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Book Review

21st Century Monetary Policy: The Federal Reserve from the Great Inflation to COVID-19

Ben Bernanke
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Readers of this book should not expect to find a monetary blueprint which uplifts their hopes for human freedom and prosperity. Rather the task of its author, a two-term ex-chair of the Federal Reserve (2006–14), is to explain how that "living institution" evolves in its conduct of monetary policy by responding to changes in the economic environment. Bernanke would have us consider this type of evolution as benign, albeit with mistakes and reversals along the way.

The author's concept of the Fed slowly evolving into a superior form of monetary policy maker is not new to this book. In his address to Milton Friedman at a University of Chicago conference to honor his 90th birthday (see Bernanke 2002), Bernanke concluded "I would like to say to Milton and Anna: Regarding the Great

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Depression, you're right, *we* did it. *We're* very sorry. But thanks to you, *we* won't do it again."

(The alleged error: monetary policy was over-restrictive through 1928–29, followed by a failure to sustainedly inject vast amounts of high-powered money to combat powerful deflationary forces, aggravated by waves of bank failures through the back-to-back recessions of summer 1929 to spring 1931 and spring 1931 to autumn 1932).

The reader might even wonder whether Bernanke considers the Fed to have a monetary soul. This would put the author's perception of the Fed at the opposite end of the spectrum from those who have an image of that institution as a bunch of top monetary bureaucrats. Puppet-masters control these bureaucrats by strings which include first, nomination by the US President who selects the board members including the Chair in full awareness of their "philosophy" and "monetary leanings" and second, Congressional oversight (including legislation, committee hearings and nomination approvals). Bernanke's perception is also at odds with existential reality; one day the US President and Congress could end the Fed's discretionary power to set money policy and create instead a solidly anchored monetary system.

The concluding sentence of this book echoes the same concept: "The Fed will doubtless make mistakes as in the past. But as Jay Powell (the present Fed chair) put it, it must continue to show that it will not make mistakes of character or integrity."

Well, historians have yet to deliver their verdict on the record of the Powell Fed's integrity and character. In doing so, they will have to consider the morality of its levying during the Great Pandemic the largest inflation tax in almost a half century. This may have been unintended in the sense that the Fed "believed" low inflation would persist—but belief in forecasts can never be 100 percent and the issue is whether its risk tolerance was malevolently high; a wide range of actors including Big Government and Wall Street cronies were cheering the "mother of all monetary stimulus." Historians should also delve into the Fed's pandemic stimulus package, which created bonanza time for the private equity industry in particular from whence Powell (and then Treasury Secretary Mnuchin) had migrated to public service.

Bernanke tells us at the start of this book that he approaches the topic of 21st century monetary policy as a historian: "This book examines today's (and tomorrow's) Federal Reserve principally through a historical lens. That's how I came to the subject. I see no other way to understand completely how the Fed's tools strategies and communications have *evolved* to where they are today." Problem: the telling of history can cross over into mythology without sufficient discipline regarding facts. This danger is acute in the case of monetary history where the author applies a favorite model of how money works without acknowledging its alleged faults or seriously considering alternative models, even if ultimately rejecting them.

The reader should already feel uneasy about the road ahead when Bernanke presents early on the "thesis of this book." According to this, changes in the Fed's tools, policy framework, and communications since the early 1950s have for the most part been the result of three broad economic developments—first, a change in the behavior of inflation and its relation to unemployment; second, the long-term decline in the neutral rate of interest; and third, increased risk of systemic financial instability. We know when proceeding to the main section of the book that for the author the "labor market" is key to the Fed's analysis of inflation; that the so-called "neutral interest rate" is a core component of Fed policy making; and that "financial instability," a growing issue due to the modern complexity of financial markets and products, hangs out there as a bugbear for Fed policymakers.

Very occasionally the author hints at ideas which are foreign and hostile (to the Fed's "being"), as when he mentions that some economists argue that

> monetary policy should be more passive, for example fixing the quantity of reserves in the banking system. Possibly that would simplify the life of bond traders by reducing at least somewhat the amount of information—including central bank communications—that they must process. However, it is hard to see why the Fed's abandoning its maximum employment and price stability mandate, as a purely passive policy would almost certainly demand, would lead to a better allocation of capital or preferable economic outcomes.

