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BOOK REVIEW

Ben Bernanke's *The Courage to Act*: A Review Essay

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Ben Bernanke. *The Courage to Act: A Memoir on a Crisis and its Aftermath*. New York: W. W. Norton. 2015.

The Courage to Act: A Memoir of a Crisis and its Aftermath, by Ben Bernanke, is many things at once. It is the autobiography of a prestigious economist. It is a history of the financial crisis of 2008, and the Great Recession that followed, from the perspective of someone at the center of events. It is a commentary on the economics profession and modern macroeconomics. It is a political tract. And it is the apologia of a public servant who was probably the target of more criticism than any in recent memory. If you come to this book looking for only one or two of these things, you will be frustrated; you are going to get them all.

There is a good reason that Bernanke wrote his book this way. He is giving the reader the complete picture—forcing us to see through his eyes for the duration of the epic story. The autobiographical sections tell us what kind of man Bernanke is; this allows us to understand what he cared about when he was making his policy decisions. The sections on economics explain his intellectual background—what he believed was actually going on in the economy. And the sections about politics tell us about the constraints under which he operated.

Basically, Bernanke wants the world to understand why he did what he did, and in order to understand we have to know everything.

And the book succeeds. Those who are willing to wade through 600 pages of history, and who know something about the economic theories and the political actors involved, will come away from this book thinking that Ben Bernanke is a good guy who did a good job in a tight spot.

But along the way, the book reveals a lot more than that. The most interesting lessons of *The Courage to Act* are not about Bernanke himself, but about the system in which he operated. The key revelation is that the way that the U.S. deals with macroeconomic challenges, and with monetary policy, is fundamentally flawed. In both academia and in politics, old ideas and prejudices are firmly entrenched, and not even the disasters of crisis and depression were enough to dislodge them.

After eight years of poor economic performance, we remain in the dark on all the big questions. What causes financial crises, recessions and stagnations? How are the three related? And what, if anything, should the government do about them? The crisis should have changed minds on these issues more than it did.

I. The Man for the Job

Most people who are forced to deal with momentous historical events do not have the luxury of preparing for the particular challenges they face. Franklin Roosevelt, for example, did not come into office expecting to fight World War II. Ben Bernanke is an exception to this rule. More than almost any other economist of his time, he had spent his career thinking about the Great Depression—the closest analogue for the crisis he would eventually face.

When Bernanke started his academic career in 1979 as a professor at Stanford's Graduate School of Business, it was precisely the wrong time to be thinking about the Depression—at least, if you cared about following the zeitgeist. The big macroeconomic challenge of the time was not unemployment or slow growth but inflation, which was running at over 10% at the time. Even more importantly, the economics profession was in the middle of a revolution that made it very hard to think about depressions at all.

Spurred by Robert Lucas's seminal 1976 paper "Econometric Policy Evaluation: A Critique," economists were discarding the so-called Keynesian orthodoxy that had dominated applied macroeconomics in the postwar period. By that time, Keynes's idea of fiscal demand management—government borrowing and spending during recessions, coupled with austerity during boom times—had already been on the out, given Congress's slow and uncertain response times. In its place, macroeconomists placed their hopes in the Federal Reserve. These technocrats, it was hoped, would be able to use monetary policy to balance unemployment by relying on the historical tradeoff between it and inflation, known as the Phillips Curve.

But Lucas showed that if the public was expecting the Fed to lower interest rates in an attempt to boost employment, the relationship broke down, and all you got was inflation with no boost to the real economy. The experience of the 1970s seemed to vindicate that prediction. The profession was thus in Lucas's hands to reshape. He joined up with Edward Prescott and others to promote a school of thought known as Real Business Cycle (RBC) modeling, also known as New Classical economics. This postulated that monetary policy had essentially zero effect on the economy. Printing money to buy bonds—or, equivalently, lowering the federal funds rate—could cause inflation, but it would not boost growth or help anyone get a job. Fed easing was believed to be, as Prescott put it, "as effective in bringing prosperity as rain dancing is in bringing rain."

