

Ben Bernanke Is Also to Blame

By Desmond Lachman
Handelsblatt (Germany)
January 29, 2008

As the United States' worst housing market bust since the Great Depression raises the specter of a nasty recession, a serious reappraisal of Alan Greenspan's 17-year chairmanship of the Federal Reserve is underway. Justified as this reappraisal might be, it should not be allowed to detract from Ben Bernanke's role in today's US housing market debacle, especially since Mr. Bernanke assumed the Federal Reserve chairmanship in February 2006 a full year before the worst of the sub-prime lending excesses were to be made.

To be sure, Mr. Greenspan must assume the major part of the responsibility for having sown the seeds of the largest US housing and credit market bubbles in the post-war period. He did so in part by lowering interest rates to abnormally low levels in the aftermath of the 2001 bursting of the NASDAQ bubble and then by maintaining interest rates at artificially low levels for far too long. As if this were not enough, Mr. Greenspan also presided over an unprecedented loosening of mortgage lending standards as epitomized by the explosion of sub-prime mortgage lending.

Far from using the Federal Reserve's regulatory authority to reign in the non-bank mortgage loan originators, which were responsible for more than half of all sub-prime loan originations, Mr. Greenspan is on record for having seen merit in sub-prime lending. He did so in the belief that such lending offered a viable route to expanding home ownership. Mr. Greenspan is also on record for having enthusiastically embraced financial market innovations, like the securitization of mortgage loans and the increased use of Adjustable Rate Mortgages, which were only to compound the problems in the financial system.

Worse still, Mr. Greenspan never tired of arguing that it was not the job of the Federal Reserve to attempt to identify asset price bubbles. Nor did he believe that the Fed should pay attention to asset price inflation in setting monetary policy. He did so in total disregard of the United States' own untoward experience with the bursting of the NASDAQ bubble as well of that of the Japanese experience with the bursting of their asset price bubbles in the late 1980s. Rather, he left it to his successor Mr. Bernanke to deal with the consequences of having created oversized housing price and credit market bubbles.

While one has to sympathize with Mr. Bernanke's present predicament, which is hardly of his own making, one has to ask why was he as passive as he was in 2006 as the worst of the sub-prime loans were made under his watch. During that year, a total of around US\$600 billion in sub-prime mortgage lending, or around one half the total amount of sub-prime lending presently outstanding, was made on conditions that were materially more lax than earlier vintages of sub-prime lending. Indeed, it became commonplace for banks to extend loans up to 100 percent of the value of the underlying property and to make such loans to borrowers without incomes, without jobs, and without assets.

Mr. Bernanke also needs to be held accountable for totally misjudging how serious would be the bursting of the housing market bubble and how large would be the losses to the financial system from imprudent sub-prime lending. In April 2007, when he first identified that something was amiss with sub-prime lending, he assured Congress that the sub-prime problem would be limited in size and that any fallout would be confined to the housing sector. A few months later he was forced to concede that sub-prime mortgage lending might result in losses to the financial system of the order of US\$50 billion to US\$100 billion, only to have to modify these estimates again to something in the ballpark of US\$150 billion. He did so even though current market estimates of sub-prime mortgage lending losses are anywhere between US\$200 billion to US\$400 billion.

Mr. Bernanke's misjudgment of the severity of the housing bust blinded him to the need for early and decisive monetary policy action. Indeed, it was as late as the middle of August 2007 before the Federal Reserve started the current interest rate cutting cycle. This was long after it had become apparent to most market observers that large sub-prime losses and a lack of transparency in the new fangled debt instruments were leading to a seizing up of the international banking system. And even when the Fed did begin cutting interest rates, it did so gingerly and it repeatedly underestimated the downside risks to economic growth from the housing market debacle.

The Federal Reserve's dramatic 75 basis point inter-meeting cut on January 21 suggests that at last the Federal Reserve is grasping how serious is the threat to the economy emanating from a lethal combination of a major housing market bust, an acute credit crunch, and international oil prices at close to US\$90 a barrel. While this latest cut is too late to prevent a recession in the first half of 2008, it does give hope that the Federal Reserve will at least not repeat the mistakes of the Great Depression or of Japan's lost decade, when monetary policy was kept too tight for too long in the face of the bursting of large asset price bubbles.

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