

In Fed We Trust: New Book Focuses on the Fed in the Eye of the Storm

By Kevin L. Kliesen

(The author's book review of *In Fed We Trust* takes the place of our usual *National Overview* feature, which will return in the next issue.)

The nation's economic policymakers are entrusted with helping to ensure economic and financial stability. Often, though, a policymaker's thought process is clouded by the storm and stress of the crisis. In his book *In Fed We Trust: Ben Bernanke's War on the Great Panic* (published in August 2009 by Crown Business), the *Wall Street Journal's* David Wessel walks us through a detailed, behind-the-scenes narrative that attempts to portray the difficulties facing Federal Reserve policymakers (and those in the federal government) as they formulated an evolving response to the financial crisis that roughly began in August 2007.

From Page 8:

This is the story of the Bernanke Fed abandoning "failed paradigms" in order "to do what needed to be done." It is a story of what the Fed saw and what it missed, what it did and what it didn't, what it got right and what it got wrong. It is a story about Ben Bernanke deciding to do *whatever it takes*. Above all, it is a story about a handful of people—overwhelmed, exhausted, beseeched, besieged, constantly second-guessed—who found themselves assigned to protect the U.S. economy from the worst economic threat of their lifetimes.

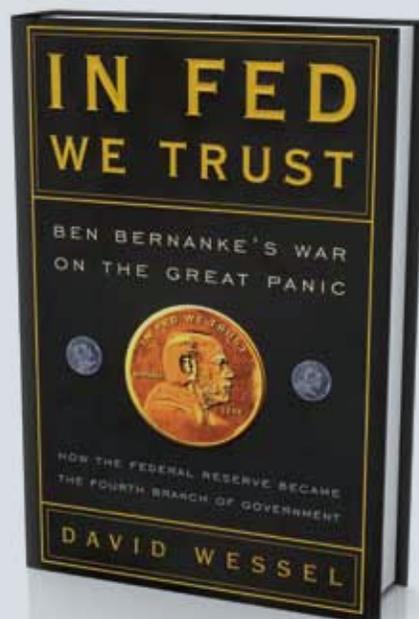
Heading into the last few months of 2009, it appears that these efforts have produced some tangible benefits: The economic and financial headwinds that have hammered the U.S. economy over the past year or so appear to be calming. Indeed, a majority of economists believe the recession that

officially began sometime in December 2007 has finally ended.

Riders on the Storm

As the book's subtitle suggests, much of the narrative is focused on the Federal Reserve's response to the financial crisis—what Wessel calls the Great Panic. The design and implementation of these policy responses are seen mainly through the lens of Chairman Ben Bernanke and his key colleagues on the Federal Open Market Committee. Wessel also added a second subtitle to the book: *How the Federal Reserve Became the Fourth Branch of Government*. By this, Wessel has in mind the Federal Reserve's special lending powers that were invoked under Section 13(3) of the Federal Reserve Act. Under the auspices of "unusual and exigent circumstances," the Federal Reserve—via the three special lending facilities named Maiden Lane I, II and III—helped to finance the purchase of Bear Stearns by JPMorgan Chase and to prevent the failure of American International Group (AIG). Wessel also relates how Bernanke and other Federal Reserve officials urged the government's other key economic players to take aggressive actions at key moments in the Great Panic. These included policies designed to stabilize the nation's 19 largest depository institutions deemed too systemically important to fail.

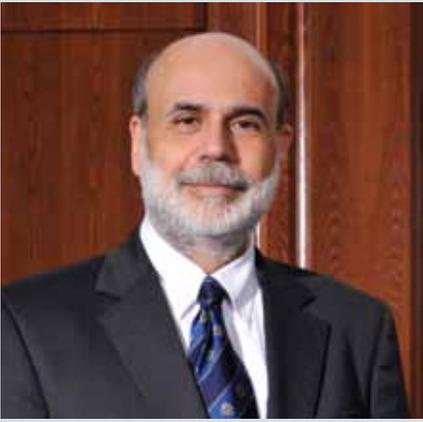
In Fed We Trust is an entertaining read, but it is generally written from a Washington, D.C., and New York City perspective. Indeed, the key Federal Reserve officials in the narrative are Bernanke, Govs. Don Kohn and Kevin Warsh, and then-New York Fed President Tim Geithner. Wessel refers to them as the four musketeers. At times, the four musketeers wanted to move faster and more aggressively than other policymakers did. This created some tension with policymakers who advocated a more cautious approach.



Among the latter was a group of several Federal Reserve District Bank presidents who "were determined to show their manhood by talking tough about inflation and economic rectitude." In perhaps the unkindest cut of all, those District Bank presidents, many of whom found intellectual support from prominent academics like John Taylor of Stanford University, were derisively labeled "presidents from the flyover states" by "internal foes."

Age of Delusion?

Former Fed Chairman Alan Greenspan is another prominent person whom Wessel takes to task. In the chapter titled "Age of Delusion," Wessel argues that the Greenspan Fed not only kept interest rates too low for too long, but it ignored important warning signs from the booming housing market. Wessel is also upset that Greenspan largely ignored former Federal Reserve Gov. Ned Gramlich's warnings about the subprime market. In short, Wessel believes Greenspan put too much faith in the financial markets and financial institutions. Some of these criticisms are fairly easy to make with the benefit of hindsight. Some may even be true. For example, Taylor, among others, has argued that monetary policy was excessively easy for too long in 2003-2004. But even if Wessel is correct in asserting that the Fed should have taken a more aggressive regulatory stance against subprime mortgages, it is difficult to



In his new book on the Federal Reserve's response to the recent financial panic, author David Wessel writes that Fed Chairman Ben Bernanke (above) and other key Fed officials wanted to move faster and more aggressively than did other policymakers during the so-called Great Panic.

conceive that this would have made much of a difference in mitigating the Great Panic. If there is empirical evidence to the contrary, Wessel does not cite it.

Moral Hazard and Other Issues

In Fed We Trust is an admirable effort to clarify how policymakers cope with the massive amounts of uncertainty during periods of turmoil. Indeed, one of the lessons, as Wessel recounts, is that economic conditions can change rapidly and be contrary to the expectations of policymakers. Most policymakers know this and design their policies accordingly. Yet, while this book provides key insights into the policy process during the height of a panic, Wessel gives short-shrift to the moral hazard and potential inflationary consequences raised by, among others, the District Bank presidents from so-called flyover states, who do not fare well in this narrative. What has yet to be determined, and, admittedly, what Wessel and others cannot know with certainty, at this point is the legacy of the Federal Reserve's innovative responses to the crisis. [Q](#)

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Eleven more charts are available on the web version of this issue. Among the areas they cover are agriculture, commercial banking, housing permits, income and jobs. Much of the data is specific to the Eighth District. To go directly to these charts, use this URL: www.stlouisfed.org/publications/re/2009/d/pdf/10-09-data.pdf.