In this new paradigm, it made no sense to think about recessions as shortfalls of aggregate demand—indeed, the entire notion of demand seemed to lose relevance and meaning. Economic downturns were the natural and efficient result of fluctuations in the rate at which scientists and engineers discovered new technologies—or, possibly, the result of harmful government meddling in the economy. Unemployment was a purely voluntary response to lower wages—in effect, a vacation. As for the Great Depression itself—which was far too severe to be explained by the new models—RBC adherents essentially threw up their hands and shrugged. Robert Lucas wrote in 1980 that "if the Depression continues, in some respects, to defy explanation . . . perhaps it is gradually succumbing under the Law of Large Numbers." In other words, the Depression was the kind of thing that could only happen once.

That was the intellectual climate into which Ben Bernanke emerged as a graduate student and young professor. He could have gone with the flow of the academic consensus, but instead he fought against it. In a time when macroeconomists were not supposed to think about the Depression, Bernanke made it an obsession, studying its history and particulars and thinking about its causes. When it came time to make formal economic models, Bernanke joined up with a group of contrary macroeconomists known as New Keynesians, who adapted Prescott's math to explain how monetary policy might be able to stabilize employment and output after all.

New Keynesian models were not, in fact, very Keynesian. Instead, they codified the intuition of Milton Friedman, who believed that counteracting depressions with easy money was a key job of central bankers. The New Keynesians believed that although attempts to boost output with easy money would fail in the long run, they could have a beneficial effect for a few years—long enough for a recession to run its course. These models also implied that beating inflation would require punishing the real economy—a prediction that appeared vindicated when Fed Chairman Paul Volcker seemed to cause two sharp recessions by raising interest rates in the early 1980s. The Volcker recessions, plus the stability of inflation and economic growth from the 1980s to 2007, helped New Keynesian models become dominant at central banks and in economics departments from the 1990s onward.

Ben Bernanke, almost alone among the New Keynesians, was pushing even harder to revisit Keynes's own ideas about the Depression. One of Keynes's central theses was that financial disruptions are a major cause of economic downturns. But financial disruptions—and even the financial sector itself—was conspicuously absent from macroeconomists' models in the 1980s and 1990s. Bernanke strove to correct this omission. Along with Mark Gertler, he created a model in which financial constraints on companies' borrowing ability made recessions far more severe and long-lasting than they would otherwise have been. This mechanism became known as the "financial accelerator," and stood out as one of the few theories of its kind for many years.

So it was eerily providential that when the Great Recession hit, America's most powerful economic policymaker (Bernanke was appointed Fed chair in 2006) was the economist who had spent more time than almost anyone thinking about the main historical precedent for this sort of crisis. At a time when the financial sector threatened to collapse, the Fed was headed by one of the only macroeconomists who realized how dangerous a financial collapse could be. Nearly anyone else—for example, Martin Feldstein or Glenn Hubbard, who were widely mooted for the top Fed job—would have been more blasé about letting the big banks collapse under the weight of their own bad decisions. Bernanke, on the other hand, bailed out big banks quickly and decisively.

Relying on an analogy to the Depression, he immediately perceived that the crash in housing prices and the accompanying financial chaos were not just harbingers of economic recession, but its primary causes. That idea, which was extremely rare in academic macroeconomics at the time, has become conventional wisdom since 2008. Today, you can find hundreds of models in academic journals showing how financial and housing crashes can bring down the economy; in 2008, Bernanke had only his intuition to tell him this, but he was right. As a result, he cut interest rates rapidly as the recession was beginning, which probably blunted its impact.

Finally, as a New Keynesian, Bernanke was far less likely than Feldstein or Hubbard to be influenced by the ideas of the RBC paradigm. As he drily puts it, he believed that "New Keynesian ideas, leavened with other schools of thought, including elements of the New Classical approaches, provide the best framework for practical policy-making." This is firmly in keeping with New Keynesians' habit of politely acknowledging the New Classicals' methodological contributions to the field, and then politely overlooking all of their policy recommendations.

When the Great Recession came around, Bernanke was more prepared than his colleagues to fight it with monetary policy. But as *The Courage To Act* reveals in its later chapters, even Bernanke ended up being held back to a great degree by the hawkish attitudes and paradigms that came out of the 1970s.