Who is Professor Bernanke intending to fool by such disparaging comments? Maybe we should see this as a feature of survival of the fittest in Fed evolution—the enfeebling of threatening foreign monetary principles; no-one holding such views would in modern times (say from the mid-1980s onwards) make it through the Fed board nomination procedures adopted by successive presidents or win approval in Congress. Even so, a core theme of much monetary economics over the past two centuries and beyond has been that a tight but flexible constraint on the supply of base money plays a key role in preventing, as J.S. Mill put it, "the machinery of money from getting out of control and becoming the monkey-wrench in all the other machinery of the economy." Out of control means monetary inflation whose ill-effects include a misallocation of capital (malinvestment) and sub-optimal economic outcomes. The advocates of a sound money regime say that it is a good thing that there would not be bond traders speculating about what Fed communications mean. The late Rudiger Dornbusch referred to such traders as chickens myopically scrambling from one Fed message or data point to another. Long-term rates would regain their function as a key reliable price signal of competitive free market capitalism, reflecting millions of individual decisions about consumption and spending based on decentralized information only available at a micro-level.

Bernanke sticks to the conventional definition of inflation as a rise in consumer prices, rather than opting for a definition based on money supply veering ahead of demand. Hence, he does not present or discuss the general malaise of monetary inflation whose symptoms emerge in both goods and asset markets. And he is not on the look-out for symptoms of monetary inflation which might be detectable in goods markets even though prices are not rising there—as could be the case if there are presently strong non-monetary influences pushing prices downward. The concept of natural rhythm of prices (see Brown and Pringle 2022) is totally missing from this book. Prices would sometimes rise persistently for an extended period of time; at other times they would fall persistently; and there would be substantial periods of white noise in between. These periods would be of unequal length, each one unpredictable. Their occurrence under a sound money regime would be consistent with the expectation that money would sustain its purchasing power over the very long run. The rises and falls of prices would be driven by such factors as spurts in productivity growth, sudden shortages of resources as during war or pandemic, or business cycle fluctuations. Also missing is the hypothesis that central banks which defy that natural rhythm do so at great peril in terms of powering asset inflation or asset deflation, an idea which has its seed in Hayek (1931).

These omissions allow the author to boldly maintain at the start of his history that the "restoration of the international gold standard was the principal cause of the Great Depression; there was not enough gold and it was not distributed appropriately." Monetary deflation was the culprit. Bernanke does not present, let alone carefully reject, the well-known hypothesis that monetary inflation as created by the Benjamin Strong Fed from 1922–27 was the key source of the global boom and ultimately bust (see Rothbard 1972, Brown and Simonnot 2020). This monetary inflation was possible because the Fed had considerable scope for pursuing a discretionary monetary policy, unlike in the pre-1914 gold standard, so the flawed restoration of gold after the First World War was part of the problem, but not in a deflationary direction.

One suspects that Bernanke accepts the thesis of Friedman and Schwartz (1971) that 1922–28 was the high tide of the Federal Reserve with goods prices overall stable during those years of prosperity. Bernanke tells us that this is the book that Stanley Fischer got him to read before deciding whether to pursue a doctoral degree in monetary economics and which was the catalyst to his approaching the topic as a historian. There is no acknowledgement by Bernanke of opposition to the high tide view (see Rothbard 1972). Given the spurt in productivity growth during the 1920s (the third industrial revolution including the auto assembly line, radio, and electrification), prices would have been falling under a sound money regime; stable prices were indicative of monetary inflation which showed up in powerful asset inflation.

Fast forward to Bernanke's salute to the McChesney Martin Fed in the years 1952–60:

> In managing monetary policy to promote economic stability and low inflation rather than as in earlier eras maintain the dollar's value in gold, counter speculative excesses, or facilitate the financing of government debt, Martin helped create the template for modern central banking. Economic historians Christine Romer and David Romer have argued that Martin's monetary policy in the 1950s, in its focus on leaning

> against cyclical winds and pre-empting inflationary pressures when necessary, was more similar to the policies of the 1980s and 1990s than to the policies of the late 1960s or 1970s.

