Business Economics (2021) 56:183–185
https://doi.org/10.1057/s11369-020-00202-3

BOOK REVIEW

Mitchel Y. Abolafia: *Stewards of the Market: How the Federal Reserve Made Sense of the Financial Crisis*

Harvard University Press, 2020

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Published online: 18 February 2021
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1 Introduction

This is a great book. It describes in granular detail the "Surprise; Confusion; and Groping Forward" of Fed Chairman Ben Bernanke and his fellow participants on the Federal Open Market Committee as they dealt with the economic paradigm that was seemingly shifting beneath their feet during the Great Financial Crisis ("GFC"). The reader gets to witness an almost live view of economic history through the eyes and perspective of a sociologist/cultural anthropologist, a refreshing alternative to the viewpoints of journalists, economists, historians, and policymakers themselves.

From our vantagepoint in 2020, we know the stories of what happened and how the Fed stabilized the financial system and the macro economy. We also grasp that the Coronavirus Pandemic of 2020 is changing our economic paradigm from the post-GFC paradigm that we were beginning to feel accustomed to. Against this backdrop, the lessons of how economic policymakers, especially the Fed, cope, and adapt to rapid changes in the economic environment, are especially relevant.

2 A unique methodology

This book is notable for its almost complete absence of macroeconomic statistics; it is devoid of econometric models; there is no counting of bank failures or calculations of home foreclosures or bank loan-loss write downs. We have heard these stories ad infinitum. The book analyzes the GFC through "Archival Ethnography," using a sociologist's techniques of "sensemaking." This technique uses automated textual analysis ("ATA") of the FOMC's meeting transcripts to discern from the FOMC's own words, discussions, and debates, how Ben Bernanke and the Committee participants eventually began to listen to, then understand, and then comprehend the new financial forces that reshaped the world around them. Only after they began to comprehend their new economic environment could the FOMC formulate and execute regulatory and monetary policies to stabilize the situation. This takes time, lots of time, and in the middle of a developing crisis, time is one of the scarcest resources available to policymakers. The time it takes for individual leaders, and their organizations, to grasp the dramatic shifts in their environment, let alone to address these shocks with existing tools and newly created policy tools of questionable legality, adds new meaning to Milton Friedman's statements about "the long and variable lags in monetary policy."

3 listening-in on the room where (much of) it happens: (with a tip of my hat to Lin-Manuel Miranda and *Hamilton: The Musical*)

The primary data source for this book is the transcripts of the FOMC meetings that took place between August 2007 and December 2008. The Fed has released these transcripts for meetings as far back as 1977. With a lag of roughly five years, the FOMC releases an ***edited*** transcript of each FOMC meeting. To protect its sources of confidential information, especially sensitive content involving companies or foreign countries, some content is redacted by the FOMC's legal and economic policy staff. In short, the transcripts provide a degree of translucency to the policy process and discussions, but they do not provide an economist's ideal of policy

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transparency. Based on my attendance at about 250 FOMC meetings in the period from 1985 to 2013, however, I can attest that the transcripts capture roughly 95 percent of the content of each FOMC meeting; the remainder is lost to historians.

More important, perhaps, are the discussions and decisions that take place outside of the official FOMC meetings. One obvious case is Lehman Weekend (Friday, September 12, to Monday, September 15, 2008), when the FOMC was not in session. Major decisions that shaped the Fed's crisis response were made in New York and Washington D.C. by Chairman Bernanke, New York Fed President Tim Geithner, and Treasury Secretary Hank Paulson, in conjunction with about 20 leaders of the banking and investment banking communities, together with a variety of U.S. and foreign regulatory officials. Clearly, FOMC transcripts only go so far. To Professor Abolafia's credit, he provides a thorough analysis of what took place "outside the room where it happens" over Lehman weekend. However, he provides very limited coverage and analysis of the events over that same weekend and the next few days, involving the discussions and decisions to quasi-nationalize AIG, one of the largest insurance companies in the world. As I sat in the FOMC meeting on Tuesday, September 16, 2008, all I could think about was: where is FOMC Vice Chairman and New York Fed President Tim Geithner? Why was he absent at this historical FOMC meeting? We all knew that Lehman had declared bankruptcy on Monday morning, and that the stock market was in freefall globally, even before we entered the meeting that morning. Clearly, not all the important, earth-shaking things happen "in the room where it happens!"

Crisis management was made more complicated and difficult by the fact that the FOMC was responsible for traditional monetary policy decisions, for example, raising or lowering the Fed funds rate, or determining the volume, timing, and mix of securities to purchase as part of its Quantitative Easing operations. Decisions to intervene in a potential rescue operation of a major financial institution, by invoking Section 13(3) of the Federal Reserve Act, were a decision for Ben Bernanke and the Board of Governors, not for the Fed presidents and not for discussion by the FOMC. Thus, many key decisions involving financial stability, as opposed to monetary policy, were not captured in the FOMC transcripts.