II. The Firewalls Held

There is not much new to write about the history of the financial crisis of 2008. Any number of books—Roger Lowenstein's *The End of Wall Street*, for example—have been written about the collapse of the housing bubble, the forced acquisition of Bear Stearns, the collapse of Lehman Brothers, the Fed's various lending schemes and the bailouts of the large banks and of AIG. The middle chapters of *Courage to Act* go over these events in great detail, but little new is revealed about the Fed's motivations or beliefs during this period. Bernanke, like most policymakers, had to balance concerns about financial stability, moral hazard and the angry, misdirected rage of politicians. Bailouts and emergency lending were extended swiftly and decisively after the Lehman debacle. In the end, the system survived, but with less punishment for big bank management than most would have liked.

Far more new and fascinating are the chapters that come before and after. In Chapters 3 through 6, Bernanke talks about his time serving as one of the Fed governors under Chairman Alan Greenspan from 2002 through 2005, and his brief tenure as chair of the Council of Economic Advisers in 2006. In Chapters 18 through 23, he tells the story of the Great Recession. These are periods when the Fed was able to forget about financial crisis management and focus on its usual job—monetary policy. Reading these sections, one comes to understand just how much Fed policy-making was constrained by the intellectual ghosts of the 1970s and 1980s.

From the very beginning of Bernanke's tenure as a Fed governor, it was clear that he was less hawkish than most of his colleagues. The Fed has a dual mandate—its jobs are to promote price stability and to maintain full employment. In practice, different Fed officials weight these two tasks quite differently. During the Greenspan Fed, Bernanke was frequently more worried about employment, and less about inflation, than other members of the Board of Governors and the Open Market Committee. During the "jobless recovery" in the early 2000s, employment rose more slowly than after previous recessions, and inflation was very subdued. Nevertheless, Bernanke repeatedly tells of his colleagues' fear of inflation if interest rates were kept too low.

Bernanke also appears to be one of the only Fed officials to have thought about the thread of deflation before 2008. In theory, "price stability" requires that inflation be neither too high nor too low. But in practice in the early 2000s, many monetary policymakers worried only about the former. Bernanke, who had studied the Depression, realized that if inflation went too low, it could be as dangerous as if it went too high, but he seems to have been nearly alone in this worry. Again and again, he describes the views of the inflation hawks, who seem to view nearly any trend as a reason to fear a spike in inflation. After the 2008 crisis, these worries begin to appear simply ludicrous.

Why did so many Fed policymakers keep worrying about inflation, even while millions of Americans were out of work, inflation expectations were historically low and GDP growth was anemic? The answer can only be that this was the legacy of the 1970s and 1980s. The Great Inflation left permanent scars on the psyches of those who experienced it; these people were then in power during the Great Recession. Economics research by Ulrike Malmendier and Stefan Nagel has shown that people who grow up during high inflation are permanently more worried about inflation than they ought to be. Fed policymakers, being only human, are presumably no different—Bernanke writes that "[t]he Great Inflation . . . had left a powerful impression on the minds of monetary policymakers."

But the Fed's peculiar anti-inflation bias probably goes beyond simple instinct. The entire theoretical edifice of modern macroeconomics was built with inflation prevention in mind.

The first round of models to come out of the Lucas-Prescott revolution, the RBC models, were explicitly designed so that monetary policy could only affect inflation, not output. So these models promoted a worldview in which inflation is the central bank's only worry. The models that replaced RBC in the 1990s—the New Keynesian models—allow the Fed a role in stabilizing the real economy. But they placed a great deal of emphasis on expectations of future monetary policy—in order to avoid spiraling inflation today, people and businesses must believe that the Fed will not raise its inflation target in the future. These models thus encourage the Fed to think of its inflation-fighting capability as its most precious asset.

Even Bernanke, among the most dovish of Fed officials, was so afraid of sacrificing this credibility that he ruled out some interesting approaches. In the Great Recession, the Fed quickly found itself in a bind—nominal interest rates reached zero. Nominal rates cannot go very far below zero without causing people to stuff money under their mattresses. The Zero Lower Bound, or ZLB as it is known among economists, is a major barrier to monetary policy in severe recessions. Two ideas—NGDP targeting and a higher inflation target—attempt to get around the dreaded ZLB by having the Fed make a promise to allow higher inflation in the future. If consumers and businesses are forward-looking, this should allow the Fed to spark both inflation and economic growth today. Both approaches were supported by a number of macroeconomists writing in the popular press, including Paul Krugman, Scott Sumner, and Miles Kimball.