Bernanke and the Romers do not deal with the issue that the Martin Fed in effect thwarted a fall in consumer prices through 1953–54 in the aftermath of the Korean War once the shortages and dislocations unwound (during the war US consumer prices climbed more than 10 per cent) by pursuing monetary inflation (no matter all the bravado about the Treasury-Fed Accord allowing a normalization of monetary policy in defiance of then President Truman). Nor do they mention the rapid productivity growth which had emerged in the US economy, and even more so in the European miracle economies (part of the dollar-zone under the Bretton Woods Treaty) and which under a sound money regime would have gone along with falling prices.

Moving forward to the Great Inflation of the mid-1960s to the end of the 1970s, Bernanke relates a history of how the Keynesian advisers to first the Kennedy and then the Johnson Administration drove fiscal policy so as to lower unemployment. They estimated that output was significantly below potential, and relied on the popular econometrics finding, the Philips curve, relating unemployment and inflation (based around an assumption that 4 per cent unemployment was consistent without output at potential). Chair Martin was skeptical of Keynesian economics but with goods inflation remaining very low through 1962–64/65 he saw no need to raise interest rates. Bernanke makes no comment on the increasing evidence of asset inflation at that time nor the fact that a surge in productivity growth was occurring (which would put downward pressure on prices), which in the absence of monetary inflation would have put downward pressure on prices. This downward pressure was amplified by miracles in the dollar zone outside the US—including Germany, Italy, France and Japan.

Bernanke proceeds to relate how Martin's belated crackdown on high inflation through 1969 was subsequently halted in 1970 by his successor as Fed Chair, Arthur Burns. He rejects narratives that tie this or subsequent reflation through 1971–72 to an election campaign "agreement" between Chair Burns and President Nixon. Burn's fault, according to the author, was viewing inflation as a phenomenon largely to be explained by institutional detail such as the power of the unions and more generally cost-push pressures.

Bernanke does not pass harsh criticism on any past chair of the Fed, "even" Burns. The reader could feel here, as elsewhere in the book, that the author as historian is straining to sustain the reputation of the Fed rather than to discover what actually happened. When it comes to Volcker, he idolizes. Bernanke is silent on Volcker's role as devaluationist-in-chief at two key junctions in US monetary history. Indeed, when it comes to dollar devaluation more generally it seems that the author can hear and see no evil. This would be in line with his strong view elsewhere that a devaluation of the dollar by allowing a shift towards US monetary stimulus means that an expanding US economy would benefit the rest of the world (see Bernanke 2004).

The first junction for Volcker was his job as devaluation "hit man" (under Secretary in charge of international affairs) under Treasury Secretary Connolly in the Nixon Administration; as such he negotiated with foreign governments the dollar devaluations of 1971 and early 1973. Bernanke does not even discuss the role of these devaluations—followed by the great dollar depreciation of 1977–78 (that time with the dollar "freely floating")—in powering and extending the Great Inflation.

Volcker's second go as devaluationist, now in the top role, was his joining with then Treasury Secretary Baker to devalue the dollar in the aftermath of the Plaza Accord (September 1985), having already abandoned the monetarist "experiment." One wonders why there is such a gap in the author's historical chronicle—no consideration of how Fed policy-making powered a new great inflation through 1986–90 featuring a virulent asset inflation (not just in US but also in Europe and most of all Japan) and later a goods and services price inflation, with CPI inflation in 1989–90 again in excess of 6 per cent.

Of course, by early 1987 Volcker was having some concerns about inflation and prevailed on Baker to negotiate the Louvre Accord (February 1987) under which the US, Germany, and Japan were to join in stabilizing the dollar (no further devaluation). There is no mention by the author of how Volcker used that as cover to start tightening monetary conditions, thereby encountering the wrath of Baker who was already scheming for his friend VP Bush to win the presidential election of November 1988. So, no re-appointment for

Volcker. The new chair from Summer 1987 was Alan Greenspan—whose slight early moves to easing were not sufficient to prevent the stock market crash of October 1987.