4 March 2008: more than bear stearns; re-discovering forgotten connections

As the Great Moderation developed in the late-1980s and the early-1990s, the Fed's economic analysis efforts evolved into a series of parallel silos of thought. The macroeconomy had two parts, the real economy and the financial economy. The financial side was divided into commercial banking, other financial intermediaries, and the financial markets. In this new culture, designed for an orderly world, staff members became over-specialized. Financial innovation could happen, but the idea that contagion could spread was outside the realm of orthodox thinking within the FOMC Staff. Contagion was a tail risk to be mitigated through buying an insurance policy, i.e., reducing the federal funds rate. Main Street and Wall Street were treated as separate. In this culture, it is difficult to visualize a financial crisis that damages the economy, given the over-arching belief that the invisible hand guides markets to self-correct. As the Fed approached its Centennial Anniversary, many of the Fed's leaders forgot the Fed's first half-century of history. The 1907 Banking Crisis led to the creation of the Fed because of the need for a Lender of Last Resort ("LOLR"), and because it was recognized that banking crises and contagion had been spilling over to the real economy for many decades. The Banking Crisis from 1929–33 that accompanied and amplified the 1930s Great Depression is another example of forgotten Fed history about the financial linkages that feed the flames of adverse feedback loops between Main Street banks, Wall Street banks, and the real economy.

Professor Abolafia calls the Federal Reserve "the state's most visible hand and lender of last resort—its central bank" (p. 170). Indeed, by Congressional design, "the Fed sits at the intersection of three institutional orders—the state, the market, and the profession of economics" (p. 66). There is a tension within the Fed over the proper balance between the state and market in guiding the Fed's ability to produce price stability and maximum employment.

Many policymakers at the Fed were inherently uncomfortable with its role as the very visible hand directing the economy. They rationalized the Fed's use of predictable policy rules like the Taylor Rule to adjust the federal funds rate, to keep inflation and economic growth near desired levels; but many demonstrated a strong aversion to the Fed's interventions to reduce the economic impacts of failing financial institutions. Whenever possible, they preferred "market solutions to market problems" rather than interventions by the Fed, representing the state (p. 67). This cultural rigidity provided a self-imposed barrier to the Fed's use of its powers as LOLR, especially if there might be a perception that the Fed had added to moral hazard. The idea of doing "whatever it takes" to slow, stop, or reverse a developing financial crisis had to wait until the intervention in Bear Stearns in March 2008. Ironically, the Fed's power to be the LOLR goes back to its founding in December 1913; the Fed has always been in the moral hazard business, even if it was reluctant to use that power. But by smoothing fluctuations in the economy, employment and inflation, the Fed over the years had become an important manufacturer of moral hazard despite its unwillingness to admit it (Rosenblum 2007).

The near-failure and Fed-subsidized sale of Bear Stearns in mid-March 2008 became the triggering event for Ben Bernanke, but it would take many months, and for many FOMC participants, more than a year, before they began to acquiesce with the FOMC's range of policy responses dealing with the GFC. Their reluctant and grudging acceptance of the necessity to do "whatever it takes" created the need for Ben Bernanke to take on the additional challenge of being the "Fed's CEO of Organizational Change Management."

5 Victim of its own orthodoxy

The failure of Lehman played out, almost in slow motion, over the six-month period that began with the near-failure of Bear Stearns. Nonetheless, the Fed failed to anticipate Lehman's failure, and more importantly, the economic and financial ramifications from this event. As a result, the Fed seemed powerless to reverse the mindset of Treasury Secretary Hank Paulson once he declared "I don't want to be remembered as Mr. Bailout." From that moment, the primary issue confronting the Fed shifted from Too Big to Fail to one that can best be characterized as Too Many to Fail, when most of the "Many" were clearly Systemic Financial Institutions. This failure to see, contemplate, study, and articulate Lehman's demise and its fallout, and therefore to convince Secretary Paulson of the consequences of the rigidity of his thinking, contributed to, and accelerated the onset of the Crisis, and the depths that it reached. The orthodoxy of Fed thinking was "its tendency to believe in the resilience of a system that is resilient most of the time;… for its technocrats to manage a cycle of expansion and contraction in which the oscillations are mostly moderate and economies are expanding most of the time. The FOMC focused on familiar risks; it was disinclined to anticipate the rare emergence of crisis-level systemic risk" (p. 156). Such situations were outside the range of economic life experiences of the FOMC's policymakers, but not really outside the range of the policy issues the Fed had dealt with over its lifetime of 94 years as of 2008. I have labeled this a type of "willful blindness" (Rosenblum 2011).

6 A closing thought

This book is well-worth reading. I learned a great deal from it, even though I was in the room where most of it happened throughout the Great Financial Crisis. It reminded me of my own sluggish learning during the GFC when my economic senses had been dulled by the experience of the Great Moderation. Those who are interested in the history of monetary policy will take away many important lessons about the Fed, and how the Fed's leaders and the institution itself, learned to adapt their policies to the new economic paradigm it faced.

Professor Abolafia wonders whether this transformational learning will persist in the Fed as an institution the next time an economic crisis happens. Based on the policies adopted by the FOMC in 2020 since the onset of the Covid-19 Recession, the Fed seems to have learned the lessons from rigid adherence to its old orthodox institutional thinking; namely, incremental monetary policy adjustments cannot address a world of systemic collapse.

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