IN FED WE TRUST

BEN BERNANKE'S WAR ON THE GREAT PANIC

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Introduction

WHATEVER IT TAKES

At the beginning of October 2008, after some of the toughest weeks of the Great Panic, the lines in Ben Bernanke's face and the circles under his eyes offered evidence of more than a year of seven-day weeks and conference calls that stretched past midnight. Sometimes all that seemed to keep Bernanke going was the constantly restocked bowl of trail mix that sat on his secretary's desk and the cans of diet Dr Pepper from the refrigerator in his office. But the balding, bearded chairman of the Federal Reserve managed a smile as he confided that he had a title for the book he would write someday about his watch as helmsman of the world economy: *Before Asia Opens*...

The phrase was a reference to the series of precedent-shattering decisions that Bernanke and others at the Fed and Treasury had been forced to make with insufficient sleep and inadequate preparation on Sundays so they could be announced before financial markets opened Monday morning in Asia, half a day ahead of Washington and New York.

Before Asia Opens...was not a laugh line. The subprime mortgage mess was made in America, and that meant the U.S. government was forced to lead the cleanup. Ben Bernanke had more immediate power to do that than any other individual. The president of the United States can respond instantly to a missile attack with real bullets; he cannot respond instantly to financial

panic with real money without the prior approval of Congress. But Bernanke could and did.

Yet the United States had become so dependent on the flow of money from abroad and the business of American financial institutions was so intertwined with those overseas that Bernanke didn't have the luxury of waiting until the sun rose over Washington to make decisions and pronouncements. Hence the subject line Goldman Sachs economists put on one of their weekly e-mails: "Sunday is the new Monday."

There was the Sunday in March 2008 when the Federal Reserve shattered seventy years of tradition and lent $30 billion to induce JPMorgan Chase to buy Bear Stearns, a flailing investment bank the Fed neither regulated nor officially protected.

And the Sunday in August 2008 when Bernanke and Treasury Secretary Henry Paulson, the nation's self-appointed investment banker in chief, decided to seize Fannie Mae and Freddie Mac, the government-sponsored, shareholder-owned mortgage giants that had borrowed heavily from abroad.

And the Sunday in late September 2008 when Bernanke and his Wall Street field marshal, Timothy Geithner, then president of the Federal Reserve Bank of New York, pressured the Federal Deposit Insurance Corporation to invoke an emergency law to subsidize Citigroup's attempt to strengthen itself by acquiring Wachovia.

Yet no Sunday of the Great Panic would prove as consequential and controversial as September 14, 2008, the day Bernanke, Geithner, and Paulson allowed Lehman Brothers to fail after a desperate search for someone to buy it.

The government-sanctioned bankruptcy of a Wall Street firm founded before the Civil War marked a new phase in the Great Panic, a moment when financial markets went from bad to awful. The *Wall Street Journal* dubbed it the "Weekend That Wall Street Died." Lehman's bankruptcy was the largest in U.S. history. The financial market reaction was ugly. At the end of trading on Monday, the Dow had plummeted over 500 points, its biggest one-day drop since September 17, 2001, when trading resumed following the 9/11 attacks. While financial giants led the way down — Goldman Sachs stock lost 19 percent, Citigroup 15 percent — every major sector on the S&P 500 index posted a loss. Other economic indicators were also negative: In antici-

pation of a global slowdown, oil prices plunged, while spooked investors sent the price of supersafe Treasury bills soaring. In a sign of what was coming, dozens of traders crowded around the specialists who trade American International Group, America's largest insurance company, on the New York Stock Exchange floor as Monday's trading began. AIG shares, which had closed on Friday at $12.14, opened Monday at $7.12 and ended the day at $4.76.

As horrible as the first day after Lehman was, the bigger fear was that nobody knew where the collapse might end. Bernanke, Geithner, and Paulson confronted the biggest threat to American capitalism since the 1930s, and their responses were commensurately big.

Within one week, they:

- married venerable brokerage house Merrill Lynch to Bank of America
- all but nationalized AIG, pumping in $85 billion of Fed money to keep it alive
- risked taxpayer money to halt a run on money market mutual funds no one ever considered guaranteed by the government
- administered last rites for Wall Street's investment-banking business model by converting Goldman Sachs and Morgan Stanley into Fed-protected bank-holding companies
- pleaded with Congress to give the Treasury $700 billion to prevent catastrophe, a request that ultimately led to a Republican administration taking a government ownership stake in the nation's biggest banks

The Fed was the first responder. It acted as quickly and forcefully as its leaders could manage in order to prevent the country—and the global economy—from plunging into the abyss. Bernanke bluntly said as much later: "We came very, very close to a global financial meltdown, a situation in which many of the largest institutions in the world would have failed, where the financial system would have shut down, and . . . in which the economy would have fallen into a much deeper and much longer and more protracted recession."

In ways that the public and politicians had never before appreciated, that weekend, and the months that followed, would reveal that the Federal Reserve

had become a *fourth branch of government,* nearly equal in power to the executive, legislative, and judicial branches, though still subject to their constitutional authority if they chose to assert it.

Ben Bernanke and a small cadre of advisers would vow to do *whatever it takes* to avoid a possibility that, until 2008, was unthinkable: a repeat of the Great Depression.

The Republic of the Central Banker

The Federal Reserve—one chairman, six other Washington-based governors, the twelve presidents of regional Fed banks that dot the map from Boston to San Francisco, 21,199 employees—is given extraordinary latitude. Few checks exist on its actions beyond the oath of the chairman and other governors to obey the Constitution and laws of the United States and the admonitions of its lawyers, a strong unwritten sense of what constitutes sound central banking, and the awareness that Congress has the power to curb the Fed's independence if it strays too far from what the public deems acceptable. As Berkeley economic historian and prolific blogger Brad DeLong put it: "It is either our curse or our blessing that we live in the Republic of the Central Banker."

During the reign of Alan Greenspan—which wasn't much of a republic—the smart people of the Federal Reserve allowed the housing bubble to inflate. They stood by as banks and investors made ever bigger bets on the flawed assumption that housing prices would never fall across the country. They encouraged financial engineering that created securities so complex that neither inventor nor seller nor buyer could fully understand them, instruments that proved toxic to those who bought them and to everyone around them. They shielded financial engineers from attempts at government regulation and restraint. With huge sums at stake, they trusted investors and traders to protect themselves—and the rest of us—better than even the smartest government regulator could hope to. Ultimately, they failed to see that the big banks that the Fed was charged with supervising were gambling with the global economy. It was, among other things, a colossal failure of imagination.

When the bubble burst, Greenspan was gone. Ben Bernanke, the Prince-