

The Man from Main Street

BEFORE GEORGE W. BUSH BROUGHT HIM TO WASHINGTON, Bernanke's only political experience was on his local school board. His friends didn't even know he was a Republican. His only leadership experience was chairing Princeton's economics department; he liked to joke that his major decisions involved what type of bagels to order for faculty meetings. Even after he took over the Fed, he never expected all this drama—which is to say he utterly failed to foresee the global financial implosion. But when credit markets disintegrated, he had the ideal background to respond. "It's like a novel," marvels Fed governor

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To earn money in college, Bernanke waited tables (and wore a poncho) at South of the Border, a storied local tourist spot

challenge. To understand geology, he says, study earthquakes; to understand the economy, study the Depression. "I don't know why there aren't more Depression buffs," he wrote in a book of essays about the period. "The Depression was an incredibly dramatic episode—an era of stock-market crashes, breadlines, bank runs and wild currency speculation, with the storm clouds of war gathering ominously in the background... For my money, few periods are so replete with human interest."

The first thing any Depression scholar comes to understand is that nothing—not hyperinflation, megadeficits or irked Chinese creditors—is as bad as a full-on Depression. A collapse in the "aggregate demand" for goods and services that makes an economy hum can be irreversible. Businesses fail, so workers lose jobs, so consumer spending declines, so more businesses fail. Depression scholars—including Bernanke—tend to see the Hoover Administration's approach of balancing budgets and tightening belts during the downturn as a tragic mistake. They embrace the Keynesian view that aggressive government action backed by government money is needed to reverse death spirals by restoring confidence and reviving demand. Get people money, and they can buy shoes for their barefoot kids, so shoe factories can reopen and rehire, which gets more people money. "People saw the Depression as a necessary thing—a chance to squeeze out the excesses, get back to Puritan morality," Bernanke says. "That just made things worse." In contrast, the Roosevelt Administration's New Deal stimulus and try-everything attitude made real, albeit uneven, progress against the downturn.

But Bernanke's main academic focus was the central role of monetary policy and the Fed in creating the catastrophe. So let's take a moment for a quick Fed primer. The Fed's central function is its dual mandate to steer the economy toward stable prices and maximum employment through monetary policy. To rev up a weak economy, it can lower interest rates by buying Treasury bonds or other safe securities, essentially printing money and dumping it into the banking system with a mouse click. Loose money can encourage banks to lend and firms to hire. This tends to make people happy but can increase inflation risks and weaken the dollar, which can make markets nervous and destroy the value of savings. Loose money can also provide the fuel for financial explosions by incentivizing wild risk-taking. Conversely, to apply brakes to an overheated economy and guard against inflation and asset bubbles, the Fed can raise interest rates by selling securities and contracting the money supply—as the saying goes, taking away the punch bowl as the party starts.

The Fed is also the nation's lender of last resort during financial panics, the original rationale for its creation in 1913. Traditional banks serve a vital economic function, providing safe places to park savings, then lending out the deposits so that borrowers can buy homes, start businesses and put the money to work. But banks are inherently vulnerable to breakdowns in confidence: when nervous depositors rush to withdraw their cash, even a solvent bank can run low on ready funds, which only intensifies the panic. After J.P. Morgan had to organize a private cash infusion to quell a 1907 panic, financiers persuaded Congress to create a central bank that could lend emergency money to stop runs, so that illiquid but otherwise healthy institutions wouldn't have to shut their doors.

Unfortunately, the Fed's leaders didn't comply after the Great Crash in 1929. Instead of lending freely, they let one-third of the nation's banks fail. Instead of lowering interest rates and expanding the money supply to spur the economy, they raised rates and tightened money, obsessing over inflation and the dollar's strength when they should have worried about deflation and runaway unemployment. Bernanke was deeply influenced by economist Milton Friedman's critiques of the Fed, and after joining its board in 2002, he apologized on its behalf at Friedman's 90th birthday party: "Regarding the Depression: You're right. We did it. But thanks to you, we won't do it again."

Bernanke's research added key nuances to the blame-the-Fed thesis. He showed that the Depression was caused not just by insufficient money sloshing around the system but also by clogged credit channels that prevented that money from flowing toward potentially productive borrowers when too many banks failed. He also outlined a "financial accelerator" effect in which disrupted financial markets increase the cost of credit, which intensifies downturns, which further increases the cost of credit. And he frequently explored the self-fulfilling nature of economic uncertainty, showing how it dissuades employers from hiring, consumers from spending and lenders from lending. The economy, after all, is a confidence game. That's why financial analysts use psychological phrases like "jittery markets" and "economic anxiety." It's no accident that the word *credit* comes from the Latin word for belief.

"Ben understood more clearly than anyone how a crisis of confidence can create a domino effect," says Liaquat Ahamed, author of *Lords of Finance*, a vivid history of the misguided central bankers who produced the Depression. It's one of Bernanke's favorite books, except that he wishes he had written it himself; he was working on a

similar history for Princeton University Press before he was summoned to Washington in 2002.

