Fed Moved by Credit Squeeze, Not Stock Meltdown

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Fed Chairman Ben Bernanke’s first published economics article begins “This paper examines the possibility that the economy-wide level of bankruptcy risk plays a structural role in the propagation of recessions.” Published in the *American Economic Review* in 1981, Bernanke’s analysis showed how a recession causes lenders to reduce their lending so that they can remain solvent, which in turn causes the recession to become worse.

The Fed Chairman spent much of his career investigating issues related to credit flows in the economy. The title of that first article was “Bankruptcy, Liquidity, and Recession” and he followed that with related studies, such as “The Real Effects of Financial Crises: Theory and Evidence,” “Non-Monetary Effects of the Financial Crisis in the Propagation of the Great Depression,” “Credit, Money, and Aggregate Demand,” “Financial Fragility and Economic Performance,” “The Credit Crunch,” and “Credit in the Macroeconomy.” There is not an economist alive who knows more about the importance of credit to the macroeconomy than Chairman Bernanke.

How ironic it is that Bernanke should be Fed chairman during the first financial crisis in a decade and the first credit crunch in almost two decades. But also how fortunate that he understands, far better than most economists, why it is crucial that the Fed ensure that credit flows smoothly in the economy, despite the clear breakdown of mortgage markets and substantial losses by financial firms.
The FOMC’s action to cut its target for the federal funds rate by 75 basis points one week before the regularly scheduled January meeting was not done in response to deteriorating economic conditions. It was not done in response to the drop in world stock markets. It was done mainly to facilitate credit flows. Bernanke’s research shows that when credit stops, the economy flops. Financial institutions that were part of the mortgage meltdown are suffering losses, which they rightly deserve as punishment for the risks they took. But the small businessperson, who relies on bank credit for survival and growth, should not be punished too. The FOMC’s actions are an attempt to keep funds in the hands of banks, with the hope that such funds will in turn keep small businesses afloat. The danger is that if credit flows dry up, an economic slowdown will turn into a major recession, as small businesses cut back their operations or close shop.

If banks do not lend, then even sound borrowers cannot get funds for good investments, and economic growth declines. All sectors of the economy other than housing are in decent shape, export industries are growing rapidly, and the economy should be accelerating. But if the credit crunch becomes severe enough, these other sectors will feel the pinch, and the entire economy will falter.

The Fed has been very creative in its battle to keep credit flowing. The Fed’s novel Term Auction Facility has supplied billions of dollars to financial institutions in a competitive bidding process. In December, this mechanism put an additional $50 billion into banks’ hands that they could use to get through this period in which funds are scarce, and then repay to the Fed in January. Similar auctions are planned at regular intervals until they are no longer needed.
The main headline of Tuesday’s Wall Street Journal screamed: “Credit Scare Spreads in U.S., Abroad: Loan Terms Tighten for Smaller Businesses; Recipe for Slower Growth.” Whether credit to sound borrowers is really becoming scarce or not, it is the “scare” that worries the Fed. If people believe that credit is scarce, they will act as if it is and that may exacerbate the problem. According to Chairman Bernanke’s own research, the easing of monetary policy is precisely the right thing to do in these circumstances.

The Fed’s press release when it cut the funds rate noted in its usual understated manner that: “. . . broader financial market conditions have continued to deteriorate and credit has tightened further for some businesses and households.” The crisis is here, the Fed is responding, and as long as banks get the funds they need to make good loans to sound businesses, the worst outcomes will be avoided.