The "Bernanke Put": A Gift or a Contract?

James Kahn

In 1790, Alexander Hamilton proposed his controversial "assumption" plan, under which the new federal government would assume responsibility for state debts incurred during the American Revolution, and pay them off at 100 cents on the dollar. This was a huge windfall to northeastern financiers, who had purchased the debt from the original creditors (a group that included soldiers who fought in the war) for as little as 25 cents on the dollar, and generated considerable outrage in other parts of the country. Ultimately the plan was approved only by virtue of the famous "dinner table compromise" worked out at Jefferson's Maiden Lane home, in which as a *quid pro quo* it was agreed that the nation's capital would be moved to a site on the Potomac River.

Fast forward 140 years. In 1930 the reluctance of Federal Reserve, some say because of the weak leadership of the New York branch's president George L. Harrison, to undertake aggressive actions to expand the money supply and to stem the tide of bank closings is widely believed to have been a major factor that transformed an economic downturn into the Great Depression. The Fed's failure to carry out its mission of safeguarding financial stability led to a loss of confidence among both bank depositors, who withdrew funds from the banking system, and banks themselves, which began to carry excess reserves and cut back on lending activity.

Hamilton's policy is widely credited for emphatically establishing the fledgling nation's good credit. Discounts on government paper dropped dramatically, and credit became readily available. Among other things, this facilitated the financing of the Louisiana Purchase in 1803. The Federal Reserve's tight money policy in 1930, on the other hand, is widely viewed as a mistake, and one of the contributing factors to the Great Depression.

What does any of this have to do with the challenges of present-day monetary policy? Many critics of Alan Greenspan and now of Ben Bernanke argue that the Fed, in opening up the spigots in response to financial turmoil, provides a windfall to financiers, in this case by effectively bailing them out of their own messes. This is the same sin of which Hamilton was accused, but which the Federal Reserve is criticized for failing to do in 1930. The present-day critics further argue that by responding to the current situation as it has, by injecting liquidity and cutting the Federal Funds rate, the Fed has put insufficient weight on the problem of "moral hazard," the notion that this so-called bailout will only encourage future unwise risk-taking.

The original Federal Reserve Act of 1913 focused on the goal of stability of the financial system, and in particular the Fed's role as lender of last resort, in the wake of periodic banking panics. (Subsequent amendments, notably the1946 Employment Act and the 1978 Full Employment and Balanced Growth Act, have stressed broader macroeconomic goals of "full employment . . . and reasonable price stability.") In effect, the Fed took over the role previously provided by the private sector's "clearinghouse" system, in which large money center banks coordinated to provide liquidity during financial crises. Thus the Fed's 1930 benign neglect was perceived as a breach of its commitment to act as lender of last resort. Depositors lost confidence in the safety of the banking system. The resulting panics and massive withdrawals from the banking system caused a massive decline in available credit, as famously documented by Milton Friedman and Anna Schwartz in their epic *Monetary History of the United States.*

For Hamilton, Harrison, and now Bernanke, the real question is whether what is at stake represents an implicit contract, or just a gift. Hamilton's assumption plan was not literally the fulfillment of any contractual commitment on the part of the federal government, since no such government existed when the paper had been issued by the individual states. And it clearly was a gift to New York financiers, who reaped huge windfalls. Nonetheless, as with many gifts, benefits rebounded to the giver many times over. Hamilton's policy established the credibility of the government's commitment to honor its debts. It said, in effect, "We will even honor commitments that we did not make. So you can trust us to honor the ones we do make." The Fed's inaction in 1930 is, at least with hindsight, viewed as the failure to keep a promise, the results of which were catastrophic.

Insurance companies are well aware of moral hazard, but when a client has a legitimate claim, there is no debate about whether to pay it off. The insurer fulfills its commitment, as it is legally bound to do. The job of the Federal Reserve—its commitment—is widely understood to include financial stability and serving as a lender of last resort, in addition to fostering price and employment stability. The charge of ignoring moral hazard could equally be leveled at the Fed for countercyclical policy more broadly. After all, when rates are cut during a downturn in an effort to stimulate the economy, does that not bail out many who took unwise risks? What if a more stable economy encourages more risk-taking? Yet few would argue on these grounds that central banks should abandon countercyclical policy altogether .

It remains to be seen, of course, whether the Fed's decision to provide liquidity to banks and to cut the funds rate is the right one. But the issue hangs not on tough love versus compassion, on how much to punish those who have made (with hindsight, at least) bad investment decisions. Rather, it depends on the tradeoffs associated with the Fed's commitments to both financial stability and low inflation. The favorable interpretation is that the stabilization measures are just short-term imperatives, the analog of emergency room doctors' efforts to stabilize the patient before dealing with any underlying health problems. The unfavorable view is that by intervening as it has, the Fed is showing a willingness to tolerate higher inflation.

This is the textbook dilemma facing central bankers, but it has naught to do with moral hazard. A refusal to intervene on punitive grounds could be seen as a breach of promise, and could have a lasting impact on investors' perceptions of risk. Investments undertaken with the expectation of the Fed's commitment to financial and economic stability received a relatively small risk premium (in contrast to those financiers who bought up the states' revolutionary war debt in Hamilton's day), thereby lowering their cost. While irresponsible risk-takers should pay a price (and they have), monetary policy is too crude an instrument for inflicting punishment on wrongdoers. A preoccupation with moral hazard is inconsistent with the central bank's job of helping to foster financial—and thereby economic—stability.