However, Bernanke considered these approaches to be non-starters, and credibility was the reason. "Would people trust that future policymakers would have the courage and competence to quash inflation later?", he frets. "[T]he Fed could eventually find itself in a 1970s-style predicament—without credibility and with the economy suffering from both low growth and too-high inflation."

What the Fed did instead was three rounds of massive asset purchases, known as quantitative easing. The first round came in late 2008, and was basically an emergency reaction to the collapsing economy. The second and third rounds, lasting from late 2010 through late 2014, were an attempt to jump-start the economy out of its slow, lackluster recovery. The evidence is unclear on how much of an effect QE2 and QE3 had on the real economy, but they certainly did not manage to raise inflation by much. From 2009 through 2014, core inflation topped 2% only for a very brief period in late 2011 and early 2012. Otherwise, it hung well below its purported target.

This probably shows that even massive and sustained QE failed to dispel the belief in the Fed's inherent hawkishness. If even the dovish Bernanke was unwilling to endorse a 4% inflation target, there was little doubt that inflation-fighting remained the Fed's true bottom line. Meanwhile, the American unemployment rate remained elevated for seven long years, and the employment-to-working-age population ratio never recovered to its pre-crisis levels, even as inflation remained below target.

In other words, the anti-inflation firewalls that academic macroeconomics built after the 1970s held firm. Even as deep and lasting of an economic wound as the Great Recession failed to convince the most dovish of Fed officials that a 4% inflation rate was a risk worth running. Even the 2% target—enshrined in official Fed policy since 2012—looks more like a ceiling than a target. The Fed's inflation-fighting credibility remains intact—but at what price, we may never know.

III. True Keynesianism Survives

In the 1970s, the word "Keynesianism" was associated with the notion of the Phillips Curve. "New Keynesian" models kept the word, but still focused exclusively on monetary policy. But monetary easing was not actually John Maynard Keynes's preferred solution for fighting recessions. Instead, he preferred fiscal stimulus—having the government spend more money, usually financed with temporary deficits.

Fiscal policy—sometimes known as Old Keynesianism—is very rarely included in modern macroeconomic models. The main audience for these models is usually presumed to be central banks, whose independent, academia-trained officials are assumed to be more willing and able to implement the models' recommendations. Yet even without the models, many macroeconomists retain a deep and abiding belief in the power of stimulus.

Bernanke's book illustrates this quite vividly. Again and again, Bernanke suggests that Congress do more to boost the economy through fiscal measures. He writes about how the Fed "got some help from fiscal policy" when taxes were cut in 2003. He recalls how he called for stimulus in 2009, and endorsed President Obama's American Reinvestment and Recovery Act despite taking considerable flak for doing so. "I am sure that the Recovery Act helped create jobs and slow the economic contraction," Bernanke writes. He sternly critiques post-2009 austerity, declaring that "fiscal policies were holding back the recovery." And he bemoans the "fiscal cliff" that reduced government spending in early 2013.

Bernanke also touches on the parallel crisis in Europe, and his recommendations bear a strongly Old Keynesian flavor. "Unfortunately," he writes, "the Europeans showed no inclination to offset necessary austerity in weaker countries by spending more and taxing less in countries, like Germany, that could afford to do so." His prescription for Europe is not quite as Old Keynesian as that of Paul Krugman, who recommended against austerity in any European country, but it demonstrates a deep and abiding belief that austerity is a bad response to a fall in aggregate demand.

So despite being ignored—and sometimes even ridiculed—by academic macroeconomists, fiscal stimulus remains a powerful idea. The notion that financial markets are naturally unstable, and that this instability can hurt the economy, is another of Keynes's ideas that refuses to die, despite having been written out of macro models for decades. The fads and fashions of the ivory tower managed to hold the Fed back from using various kinds of monetary policy to fight the Great Recession, but they have not been able to dislodge the key pillars of Old Keynesianism. As Robert Lucas ruefully put it in 2008, "everyone is a Keynesian in a foxhole."

