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ANNA SCHWARTZ

# Bernanke Is Fighting the Last War

*'Everything works much better when wrong decisions are punished and good decisions make you rich.'*

By BRIAN M. CARNEY

*New York*

On Aug. 9, 2007, central banks around the world first intervened to stanch what has become a massive credit crunch.

Since then, the Federal Reserve and the Treasury have taken a series of increasingly drastic emergency actions to get lending flowing again. The central bank has lent out hundreds of billions of dollars, accepted collateral that in the past it would never have touched, and opened direct lending to institutions that have never had that privilege. The Treasury has deployed billions more. And yet, "Nothing," Anna Schwartz says, "seems to have quieted the fears of either the investors in the securities markets or the lenders and would-be borrowers in the credit market."

The credit markets remain frozen, the stock market continues to get hammered, and deep recession now seems a certainty -- if not a reality already.

Most people now living have never seen a credit crunch like the one we are currently enduring. Ms. Schwartz, 92 years old, is one of the exceptions. She's not only old enough to remember the period from 1929 to 1933, she may know more about monetary history and banking than anyone alive. She co-authored, with Milton Friedman, "A Monetary History of the United States" (1963). It's the definitive account of how misguided monetary policy turned the stock-market crash of 1929 into the Great Depression.

Since 1941, Ms. Schwartz has reported for work at the National Bureau of Economic Research in New York, where we met Thursday morning for an interview. She is currently using a wheelchair after a recent fall and laments her "many infirmities," but those are all physical; her mind is as sharp as ever. She speaks with passion and just a hint of resignation about the current financial situation. And looking at how the authorities have handled it so far, she doesn't like what she sees.

Federal Reserve Chairman Ben Bernanke has called the 888-page "Monetary History" "the leading and most persuasive explanation of the worst economic disaster in American history." Ms. Schwartz thinks that our central bankers and our Treasury Department are getting it wrong again.

To understand why, one first has to understand the nature of the current "credit market disturbance," as Ms. Schwartz delicately calls it. We now hear almost every day that banks will not lend to each other, or will do so only at punitive interest rates. Credit spreads -- the difference between what it costs the government to borrow and what private-sector borrowers must pay -- are at historic highs.

This is not due to a lack of money available to lend, Ms. Schwartz says, but to a lack of faith in the ability of borrowers to repay their debts. "The Fed," she argues, "has gone about as if the problem is a shortage of liquidity. That is not the basic problem. The basic problem for the markets is that [uncertainty] that the balance sheets of financial firms are credible."

So even though the Fed has flooded the credit markets with cash, spreads haven't budged because banks don't know who is still solvent and who is not. This uncertainty, says Ms. Schwartz, is "the basic problem in the credit market. Lending freezes up when lenders are uncertain that would-be borrowers have the resources to repay them. So to assume that the whole problem is inadequate liquidity bypasses the real issue."

In the 1930s, as Ms. Schwartz and Mr. Friedman argued in "A Monetary History," the country and the Federal Reserve *were* faced with a liquidity crisis in the banking sector. As banks failed, depositors became alarmed that they'd lose their money if their bank, too, failed. So bank runs began, and these became self-reinforcing: "If the borrowers hadn't withdrawn cash, they [the banks] would have been in good shape. But the Fed just sat by and did nothing, so bank after bank failed. And that only motivated depositors to withdraw funds from banks that were not in distress," deepening the crisis and causing still more failures.

But "that's not what's going on in the market now," Ms. Schwartz says. Today, the banks have a problem on the asset side of their ledgers -- "all these exotic securities that the market does not know how to value."

"Why are they 'toxic'?" Ms. Schwartz asks. "They're toxic because you cannot sell them, you don't know what they're worth, your balance sheet is not credible and the whole market freezes up. We don't know whom to lend to because we don't know who is sound. So if you could get rid of them, that would be an improvement." The only way to "get rid of them" is to sell them, which is why Ms. Schwartz thought that Treasury Secretary Hank Paulson's original proposal to buy these assets from the banks was "a step in the right direction."

The problem with that idea was, and is, how to price "toxic" assets that nobody wants. And lurking beneath that problem is another, stickier problem: If they are priced at current market levels, selling them would be a recipe for instant insolvency at many institutions. The fears that are locking up the credit markets would be realized, and a number of banks would probably fail.

