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Lessons from History

Financial Meltdown and Governmental Response

It's been nearly two years since we heard the first distant rumblings of the financial storm that has overtaken the global economy. The crisis has claimed as its casualties a seemingly endless list of financial institutions. Some, like early victim Sachsen LB, are distant and obscure to American investors. Others, like Bear Stearns, Merrill Lynch, and Lehman Brothers, are household names whose demise substantially alters the shape of the financial services industry. Such a widespread financial catastrophe inevitably inundates the real economy as well. That damage has played out in falling home prices, a major bear market in stocks, collapsing corporate profits, and widespread job losses.

Just as striking as the breadth and severity of the crises has been the massive governmental response. The Federal Reserve took the first major steps, supplying credit in the markets where financial institutions fund their holdings of securities. The Fed has steadily broadened its funding activities, resulting in a massive expansion of its balance sheet, which grew from about $950 billion at the end of 2007 to $2.3 trillion at the end of 2008[1].

The Fed hasn't just backstopped the funding of financial firms' holdings. In its policy role, the Federal Open Market Committee has lowered its target for the short-term Fed Funds rate effectively to zero. Even after expanding credit and lowering the Fed Funds rate to zero, the Fed has applied further monetary stimulus by beginning to buy longer-dated US Treasury notes.

In addition to the Fed's open market operations, the Fed and the US Treasury have made huge direct investments in a number of financial firms, first through the Fed's extraordinary investment in AIG, and later through last fall's Troubled Asset Relief Program (TARP). The aim of these outlays has been to forestall the collapse of yet more large institutions and the unpredictable collateral damage that could result. In addition, Treasury made large commitments last fall to US automakers, fearing that a sudden bankruptcy in that sector could also damage the economy.

[1] Source: Federal Reserve H.4.1 Release, January 2, 2009:
http://www.federalreserve.gov/releases/h41/20090102/

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Monetary stimulus and direct public investments — bailouts, if you prefer — are hardly the end of the story. In the first weeks of the Obama administration, the new Congress passed an immense fiscal stimulus bill, calling for some $787 billion in government spending. A few days later, President Obama submitted his $3.2 trillion budget proposal, including a Federal deficit estimated as high as $1.75 trillion. The stimulus bill and budget proposal call for large outlays for our energy, education, transportation, and public safety infrastructure.

Opponents of many of the government's measures have objected by arguing that the massive intervention is at odds with America's tradition of *laissez faire* capitalism. But while the actions are extraordinary in their scope, their roots lie in an intellectual tradition of economic thought as old as the Republic itself. The Fed's aggressive provision of market liquidity is exactly consistent with Fed Chair Bernanke's writings on deflation. The fiscal stimulus package reminds us of the great English economist John Maynard Keynes. Even President Obama's comments about "spreading the wealth around" and the importance of high-paying jobs aren't what some opponents call "creeping socialism" — they echo the writings of Marriner Eccles, Fed Chair in the 1930s. And the notion of taking on public debt to support the banking system and invest in economic infrastructure goes back at least to Alexander Hamilton, Treasury Secretary under George Washington. Each of these intellectual antecedents had distinguished opponents and detractors. There is ample room for fruitful debate on both the philosophy and the particulars of the Administration's response to the crisis. But the actions of the Fed, and the Obama stimulus bill, show a coherent policy emerging from a thoughtful reading of history and economic theory.

Helicopter Ben fights deflation

In the early stages of the financial crisis, the Federal Reserve acted swiftly and forcefully, dramatically expanding the size and scope of its monetary policy activities. The Fed broadened the collateral it would accept from banks wishing to borrow from the Fed. It lowered short-term interest rates. More recently it launched a program of buying US Treasury notes. (The financial press called this program "quantitative easing;" economists call it "monetizing the debt;" and normal people call it "printing money.") Where did all these steps come from? What could Fed Chair Ben Bernanke possibly be thinking?

As it turns out, we have a pretty good idea what Mr. Bernanke is thinking, because he has told us. In 2002, he gave a talk before the National Economists Club in Washington, DC, in which he talked about his strategy for fighting deflation.[2] In it, he laid out the causes and problems of deflation, and a series of remedies the Fed could adopt if deflation should take hold.

Mr. Bernanke has pretty much followed the strategy he outlined in his 2002 talk. To start, he seems to take for granted that faced with deflation, the Fed would lower its interest rate target to zero. The Fed has done just that, setting its target for the overnight Fed Funds rate to be a range from zero to 0.25%. But it doesn't stop there:

> As I have mentioned, some observers have concluded that when the central bank's policy rate falls to zero—its practical minimum—monetary policy loses its ability to further stimulate aggregate demand and the economy. At a broad conceptual level, and in my view in practice as well, this conclusion is clearly mistaken. Indeed, under a fiat (that is, paper) money system, a government (in practice, the central bank in cooperation with other agencies) should always be able to generate increased nominal spending and inflation, even when the short-term nominal interest rate is at zero….
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> Normally, money is injected into the economy through asset purchases by the Federal Reserve. To stimulate aggregate spending when short-term interest rates have reached zero, the Fed must expand the scale of its asset purchases or, possibly, expand the menu of assets that it buys.