IV. Politicians Versus Technocrats

One consistent theme that arises in *The Courage to Act* is the conflict between technocrats and politicians. The Fed is a famously technocratic institution—that we should have an independent central bank is almost an article of faith among macroeconomists. But democratic nations have uneasy relations with powerful unelected bureaucrats, especially when those bureaucrats' decisions have potentially major consequences for the distribution of wealth. This naturally leads to an adversarial relationship between politicians and central bankers. *The Courage to Act* documents that friction vividly.

One of the biggest conflicts, of course, came from the bank bailouts during the financial crisis. The middle chapters of the book recall in copious detail the angry resistance against the Troubled Asset Relief Program and other bailouts, mostly from the Republican side of the aisle. This disagreement was natural—Republican legislators knew that they would have to answer to their constituents if they voted for bailouts. Neither said constituents nor their representatives understood the danger of letting the big banks fail; both were weighing the considerations that would be important to them in normal times—the unfairness of rewarding big banks and their rich managers for failure, the dangerous precedent of government support for dominant companies. Fed officials, Bernanke in particular, understood that this was not a normal situation, but they naturally had trouble communicating this fact.

Disagreement and misunderstanding are an unavoidable feature of any political system, and in the end the bailout policies that were implemented were not too bad, given the constraints, the uncertainty and the short time available. More disturbing are the book's accounts of political interference in monetary policy-making long after the crisis was over.

One example is the Senate's refusal to confirm Peter Diamond to the Fed's Board of Governors in 2010. Diamond, an enormously respected economist who won a Nobel Prize for his work on labor search theory in October of that same year, should by any reasonable criteria have been a shoo-in for the nomination. But Senate Republicans, deciding that Diamond's politics were too liberal for their tastes, blocked his nomination twice, forcing him to withdraw on the third round. Anti-tax activist Grover Norquist even threatened Republicans to keep them from voting for Diamond.

Bernanke rightly expresses frustration with this partisan action. The idea of an independent, technocratic central bank comes under threat when governors are hired for their partisan political views. Central bank governors are supposed to follow the Fed's legislated mandate to the best of their ability, not wage partisan campaigns using interest-rate policy.

Polarization and extremism, especially but not exclusively on the right, hurt monetary policy in several other ways during the recovery, and Bernanke recounts them all. Top congressional Republicans, for example, publicly opposed the second round of quantitative easing in late 2010. They wrote a letter warning that QE2 would generate "long-term inflation and . . . artificial asset bubbles." Needless to say, none of these politicians were experts in the inflationary or financial consequences of asset purchase programs.

In one memorable passage, Bernanke allows himself to rant about the economic ignorance of the Republicans who attacked his policies. "They saw inflation where it does not exist," he gripes, "and when the official data did not bear out their predictions, [they] invoked conspiracy theories. . . . They advocated discredited monetary systems, like the gold standard." This sort of behavior by politicians, of course, serves to illustrate why central bank independence is a good idea in the first place.

Even worse was the attempt by a few politicians to "audit the Fed"—a somewhat misnamed campaign, since the Fed is already audited quite thoroughly. The "audit the Fed" campaign was actually an attempt to end the central bank's independence by allowing Congress to review monetary policy decisions through the Government Accountability Office. This movement was spearheaded by two maverick politicians, Representative Ron Paul of Texas, a libertarian Republican, and Senator Bernie Sanders of Vermont, a self-described "democratic socialist" who caucused with Democrats. Neither was in the mainstream of his party, and the movement ultimately failed—as did a later proposal to force the Fed to follow a simplistic monetary policy rule set by Congress. But the episodes illustrate how technocracy, which functioned effectively during the crisis, nevertheless became a target for political grandstanding and opportunism.