The reaction of Greenspan to that crash was deliberate and forceful, but Bernanke rejects any suggestion that he veered towards monetary inflation (a term he does not use explicitly) and he rejects firmly the charge that this new chair administered a "put" to bail out the stock market. The author just chooses not to mention that Greenspan's great new monetary stimulus through late 1987 and 1988 stoked the run-up of inflation in 1989–90 and intensified the boom-and-bust in global asset markets at that time (most of all in Japan). There is no mention of how the great dollar devaluation of autumn 1985 to winter 1988, with its corollary of a super-strong Deutsche mark, had broken the political support for monetarism in Germany and launched the train to the European Monetary Union.

Indeed, Bernanke is sympathetic and loyal to Greenspan in the historical sketch of his long tenure (loyal in respect to his service as Governor under him from 2002 to 2005. This sketch, as it continues beyond the recession of 1990–92, is flawed in at least three respects. The author underplays the seriousness of the 1990–92 economic weakness, choosing to just focus on the 9-month recession as identified by the NBER. Second, he overplays the seriousness of the 2001 recession, which in fact now is barely evident when all revisions of the data are taken into account; a better idea of the monetary forces at work would be gained from treating the years 1993–2006 as forming one integral episode of monetary inflation. Third, and most important of all, during these years there was a spurt in productivity growth driven by the IT revolution; that meant a natural rhythm of prices downwards which under a sound money regime would have been reflected also in falling prices.

The Fed chair under which Bernanke first served, Alan Greenspan, just did not entertain this concept at all. Greenspan found, to his wonderment, that low unemployment did not seem to push up inflation at the same trigger points as before, and Greenspan earned his "maestro status" for not embarking on a series of interest rate rises in 1996–97 in response to the super strong economy (see Woodward 2000). But under a sound money regime, that is exactly what would have happened (interest rates would have risen, more in real terms than in nominal, as the latter would have been contained by expectations of falling prices in line with the continuing productivity spurt). The maestro-work of Greenspan in effectively already aiming for still positive inflation at around 2 per cent, rather than allowing prices overall to fall during the productivity miracle, meant a growing asset inflation: hence the bubbles and busts first in Asian credit, then Russian credit, and then in the NASDAQ (dot coms).

Bernanke himself arrived at the Fed in the autumn of 2002, when there was still some economic weakness in an intermission which followed the bursting of the dot com bubble and then included the September 11, 2001 attacks on New York. In passing, Bernanke provides an autobiographical account of his arrival at the Fed "In 2002 I was invited to interview with President Bush—it seemed like an ideal opportunity to put what I had learned in my research and writing to practical use."

Well, autobiography is never top-quality evidence for historians. Here they might ask whether this enthusiastic Princeton professor posed the obvious question to himself: why is the President asking me rather than someone else? If he had considered this question, was he so naive not to realize that President Bush and his political advisors, with an eye to the approaching 2004 elections, might appreciate his record as an outspoken expert on preventing recessions and depressions, who was strongly opposed to any hint of deflation. He surely appreciated that the Bush family and its close advisor (James Baker) resented Greenspan's role in the senior Bush's election defeat in 1992 (alleged slowness to pursue stimulus policy in the context of an extended weak recovery from the 1990–91 recession). Bernanke might also have asked himself whether his reputation as seeing dollar devaluation as an important tool of stimulus policy which in fact benefits the rest of the world could be a factor in Bush's selection. He would soon get the answer to that with the Great Bush Dollar Devaluation of 2002–04 (trade-weighted dollar index down by more than 20 per cent) including the US negotiating the end of the Asian dollar bloc at the Dubai G-7 summit in October 2003.

Bernanke is a fan of transparency, but there is no hint or disclosure here about any nods and winks he might have detected in his direction, as he had the White House's back as the rising star and even *éminence grise* during what were surely going to be the twilight years of Greenspan's chairmanship of the Fed. No word from Bernanke in this book about his influence on that remarkable policy outcome in Spring 2003 when the Fed resolved that inflation had fallen too low and that it was now determined to breathe inflation back into the US economy. Bernanke does tell us about his concern at that time about the fact that prices were only rising at 1 per cent (albeit in the midst of the IT revolution and continued spurt in productivity growth, along with rapid globalization); but no details on his dialogue with Greenspan.

