations should be linked to specific conditions (e.g. subject to which indicators, how much and when these operations were planned to be implemented) or whether it was appropriate to use certain loose phrases in the communication ("in the event of a significant fall in employment"; "in the near future", "subject to economic recovery", etc.). After all, the Fed basically influences the market indirectly. The reader is left with the constant feeling that monetary policy, which focuses on market reactions, is *increasingly* using the tools of *psychology*. Indeed, the market reacts nervously to every sentence from the central bank governors. The speculation starts immediately... Bernanke discusses this in great detail.

What was certainly revolutionary was the Fed's purchase of securities other than government bonds. For decades, we were taught that the central bank is only a bank for banks and has no direct relationship with companies. But when it also bought GM's commercial paper, it was clearly a discretionary move, a direct relationship with a non-bank real economy player. As the crisis subsided, the Fed tried to return to traditional instruments. The author also discusses in detail the events that occurred after his own time in office. This is when *new types of problems* arose.

The *coronavirus crisis* caused serious difficulties for specific companies and entire sectors. International supply chains were disrupted; the pandemic made personal service businesses impossible. These changes were not management failures; they were force majeure. A variety of "subjects" needed temporary help: funds, local authorities, small and medium-sized enterprises, companies, commercial paper dealers. Once again, Section 13/3 was applied.

How the US economy managed to weather this extraordinary situation depended on the cooperation between the Fed and the government. Bernanke shows that the problems caused by the coronavirus crisis required close cooperation between the government and the Fed. There were also arrangements where the government injected some capital into special purpose vehicles (SPVs) set up by the Fed, e.g. to finance the small business sector. These budget funds could be multiplied by the Fed's loans. The funds thus made available helped to overcome the difficulties.

Janet Yellen, who succeeded Bernanke as Fed Chair, was appointed as Treasury Secretary in 2021. In this capacity, she immediately launched the American Rescue Plan. Her experience as a central banker made her aware of what the Fed could and could not do. She saw fiscal sacrifice as necessary, and even inevitable, since capital replacement was sometimes needed. Fed credit is not suitable for this. Because a loan is not a fiscal subsidy; it must be backed by collateral; and it must be repaid. The government also became active, as it specifically used budget resources to help specific actors in the real sector, for final use (p. 274). (Of course, some Fed analysts immediately began to check whether this would have an inflationary effect...) Bernanke clearly points out that monetary policy can *only* strengthen the economy *indirectly* in general, and that this is the only way it can contribute to better living conditions for business and workers. However, he stresses that the use of fiscal instruments is indeed cumbersome; changing the revenue and expenditure side of the budget requires laws and political debates. Monetary policy can adapt more flexibly to unexpected situations (p. 355).

In any case, it shows that the Fed has less discretionary power than other central banks. It refers to the ECB, which subsidised some lending by commercial banks at the expense of its profits. However, the law in the US also delegated certain discretionary powers to the Fed in the CARES Act (e.g. when it set up joint ventures with the Treasury, as I referred to above). Here, in order to survive, lending could take place that could result in losses, but ultimately at the expense of the budget. The line between the Fed's and the government's actions is definitely getting blurred, according to Bernanke.

It can be seen that solutions that were previously considered exceptional are increasingly being incorporated into the monetary policy toolbox of the new phase. That is why the change I mentioned above, namely the introduction of *the third function* into the Fed's statute and practice, was inevitable. How the Fed can achieve this in the future is a fascinating question of monetary theory and practical economic policy.

This is why the Fed is trying to get a more and more accurate picture of the actual state of the economy, including the real economy, not just the financial world. This is the purpose of the so-called "Fed Listens" events, i.e. conferences at which the Fed meets a wide range of economic actors. It listens to them, and asks questions to understand more clearly how its policies affect everyday practices and people's lives. The process was launched in 2019 and has only intensified in the following years, driven by the coronavirus crisis and increasing geopolitical turmoil. The Fed's increasing role in economic policy seems to call for more information.

At the end of his book, Bernanke raises three important questions for the future.

First, to what extent will the task of reducing inflation play a role in the future, compared to the other two basic tasks, especially employment? During his own tenure, Bernanke treated the two variables of the Phillips curve as issues of roughly equal importance, but in 2023 he saw his successors (J. Powell, for example) as allowing for greater volatility (possibly overshooting) in the inflation numbers where appropriate, because employment developments had become such a key issue (reflecting the strengthening of the central bank's role in economic policy mentioned above). Bernanke stresses that it is very important for the Fed to maintain its credibility, and therefore, despite all the problems, in terms of monetary stability, it must strive to keep inflation low.

The second question, not unrelated to the first, is how the neutral (natural) interest rate, R*, evolves. This concept refers to the inflation-adjusted interest rate at which the economy operates efficiently over the long run, using its full capacity, because this interest rate has neither a restraining nor an expansionary effect. It depends on the state of the real economy; it can only be estimated; it is not determined by the Fed – or any central bank. The question is, at what level will it stabilise?

It has been observed that the R* rate has decreased by about 3 percentage points since the mid-1980s. For central banks, a low neutral rate means that they have less scope to cut interest rates to stimulate the economy. Demographic and technological trends are working towards lower rates and the maintenance of low interest rates. Under these conditions, the Fed should continue to be prepared to use a new set of monetary tools that is not traditional. Monetary policy then requires more fiscal policy intervention when a severe recession occurs. In such a case, fiscal policy would need "automatic stabilisers" to stimulate the economy. In 2023, Bernanke said that interest rates were unlikely to remain low. Slightly higher inflation and large budget deficits in the US require investors to be compensated more for their long-term bonds, but higher interest rates at least provide more room for more flexible monetary policy accommodation.

Bernanke sees the *third task* as the most difficult. Ensuring financial stability would require very significant changes to supervisory and institutional systems. As we pointed out, regulators in the shadow banking sector and in housing finance do not have sufficient tools in the US. More serious consideration should therefore be given to ensuring that entities performing the same functions are subject to the same regulation. Only then would the Fed be better able to fulfil its macroprudential regulatory role.