His working title was *The Age of Delusion*.

"Once He Got It, He Really Got It"

BERNANKE BECAME A FED GOVERNOR AT THE height of the Age of Greenspan, shortly after Bob Woodward's biography hailing the "Maestro" but before John McCain's quip that if Greenspan died, he should be propped up at the Fed like the corpse in *Weekend at Bernie's*. Bernanke quickly emerged as a staunch defender of the Greenspan Fed and its loose monetary policies. He suggested that raising interest rates to deflate the dotcom bubble before it popped would have been like using a sledgehammer to perform brain surgery. He delivered a call to arms against deflation, proposing ways the Fed could keep juicing the economy even if rates fell to zero. When he took over the Fed in 2006, after an uneventful eight-month White House stint leading Bush's Council of Economic Advisers, he said his top priority would be continuing Greenspan's policies. "Ben and I have never had a serious disagreement," Greenspan says.

In fact, Bernanke did make subtle changes, pushing for more transparency and clarity, speaking last instead of first at rate-setting meetings to avoid imposing his views. And while Greenspan had been laissez-faire about the Fed's oversight responsibilities, Bernanke pushed through long-overdue subprime-lending reforms in 2007. Still, Bernanke was as clueless as Greenspan about the coming storm. He dismissed warnings of a housing bubble. He insisted that economic fundamentals remained strong. In March 2007, he assured Congress that "the problems in the subprime market seem likely to be contained." The day before the global crisis erupted with a run on a French bank, the Fed was still saying its primary concern was inflation. "Bernanke had no idea what was going on," a foreign central banker tells *TIME*. "Once he got it, he really got it, and he acted swiftly and decisively. But wow! It took a while."

Bernanke concedes that he failed to anticipate how fragile such an overleveraged and interconnected system could be, how fear about a \$1 trillion subprime mess could paralyze a \$60 trillion global economy, how overnight-lending markets that got banks and corporations through the day could seize up overnight. He didn't share Greenspan's ideological faith that markets always know best, but he was surprised how spectacularly financial firms misjudged risk in their own portfolios, how collateralized debt obligations, credit-default swaps and other exotic financial weapons of mass destruction blew up in their faces. "None of us appreciated what a jury-rigged thing the financial system had become," he says. And while the Fed

clearly blew its supervision of bank holding companies like Citigroup, it wasn't responsible for investment banks like Bear Stearns and Lehman Brothers, the housing enterprises Fannie Mae and Freddie Mac or the other untraditional financial contraptions whose troubles drove the crisis. The Fed was not in charge of monitoring risks to the entire system either. No one was. "Of course there were things we could have done better," he says, "but this was a perfect storm."

Once Bernanke realized a disaster was unfolding, he made a conscious effort to project calm, even when he was working seven days a week and all hours of the night, even when the Wall Street types around him were screaming and cursing like stressed-out sailors. "He decided he wouldn't be a deer in the headlights and wouldn't let the world blow up," recalls Columbia University economist Frederic Mishkin, who was on the Fed board at the time. He also made a conscious decision to avoid the mistakes made by the bankers of the 1930s—not only their stingy refusals to supply cash but also their inflexible inside-the-box thinking. He hung their picture on his office wall. He held "blue sky" brainstorming sessions to solicit unorthodox ideas. An obscure legal provision gave the Fed broad latitude in "unusual and exigent circumstances," and he did whatever it took. "In exceptional circumstances," says European Central Bank president Jean-Claude Trichet, "he has done exceptional things."

"A War of Necessity"

TODAY THE SECOND-GUENESSERS ARE RUNNING wild. Why didn't the Fed stop bailed-out companies from handing out lucrative dividends and bonuses? Why pay off AIG's creditors in full? Why save Bear Stearns but not Lehman Brothers? "It's the price of success: people start to think you're omnipotent," Bernanke says. "We say we didn't have the authority, and it's 'Oh, you're the Fed. You could've come up with something.'"

The Fed has become the new Trilateral Commission; no conspiracy theory is too far-fetched. There's a vivid example on YouTube, a video titled "Florida Congressman Alan Grayson Laughs in Ben Bernanke's Face—Priceless!" The rabble-rousing Democrat, wearing a shiny tie festooned with dollar bills, grills Bernanke (and mispronounces his name) about \$553 billion worth of currency swaps the Fed made with foreign central banks that ran low on dollars during the credit crunch. This was textbook central banking: pumping liquidity into markets during a panic. The swaps were safe, interest-bearing loans and didn't cost taxpayers a dime. But Grayson seems to think he's uncovered a nefarious handout to shadowy foreigners. The laughter



Bernanke and his wife own just one car, a Ford Focus. It is almost paid off.



Bernanke met his wife Anna, a teacher, on a blind date. She was a student at Wellesley College, and he was in graduate school at MIT. The Bernankes have two children. They refinanced their Capitol Hill home a couple of months ago because they "had an adjustable-rate mortgage, and it exploded." Now they have a 30-year fixed rate of a little over 5%.