Perhaps a more serious flaw in the autobiographical narrative, from the viewpoint of the reader, is his statement that "the Senate approved me as Fed Chair in 2005 without opposition." Has he forgotten the attack on his nomination by Senator Bunning, who expressed disappointment in his failure to rein in the bubble-forming policies of the Greenspan Fed? There is no mention of the same Senator's opposition speech in the Senate (December 2, 2009) when considering his re-nomination as Chair by President Obama. "You are the definition of moral hazard." Giving a thoughtful non-disdainful response to his critic would surely have been more endearing to many readers than treating Bunning and his thoughtful critique as if he never existed.

A key criticism from Bunning at the 2009 hearing was the failure of the Fed to ease monetary policy through 2006–07 once the housing market was visibly cooling and inflation had fallen sharply. Yes, obliquely Bernanke tells us that in view of those facts he stopped raising rates from the time he took office as chair in early 2006; but desisting from further increases after a 400 basis point increase in the preceding 2 years is surely not evidence of easing!

Indeed, there is little new in this book in terms of Bernanke's explanations as to how the Fed was not to blame for the Great Financial Crisis and subsequent Great Recession. His previous book about his "courage to act" during that crisis already tells that story (see Bernanke 2017) though it leaves readers scratching their head about what mega printing of money and joining with the Treasury in providing various forms of lifelines to the most powerful US investment bank has to do with courage, as opposed to deception.

The courageous course would have been not to act in this way. Perhaps there is a new line of apologist argument in this book, where Bernanke observes that long-term fixed rates on mortgages were high in real terms, so how could the Fed be responsible for a boom and bust centered on US residential real estate and the subprime mortgage market? There are two answers at least to this question, neither suggested by the author.

First, asset inflation including a hot speculative market in houses is generated not by the absolute level of real interest rates (as suggested by Bernanke) but by monetary excess. This would show up in real interest rates being substantially lower than they would be under a sound money policy, but the latter level could be abnormally high if indeed the economy is still in a productivity spurt and demand for capital buoyant as reflecting investment opportunity. Long-term rates held down, even if high by average standards, can go along with widespread mal-signaling of prices in capital markets and generate such phenomena as irrational exuberance, as described by the behavioral finance theorists (see Shiller 2000). This includes a pattern of continuing capital gains in a range of asset markets, which in turn foster positive feedback loops from these to irrational belief in investment expertise and overlooking of camouflaged leverage.

Second, surely the fact that the Fed kept rates well below where they would have been under sound money throughout most of 1996–2005 explained a hunt for yield in which many investors were unusually ready to take on high-risk credit at narrow spreads. The credit bubble and related asset inflation was much broader than just US houses and sub-prime, a point not admitted by the author. We should also include the fantastically high valuation of financial equities both in the US and especially in Europe, built on part on over-blown narratives about European monetary integration (which Bernanke himself helped to spread—see Bernanke 2004); the high leverage and compressed spreads across corporate debt markets, including a remarkable boom in private equity; the super low credit spreads on sovereign debts of highly indebted European countries, including Italy, Greece and Spain; the hot markets in Spanish and British real estate and related markets; and the fantastic carry trade booms in borrowing yen and Swiss francs to fund assets in other higher-yield currencies. Bernanke could offer the defense that

Europe did not need to follow US monetary policy and thereby the asset inflation could have remained more concentrated in the US (though there would have been spill-over effects); the ECB should not have buckled under the pressure of the Great Bush Dollar Devaluation (see above) and taken its cue instead from the defiance of the Bundesbank in the early 70s against the Burns Fed. But for an author who assiduously denies any causality between monetary inflation and hot asset markets that would be a stretch.

In the final decade of his history—2010 to the great pandemic—Bernanke is focused on the zero rate boundary problem: how to conduct monetary policy when the neutral rate of interest as judged by the Fed is at or below zero. This was the case, according to Bernanke, in the extended aftermath of the Great Financial Crisis (2000–12, including the European dimension). The continuing challenge for the Fed beyond that into the second half of the 2010s was to prevent inflation falling below their 2 per cent inflation target. The tradeoff between unemployment and inflation (the Phillips curve) seems to have shifted yet again, whereby lower unemployment is now possible without triggering inflation.

