Central Bankers in the Minsky Moment: How Different Central Banks Have Responded to the Threat of Debt-Deflation

Robert W. Dimand
Brock University

Robert H. Koehn[1]
Brock University

Abstract: The differing responses of the Federal Reserve, Bank of England, and European Central Bank to the credit crunch of 2007-2008 reflects the differing lessons each has drawn from history. Ben Bernanke of the Federal Reserve and Mervyn King of the Bank of England each studied the debt deflation of the 1930s, stressing different aspects of the process, while the ECB is more influenced by the German hyperinflation of the early 1920s.

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1. Introduction

Liquidity crunches can have far-reaching effects in a complex international financial system in which the viability of a financial institution depends on confidence in the liquidity of the other institutions with which it deals. Thus for example, the failure of a single Anglo-Scottish bank brought down banks in the Netherlands, caused bankruptcies and suicides in Virginia, and led an observer in Hamburg to remark, "One link gave way. The charm was instantly dissolved, leaving behind it consternation in the place of confidence, and imaginary affluence changed to real want and distress." The repercussions across the Atlantic, in Virginia and elsewhere, proved particularly inconvenient for Britain's Prime Minister. The Prime Minister, who had some other matters at issue with the Americans at the time, was Lord North, the year of the liquidity crisis was 1772 (Rothschild 2001, Wheen 2004, p. 226). Such crises have recurred more recently, to the discomfort of central bankers, whose responses to such credit crunches have been shaped by the differing lessons that they have drawn from what they see as parallels in history. Thus, at a celebration of Milton Friedman's 90th birthday in 2002, a newly-appointed member of the Board of Governors of the Federal Reserve System, Ben Bernanke, accepted the argument of Friedman and Schwartz (1963) that the Federal Reserve was to blame for the Great Depression (what Friedman and Schwartz termed the "Great Contraction" of the

money supply): “Yes, we did it. We’re very sorry. We won’t do it again.” Bernanke’s witticism was, at the time, warmly received. In the “Minsky moment” of turmoil in financial markets since August 2007, when central bankers face the question “Can ‘It’ Happen Again?” (the title of Minsky 1982), Bernanke, no longer just one of seven members of the Federal Reserve Board, has been acutely aware of his responsibility for not doing “it again” (see McClearn 2008 on parallels with 1929).

2. Bernanke on the Depression

Bernanke’s sense of what a lender of last resort must do in such a situation (even when it conflicts with the other theme of his academic research, inflation targeting) is shaped by his own scholarly studies of the macroeconomic consequences meltdown of the system of financial intermediation in the 1930s (in several essays reprinted in Bernanke 2000), just as the initially quite different approach of Mervyn King, Governor of the Bank of England, reflected the different lessons that he derived from his analysis of the same phenomenon (King 1994). Both Bernanke and King were influenced, not only by Keynes (1936) and Friedman and Schwartz (1963), but also by Irving Fisher’s account of “debt deflation” (Fisher 1933), to which Hyman Minsky (1975, 1982, 1986) and James Tobin (1980) had drawn attention. For the European Central Bank, however, the defining historical trauma has been the German hyperinflation of the early 1920s (see Keynes 1923) rather than the debt-deflation of the early 1930s. Even though Jean-Claude Trichet of the ECB is French and his predecessor Wim Duisenberg (with whom he split the four-year term first presidential term at the ECB) is Dutch, *The Economist* (2008, p. 62) is clearly correct in headlining, “The lessons of German history haunt the single currency.” Ben Bernanke does not wish history to compare him to the Fed’s Eugene Meyer, letting monetary aggregates collapse while maintaining traditional rules about what paper the Fed would accept as collateral. His counterparts at the ECB fear being remembered in the company of Dr. Rudolf Havenstein, the distinguished, long-serving Reichsbank President who in 1923 lamented that the price level had risen so much faster than the nominal money supply, but promised that with thirty eight new high speed printing presses, the Reichsbank would print enough currency to catch up with prices. The Fed, ECB, and Bank of England responded to financial turmoil in different ways, for instance in January 2008, when the Federal Reserve reduced its target federal funds rate by 75 basis points in one day while the ECB and Bank of England held rates unchanged. These different monetary policy responses reflect the different lessons of financial history guiding the policy-makers.

Ben Bernanke graduated from Harvard in economic history, which sets him apart from most academic economists and most central bankers. His MIT doctoral dissertation, summarized briefly in his first article (Bernanke 1981) and at greater length in his 1983 *American Economic Review* article on “Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression” (1983, Chapter 2 of Bernanke 2000), made his reputation by arguing that the severity and length of the

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