Political polarization did not just attack the Fed in the years following the crisis. It also made the Fed's job much harder. Bernanke recounts how the fight over the debt ceiling in 2011, when Republican brinksmanship almost sent the country into a technical default, upset financial markets and inhibited the recovery by increasing uncertainty. The budget deal that ended the showdown, however, led to the threat of a "fiscal cliff" in early 2013—again, narrowly averted, but not without increasing uncertainty in financial markets. A final such episode was the government shutdown of 2013—an even more pointless piece of brinksmanship by Republicans. If policy uncertainty is bad for the economy—and many studies indicate that it is—then it appears clear that partisan brinksmanship made central bank technocrats' job harder in the early 2010s.

The Courage to Act is thus a deeply frustrated memoir by a public servant who, in his own words, "just wanted to do the right thing." The worsening extremism of the Republican Party during and after the crisis caused Bernanke, a lifelong Republican, to leave his party and become an independent. The departure of such a reasonable man should be a warning to conservative politicians and thought leaders alike, as well as to liberals like Sanders who might think about radicalizing their own party in response.

V. To Err Is Human

Up until now, this review has generally agreed with Bernanke's evaluations of economic conditions, the role of policy, his own decisions and the mistakes of his critics. This is a testament to Bernanke's persuasive power. By showing everything, Bernanke avoids writing a polemic—instead, he reconstructs his world so that reasonable people can put themselves in his shoes. That speaks to his gifts as a writer and to his inherent acumen and thoughtfulness.

But there are certainly parts of the book where an astute reader can detect a bit of over-defensiveness, some overconfidence in a viewpoint or even an internal contradiction. One such case is Bernanke's treatment of the Fed's relationship to asset bubbles.

In the early 2000s, when Bernanke served as a governor in the Greenspan Fed, there was discussion of whether the Fed was allowing a housing bubble by keeping rates too low. Bernanke believed that "monetary policy is not the right tool for tackling bubbles," a conclusion that "still seems right" to him in writing his book. But in recounting his consideration of QE2 in 2010, Bernanke discusses the worry that "low rates might encourage investors. . .to take excessive risks, possibly fueling new asset bubbles." "I took that issue very seriously," Bernanke writes. This is somewhat loose logic—if high rates are not a good tool for popping existing bubbles, why should the Fed leave rates high in order to prevent new bubbles from forming?

A second example regards Bernanke's belief in the power of Fed communication as policy. He evinces a deep faith in the importance of Fed transparency, and argues strongly for an explicit inflation target. But when he explains his decision not to push for a higher percent inflation target or for NGDP targeting, he expresses skepticism about whether the Fed's promises would be believed by the public. There is a bit of tension here.

Bernanke also skimps a bit on his discussion of the tapering of QE3, the open-ended program of monthly asset purchases. Many observers believed that QE3 was not especially effective—influential New Keynesian theorist Michael Woodford even wrote a paper to this effect in 2012. But Bernanke does not discuss the possibility that QE3 simply did not do very much.

Finally, Bernanke does not do much public soul-searching regarding his beliefs about the Fed's fundamental capabilities. The failure of quantitative easing to generate inflation should have caused at least a little doubt about whether the Fed's basic models were flawed. Indeed, in recent years, a small group of macro-economists have put forward a theory known as Neo-Fisherism, which posits that low interest rates are deflationary rather than inflationary, at least in the long run. Bernanke ignores this and other ideas that challenge the standard New Keynesian concept of how monetary policy works. That is mildly troubling, at least from an academic point of view. The Great Recession, and the policies that were enacted to fight it, were such epochal and dramatic events that if they taught us absolutely nothing new, macroeconomics is in big trouble.

But these are small flaws indeed. No public servant is infinitely wise, altruistic or even-handed. Even the best are merely human. *The Courage to Act* makes a successful case that Ben Bernanke was indeed one of the best public servants we have seen in recent times—a man luckily and uniquely suited to his time, who did as well as anyone could in the environment of extreme uncertainty, time pressure, stress and political controversy into which he was thrown.

The system in which he operated, however, had some flaws that prevented it from doing as well as it might have. Political polarization and the persistent anti-inflation bias of the economics profession combined to limit the options the Fed was able to try in its struggle against the greatest economic crisis of the last 70 years. Rather than hoping that these obstacles go away, we should realize that they represent long-term constraints on the power of central banks. And we should adjust our expectations accordingly.

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