Bernanke just does not consider any counter-narratives to fit the facts he describes above, but instead confines his analysis to how the Fed built up its tool kit to deal with such circumstances and how this is now ready for future use and was indeed used during the Great Pandemic Spasm of early 2020 (which he considers to be a financial crisis and recession)—a use of which he fully approves, though he does indicate concerns about the rise of consumer price inflation above target from mid-2021 onwards. One alternative narrative (see Brown and Pringle 2022) is that the Fed's policies of monetary inflation in the aftermath of the great financial crisis, coming on top of the earlier long monetary inflation, now were emitting a serious side effect in the form of growing economic sclerosis. Asset inflation had played a big role in the advance of monopoly capitalism, which sapped the dynamism of the US economy; growing malinvestment went along with extended weak real income growth (except at the very top). Investors preferred to chase the apparent high-returns of financial engineering (involving much camouflaged leverage) rather than plowing funds into some long-gestation projects, especially given widespread recognition that at some point there would be an asset market bust. Low real interest rates, on this analysis, reflected economic sclerosis; and in turn the continuation of low rates added to the virulence of the asset inflation as the hunt for yield became more desperate.

Bernanke scrupulously avoids any mention of the asset inflation concept, which does not even make itself into the index of this book. Yet financial stability and its relationship to monetary policy is the final theme for the author as he rounds up his hoped-for direction of 21st century monetary policy, building on the expanded tool kit and improvements in Federal Reserve policymaking which have occurred during the long evolutionary process of which he played an important part.

In his discussion of monetary policy and financial stability going forward, Bernanke takes his cue from ideas developed by William White and Claudio Borro at the Bank for International Settlements in the early 2000s. These ideas were presented at the Fed's Jackson Hole conference in 2003 (see Borio and White 2004), thereby appropriately fitting into the evolutionary process of Fed policymaking which forms the central theme of this book. Borio and White advocate a "leaning-against-the-wind" (LATW) approach. The idea is that central bankers should use monetary tools to lean against a build-up of financial risks—often described as financial imbalances. Bernanke analyzes LATW supporters as falling into two categories: 1) always-on LATW, according to which growing financial risks are often invisible, so that monetary policy should always be set with potential financial imbalances in mind (policy makers should try to avoid extended periods of easy money even when no threats to financial stability are evident); and 2) situational LATW where monetary policy responds primarily to observable indications of risk-taking such as rapid growth in house prices, stock prices of credit.

Bernanke rejects the always-on LATW approach—there is too much potential benefit to be given up by adopting such a strait-jacket. But he is now sympathetic to the situational LATW.

> In 2002 I was skeptical that the Fed could identify market bubbles or other precursors of financial crises reliably enough for such policies to be useful. Since then the evidence has led me to shift my views. Identifying risks to systemic financial stability is difficult, but our ability and commitment to monitor them have improved. Economists inside and outside the Federal Reserve have developed systematic frameworks and new metrics for assessing potential risks.

He cites a mega-study by a Harvard team (Greenwood et al. 2020) using data since 1960 from 42 countries. They show that rapid growth in credit and asset prices over the prior three years increased the probability of a crisis in the succeeding three years.

So there we have the core of Bernanke's optimistic case for 21st century monetary policy—a gradualist continuing evolution of the status quo Federal Reserve. Some would say it is to the author's credit that he does not conclude with a warning in the style of *après moi, le déluge* ("after me, the flood")—he has too much confidence in the Fed as a living institution to go down that route (unlike Louis XIV who evidently had no confidence in the institution of monarchy in France without him at the helm—albeit that it survived another quarter-century after his death). On the other hand, there is no anguished cry of desperation in a late professional life confession pointing to a better way forward. The critic could say, as Talleyrand said of the Bourbons, that Bernanke forgot nothing and learned nothing. In this book, the author gives a blow-by-blow account of his actions as top monetary bureaucrat and the justifications. Still, at the time of writing, he gives no ground in his refusal to recognize the malaise of monetary inflation, or how in time it produces the symptoms of goods inflation and asset inflation.

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