Ms. Schwartz won't say so, but this is the dirty little secret that led Secretary Paulson to shift from buying bank assets to recapitalizing them directly, as the Treasury did this week. But in doing so, he's shifted from trying to save the banking system to trying to save banks. These are not, Ms. Schwartz argues, the same thing. In fact, by keeping otherwise insolvent banks afloat, the Federal Reserve and the Treasury have actually prolonged the crisis. "They should not be recapitalizing firms that should be shut down."

Rather, "firms that made wrong decisions should fail," she says bluntly. "You shouldn't rescue them. And once that's established as a principle, I think the market recognizes that it makes sense. Everything works much better when wrong decisions are punished and good decisions make you rich." The trouble is, "that's not the way the world has been going in recent years."

Instead, we've been hearing for most of the past year about "systemic risk" -- the notion that allowing one firm to fail will cause a cascade that will take down otherwise healthy companies in its wake.

Ms. Schwartz doesn't buy it. "It's very easy when you're a market participant," she notes with a smile, "to claim that you shouldn't shut down a firm that's in really bad straits because everybody else who has lent to it will be injured. Well, if they lent to a firm that they knew was pretty rocky, that's their responsibility. And if they have to be denied repayment of their loans, well, they wished it on themselves. The [government] doesn't have to save them, just as it didn't save the stockholders and the employees of Bear Stearns. Why should they be worried about the creditors? Creditors are no more worthy of being rescued than ordinary people, who are really innocent of what's been going on."

It takes real guts to let a large, powerful institution go down. But the alternative -- the current credit freeze -- is worse, Ms. Schwartz argues.

"I think if you have some principles and know what you're doing, the market responds. They see that you have some structure to your actions, that it isn't just ad hoc -- you'll do this today but you'll do something different tomorrow. And the market respects people in supervisory positions who seem to be on top of what's going on. So I think if you're tough about firms that have invested unwisely, the market won't blame you. They'll say, 'Well, yeah, it's your fault. You did this. Nobody else told you to do it. Why should we be saving you at this point if you're stuck with assets you can't sell and liabilities you can't pay off?'" But when the authorities finally got around to letting Lehman Brothers fail, it had saved so many others already that the markets didn't know how to react. Instead of looking principled, the authorities looked erratic and inconstant.

How did we get into this mess in the first place? As in the 1920s, the current "disturbance" started with a "mania." But manias always have a cause. "If you investigate individually the manias that the market has so dubbed over the years, in every case, it was expansive monetary policy that generated the boom in an asset.

"The particular asset varied from one boom to another. But the basic underlying propagator was too-easy monetary policy and too-low interest rates that induced ordinary people to say, well, it's so cheap to acquire whatever is the object of desire in an asset boom, and go ahead and acquire that object. And then of course if monetary policy tightens, the boom collapses."

The house-price boom began with the very low interest rates in the early years of this decade under former Fed Chairman Alan Greenspan.

"Now, Alan Greenspan has issued an epilogue to his memoir, 'Time of Turbulence,' and it's about what's going on in the credit market," Ms. Schwartz says. "And he says, 'Well, it's true that monetary policy was expansive. But there was nothing that a central bank could do in those circumstances. The market would have been very much displeased, if the Fed had tightened and crushed the boom. They would have felt that it wasn't just the boom in the assets that was being terminated.'" In other words, Mr. Greenspan "absolves himself. There was no way you could really terminate the boom because you'd be doing collateral damage to areas of the economy that you don't really want to damage."

Ms Schwartz adds, gently, "I don't think that that's an adequate kind of response to those who argue that absent accommodative monetary policy, you would not have had this asset-price boom." Policies based on such thinking only lead to a more damaging bust when the mania ends, as they all do. "In general, it's easier for a central bank to be accommodative, to be loose, to be promoting conditions that make everybody feel that things are going well."

Fed Chairman Ben Bernanke, of all people, should understand this, Ms. Schwartz says. In 2002, Mr. Bernanke, then a Federal Reserve Board governor, said in a speech in honor of Mr. Friedman's 90th birthday, "I would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again."

"This was [his] claim to be worthy of running the Fed," she says. He was "familiar with history. He knew what had been done." But perhaps this is actually Mr. Bernanke's biggest problem. Today's crisis isn't a replay of the problem in the

1930s, but our central bankers have responded by using the tools they should have used then. They are fighting the last war. The result, she argues, has been failure. "I don't see that they've achieved what they should have been trying to achieve. So my verdict on this present Fed leadership is that they have not really done their job."

**Mr. Carney is a member of The Wall Street Journal's editorial board.**

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