In fact, the Fed has steadily expanded both steps, increasing its asset purchases and taking in additional types of assets, typically as collateral for loans to banks.

Mr. Bernanke also worried about longer-term interest rates in a deflation, and suggested that the Fed can put a lid on those, too:

> The Fed could enforce these [longer-term] interest-rate ceilings by committing to make unlimited purchases of securities up to two years from maturity at prices consistent with the targeted yields. If this program were successful, not only would yields on medium-term Treasury securities fall, but (because of links operating through expectations of future interest rates) yields on longer-term public and private debt (such as mortgages) would likely fall as well.

[2] Ben S. Bernanke, "Deflation: Making Sure 'It' Doesn't Happen Here," remarks before the National Economists Club, Washington, DC, November 21, 2002. Available at http://www.federalreserve.gov/boardDocs/speeches/2002/20021121/default.htm

The Fed has stopped short of this policy prescription, but it has begun buying longer-dated Treasury securities directly, a step that both injects money into the financial system and helps drive longer-term rates lower.

In aggregate, the Fed's balance sheet has more than doubled in the last 18 months or so, in a determined strategy to inject enough money into the financial system to avert, or if necessary reverse, a deflationary trend. The steps the Fed has taken to do this are unusual, but they do not represent mindless flailing. Rather, they are consistent in style and philosophy with policy options Mr. Bernanke has contemplated seriously for years.

Stimulus Obama Style — channeling John Maynard Keynes

While the Fed's deflation-fighting actions put into practice Mr. Bernanke's own thinking, the Obama stimulus bill has roots that go back much further. The economist we most often associate with fiscal stimulus (that is, government spending, especially deficit spending) to head off a depression is the English economist John Maynard Keynes. In his modestly-titled *General Theory of Employment, Interest, and Money* (1935)[3], he argued that in the face of high unemployment, government could support the general prosperity by putting people to work doing virtually anything. He could be quite sarcastic about the matter:

> Pyramid-building, earthquakes, even wars may serve to increase wealth, if the education of our statesmen on the principles of the classical economics stands in the way of anything better. (Ch. 10, Section VI)

Nor was he afraid of deficit spending in the pursuit of stimulus:

> Ancient Egypt was doubly fortunate, and doubtless owed to this its fabled wealth, in that it possessed two activities, namely, pyramid-building as well as the search for the precious metals, the fruits of which, since they could not serve the needs of man by being consumed, did not stale with abundance. The Middle Ages built cathedrals and sang dirges. Two pyramids, two masses for the dead, are twice as good as one; but not so two railways from London to York. Thus we are so sensible, have schooled ourselves to so close a semblance of prudent financiers, taking careful thought before we add to the "financial" burdens of posterity by building them houses to live in, that we have no such easy, escape from the

[3] Amusingly, the easiest place to find the text of the *General Theory* is at http://www.marxists.org/reference/subject/economics/keynes/general-theory/

> sufferings of unemployment. We have to accept them as an inevitable result of applying to the conduct of the State the maxims which are best calculated to "enrich" an individual by enabling him to pile up claims to enjoyment which he does not intend to exercise at any definite time. (*ibid.)*

The Obama stimulus bill is primarily an effort to jumpstart economic activity through Government spending. But while Keynes affected not to care what the content of any stimulus would be, so long as it put people to work, the Obama plan has features that hark back to other antecedents.

Spreading the wealth around – a lesson from a conservative western banker

Last September, then-Candidate Obama caused a bit of a stir when during the final Presidential debate he talked about "spreading the wealth around." The McCain camp made much of the comment, arguing that it displayed socialist tendencies that Mr. Obama had previously hidden. But Mr. Obama likely had something entirely different in mind. He was articulating the general principle that the main problem in a Depression is too little aggregate demand. By talking about the problem as one of wealth distribution, he wasn't showing socialist colors. He was reiterating an observation made in the 1930s by a conservative western banker, Marriner S. Eccles, who served as Chair of the Federal Reserve from 1934 to 1948. Mr. Eccles summed up the matter this way in testimony before the Senate Finance Committee[4] in February 1933:

> In the real world there is no cause nor reason for the unemployment with its resultant destitution and suffering of fully one-third of our entire population. We have all and more of the material wealth which we had at the peak of our prosperity in the year 1929. Our people need and want everything which our abundant facilities and resources are able to provide for them. … We have a complete economic plant able to supply a superabundance of not only all of the necessities of our people, but the comforts and luxuries as well. Our problem, then, becomes one purely of distribution. This can only be brought about by providing purchasing power sufficiently adequate to enable the people to obtain the consumption goods which we, as a nation, are able to produce. The economic system can serve no other purpose and expect to survive. (p. 705)

[4] This testimony is available at http://fraser.stlouisfed.org/docs/meltzer/ecctes33.pdf

Mr. Eccles was a vocal proponent of what we might call trickle-up economics. The idea is that accumulating wealth is pointless unless there are worthwhile investment opportunities, and there won't be worthwhile opportunities unless enough people have high enough incomes to enable them to buy goods. Nothing about the way the Depression or World War II proceeded changed his mind. In his 1951 memoir, *Beckoning Frontiers,*[5] he said much the same thing:

> As mass production has to be accompanied by mass consumption, mass consumption, in turn, implies a distribution of wealth—not of existing wealth, but of wealth as it is currently produced—to provide men with buying power equal to the amount of goods and services offered by the nation's economic machinery.
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> Instead of achieving that kind of distribution, a giant suction pump had by 1929-30 drawn into a few hands an increasing portion of currently produced wealth. This served them as capital accumulations. But by taking purchasing power out of the hands of mass consumers, the savers denied to themselves the kind of effective demand for their products that would justify a reinvestment of their capital accumulations in new plants. In consequence, as in a poker game where the chips were concentrated in fewer and fewer hands, the other fellows could stay in the game only by borrowing. When their credit ran out, the game stopped.

It's no accident that President Obama, in his address to that joint session of Congress, highlighted police officers the stimulus bill allowed to continue working in Minneapolis. The example had a strong political component, to be sure, but there's much more at work. Few would grudge one of our major cities improvements in public safety. More important, police departments also offer the type of solid-earning, middle class jobs that Mr. Eccles argued underpin our general prosperity.

Mr. Eccles also promoted the idea of deficit spending to counter economic contraction, followed by a balanced budget to temper economic expansion. While we're only seeing the downturn phase of this counter-cyclical fiscal policy, it may be fair to imagine that President Obama has similar thoughts when he contemplates the eventual resolution of the current crisis.

If the idea of fiscal stimulus to counter an economic downturn is from Lord Keynes, and the emphasis on good jobs comes from Marriner Eccles, what about the stimulus plan's emphasis on infrastructure investment, energy independence, and so on? These are big-government programs, and the trillion-dollar price tag is startling. But the core ideas behind them goes all the way back to the contentious debates of our nation's infancy. To find the wellspring of those ideas, we have to go back to Alexander Hamilton, Secretary of the Treasury under George Washington.

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[5] Marriner S. Eccles, *Beckoning Frontiers* (New York: Knopf) 1951.

President Obama's Hamiltonian Stimulus

Probably the best source for the context of the Obama stimulus plan is Alexander Hamilton's 1791 *Report on Manufactures*[6]. In it, Hamilton argued for policies designed to encourage the development of manufacturing industries in the United States. He argued that a more diversified economy would add to prosperity by creating a more efficient division of labor, an idea drawn from Adam Smith's 1776 *Wealth of Nations*.[7] Hamilton, still following Smith's arguments, also maintained that the development of domestic markets was essential to creating this efficient division of labor, and that the development of manufacturing and the increasing returns to capital that would result from it would enhance the wealth of the fledgling Republic. Hamilton's *Report* had several features with direct, and I would argue intentional, echoes in the Obama plan:

- Hamilton insisted that a more robust manufacturing base would make the United States less vulnerable to pressure from trading partners whose interests are often hostile to our own. President Obama argues for greater energy independence, for the same reason.
- Hamilton believed that public investment in roads, bridges, and canals would support commerce and allow manufacturing to flourish, producing handsome returns on those investments. The Obama plan invests in roads, bridges, levees, high-speed internet connections, and a smart electric grid for the same reasons.
- Hamilton argued that a successful manufacturing economy would become a more fertile incubator of technological innovation, yielding still greater prosperity. Further, government could adopt policies aimed at promoting innovation. President Obama argues that the stimulus, far from creating a centrally planned economy, lays the groundwork for the next generation of innovation.
- Hamilton was not afraid of deficit spending. He argued that the "funded debt" of the government — that is, debt that investors could reliably expect to have repaid — would in fact provide a basis for substantial capital formation and wealth creation.

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[6] Alexander Hamilton, Secretary of the Treasury, *Report on Manufactures*, transmitted to the House of Representatives December 5, 1791. Available through Google Books: http://books.google.com/books?id=gCk5AAAAMAAJ&dq=hamilton+report+on+manufactures&printsec=frontcover&source=bn&hl=en&ei=MxQCSqvyKIWYtAOZxJnpBQ&sa=X&oi=book_result&ct=result&resnum=4

[7] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations,* 1776. Available at http://www.econlib.org/library/Smith/smWN.html

Conclusion — The Right Basis for Debate

So the Obama plan isn't really new and radical. The stimulus plan is unmistakably Keynesian in intended economic impact, and Hamiltonian in shape. For supporters of the plan, its strength lies in the coherence and consistency of the ideas behind it. We can hope that by operating within a clear philosophical framework, the Administration will have a better chance of adapting successfully to the inevitable surprises that present themselves along the way.

Ideally, the plan's coherent framework should be helpful to opponents of the plan as well. Hamilton faced reasoned opposition in his own day. In the same way, reasonable people can disagree about the Obama stimulus plan. There's no reason for even the most ardent Obama supporter to suppose that the stimulus plan is perfect. Logically, the foundation of debate over the plan should be the intellectual basis of the plan itself. Measures of such magnitude should be subject to debate. If the debate is well-reasoned, the result should be a more robust plan.

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