

BERNANKE vs. GREENSPAN

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Recent commentaries have derided Bernanke as an “ivory tower” academic. But commentaries have also derided Greenspan as too close to the Street, and therefore too quick with the Greenspan put. In fact, neither is superior to the other, just slightly different. And while Bernanke may draw complaints about not being transparent, he is in fact being very transparent (to another academic, at least), just not in a way that journalists and Street economists are used to.

Recall some years ago Greenspan was derided for deviating from monetary policy “rules,” instead making monetary policy decisions on the basis of “discretion.” With Greenspan, that meant spending hours in the bathtub pouring over arcane economic reports and then dominating the Federal Open Market Committee meetings. Bernanke, on the other hand, has returned to monetary rules. Bernanke understands that discretion cannot be trusted overnight, and that credible commitment to rules can bolster a reputation for sound monetary judgment.

But while Greenspan used discretion in monetary policy, he also developed the rule of the “Greenspan put.” The Greenspan put rule implied that any time markets got into trouble, the Fed would provide adequate liquidity to stem the crisis. Bernanke, instead, seems to be using discretion in responding to Wall Street’s woes, forcing investors to again price risk.

THE IMPORTANCE OF THE GREAT DEPRESSION

Some of the derision pointed toward Bernanke comes from his supposedly “arcane” study of the market and economic dynamics of the Great Depression. But that focus is precisely what gives Bernanke the advantage in responding to crises with discretion. One of the biggest problems in macroeconomics is that while contemporary theory explains adequately business cycle turning points, it cannot explain usefully the depth and duration of business cycles.

The work of Bernanke and others suggests that the depth and duration of business cycle downturns is strongly affected by financial conditions. Hence, while the recession of 2001 was short and shallow, those of 1982 and 1991, both

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accompanied by some degree of financial market turmoil, were substantially more pronounced.

Financial crises, present company included, generally arise from overextending new, albeit poorly understood, financial products. In that way, financial crises are part and parcel of financial innovation. But the study of financial crises therefore becomes an epistemological problem: the crisis happened in an opaque financial sector that was not being monitored, so there is little data available to study the contribution of the sector to the crisis. If investors and regulatory had the benefit of transparency, there often would have been no crisis!

Investors react to the lack of transparency, however, by pulling back all actual and potential sources of exposure to the affected sector until they can once again distinguish good risk from bad. During the investors' absence, funds may not be available at any price. As Bernanke characterized the situation in his 1983 American Economic Review article, the cost of credit intermediation rises to a prohibitive level. Furthermore, monetary policy is too blunt an instrument to use for addressing market crises. Rather, in line with Greenspan's actions, target injections of liquidity can often adequately address problems that are not manifested in real economic performance.

CREDIT SUPPLY OR DEMAND?

Once liquidity is injected, however, an issue that manifested itself in the Great Depression immediately raises its ugly head: is the problem credit supply or credit demand? The problem at this stage many work out through a process of "optimal waiting." The way I characterize that problem in follow-up research to Bernanke's is that of valuing the "Vulture" timing option. Everyone waits for markets to get better before selling, but if everyone waits, markets don't improve. That standoff arises because the value of the timing option, the is the value of the option to wait, is most valuable when investors anticipate high volatility (prices restored from their previous trough) and low discount rates (to relieve the opportunity cost of waiting). This characterization explains why Japan experienced the "lost decade," while investors waited for price recovery at 0% interest rate opportunity cost.

SET-UP FOR A PROLONGED RECESSION?

So does all this mean that Bernanke is dithering, setting us up for a prolonged recession? Well, if the Street economists really believe that "economic fundamentals are strong," there should be no worry. There is no economic evidence that financial market movements cause recessions. They may cause existing recessions to be deeper and longer than otherwise, but they do not cause recessions. Furthermore, if the Street can talk down the crisis, why should Bernanke do the work for them? If, instead, as Cramer claimed in his recent rant on CNBC, that the Street doesn't really believe the underlying fundamentals are as strong as they claim, they should stop lying to the public. Bernanke is right not to condone such behavior.

So what is the solution? Transparency for the thirty year-old structured finance sector. The sector led the economy out of the 1982 recession and associated thrift crisis and helped mitigate the effects of the recession of 1991.

Unfortunately, with having grown to a mature industry with attenuating transparency, market depth, and liquidity, the structured finance sector now poses risks to broader economic growth. Just like an adolescent coming of age, there should be no bailout without responsibility for reaching maturity and acting accordingly.