What Stabilized the Economy in 2009

Author : James Annable

Date : Sep 21, 2018

Last week took a critical look at Andrew Ross Sorkin's underdeveloped take on the macrodynamics of the Great Recession. What follows, originally published on April 8, 2016, looks at what actually worked in containing the 2008-09 extreme instability. Hint: It is not financial reregulation or any other attempt to prevent financial disruptions. As demonstrated in the GEM Project, logic and history indicate that crisis-prevention strategies are not sufficiently reliable to thwart future episodes of acute instability.

This post examines, with admiration, the massive Federal Reserve effort to use its balance sheet to counterbalance mounting rational inaction of investors/lenders in the context of collapsing asset markets. Such inaction was the engine of the powerful contraction of nominal demand that was overwhelming automatic stabilizers and the central-bank purchases of short-term Treasury debt. The Fed's goal in becoming the buyer and guarantor of last resort was designed to revive the recycling of saving into spending and reverse downward spiraling total spending and its associated huge losses of jobs, production, wage income, profits, and wealth. In so doing, the central bank critically demonstrated both its ability and will to deliver on its real-side objective of trend high employment and thereby prevent 1930s-class depression.

The crisis. Asset markets quickly tanked after the bankruptcy filing by Lehman Brothers on Monday, September 15, 2008. During the first post-Lehman week, the bleak mood was punctuated by the Fed's bailout of the trillion-dollar insurance giant AIG and the "breaking the buck" by the Reserve Primary Fund, a $67 billion money-market mutual fund hit by a wave of withdrawal requests. The Fed understood that Reserve-Fund busted-buck shock, if unchecked, presaged the failure of the $3.8 trillion MMMF industry.

Bernanke and his inner circle recognized the making of, in GEM Project terminology, a nonstationary collapse in total spending that threatened depression. (Chapter 5) He adopted a "kitchen-sink" strategy. He instructed his advisors to think outside the box with respect to the Fed balance sheet, requesting everything they could think of to throw at the crisis. He wanted ideas that contributed to halting and reversing the breakdown in nominal demand, especially those that helped restore the economy's capacity to recycle saving into investment spending. I can attest that Bernanke's mantra during those dark days was that no program is too big, no program too quick.

The massive response. Many prominent economists, media centers, Congress members, and the public still incompletely understand, despite its extraordinary success, Bernanke's strategy. The particulars, at least, are well documented. Three days after the Reserve Primary Fund broke the buck, the Fed announced the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) that lent to cooperating banks so that they could purchase securities being sold by money-market mutual funds, which were then pledged to the central bank. Some $24 billion was lent the first day of AMLF operations, $217 billion for the run of the program. The MMMF industry did not fail, avoiding obvious dire consequences for total spending. On October 7, the Fed announced the Commercial Paper Funding Facility. The commercial-paper market, a huge source of short-term funding for financial and nonfinancial corporations, had dried up for lack of buyers. The Fed used its 13(3) authority to lend in "unusual and exigent circumstances" to become the commercial-paper buyer of last resort. Illustrating the CPFF's link to total spending, Harley Davidson borrowed $2.3 billion that was used to finance spending on its motorcycles.

The alphabet-soup programs, each seeking to help halt and reverse the collapse in nominal demand, greatly multiplied. Time (2009) nicely captured the extraordinary process: "[The Federal Reserve] conjured up trillions of new dollars and blasted them into the economy; … lent to mutual funds, hedge funds, foreign banks, investment banks, manufacturers, insurers, and other borrowers who had never dreamed of receiving Fed cash; jump-started stalled credit markets in everything from car loans to corporate paper; … blew up the Fed's balance sheet to three times its previous size; and generally transformed the staid arena of central banking into a stage for desperate improvisation."

Lessons yet to be learned. Kenneth Arrow (1967, p.735) opined a half-century ago that "the mutual adjustment of prices and quantities represented by the neoclassical model is an important aspect of reality worthy of the serious analysis that has been bestowed on it". He also concluded that for the explanation of depressions "something beyond, but including, neoclassical theory is needed."

Bernanke was confident that Arrow's "something beyond" would confirm his intuition that the Fed's 2008-09 focus had to be halting and reversing the gathering collapse in total spending. In executing that strategy, there was no tolerance for diversions into moral hazard, mainstream macro theorists insisting price inflation is the only proper Fed objective, or other misguided mainstream nattering. The stakes were too high to abide such, putting it politely, clouded thinking. The Fed chief recognized the wisdom of Tim Geithner's insistence that attention be paid to the "theater" of the Fed's actions. Reestablishing confidence, especially by investors and lenders, in stabilization authorities' capacity to effectively reverse contracting demand was crucial. What GEM Project modeling denotes as Ć, investor/lender perceptions of the credibility of the Fed's trend real-side objective, was the keystone of the central bank's massive stabilization effort.

Bernanke, Geithner, and their advisors worked without a useful macro model. They recognized the obvious, i.e., the micro-coherent market-centric general-equilibrium macroeconomics upon which academic gatekeepers had bet the ranch did not come close to being adequate to the task at hand. The massive, successful approach was instead ad hoc early Keynesianism. An inevitable, critical problem with ad hocery is preserving what has been learned. Bernanke and Geithner are no longer in charge. Now what? The lessons of 2008-09 have been badly muddied, in part because mainstream macroeconomists have been, for reasons of self-interest, working hard to reassert the pre-crisis consensus organized around general-market equilibrium, the analytic framework broadly assessed by policymakers to have been useless in the post-Lehman instability. Arrow's "something beyond" market-centric neoclassical theory, which I believe to be the generalization of rational exchange championed in the GEM Project, continues to be ignored at our peril.

Blog Type: Policy/Topical Chicago, Illinois