American Enterprise Institute

Peter J. Wallison

November 5, 2015 | The Wall Street Journal

Bernanke and the slow-growth crew

The former Fed chairman's memoir helps explain why this economic recovery has been so disappointing.

Economics, Monetary Economics

News that the U.S. economy grew only 1.5% in the third quarter again raises the question: Why has the recovery from the recession been so historically weak?

New York Federal Reserve President Timothy Geithner (R) attends a news conference with U.S. Treasury Secretary Henry Paulson (L) and Federal Reserve Chairman Ben Bernanke (C) at the Treasury Department Cash Room in Washington, October 14, 2008. Reuters

Former Federal Reserve Chairman Ben Bernanke's new book, "The Courage to Act," amply illustrates how the failure to understand what caused the 2007-08 financial crisis ushered in

policies that have slowed growth.

By the time he became Fed chairman in February 2006, Mr. Bernanke was aware that a large housing bubble was developing—by 2007 it had inflated to the largest in U.S. history—and that underwriting standards across the housing market were declining. Yet he apparently never tried to determine why these major shifts were occurring.

Learn more: In his new memoir, Ben Bernanke is wrong about the fall of Lehman (http://www.aei.org/publication/in-his-new-memoir-ben-bernanke-is-wrong-about-the-fall-of-lehman/

Because he didn't investigate this issue, in March 2007 Mr. Bernanke famously told Congress that "the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained." When the crisis developed later that year, the only changes he could imagine that would prevent another crisis were, as he says in his book, "improved monitoring of the financial system and stronger financial regulation."

Nowhere in the book does he mention or show any grasp of the true causes of the decline in underwriting standards: the federal government's affordable-housing goals, which required Fannie Mae and Freddie Mac to meet annual quotas for mortgages made to borrowers at or below the median income. Nor does he mention that these goals had increased from 30% of all mortgages they acquired in 1992 to 56% of all they acquired in 2008, forcing Fannie and Freddie to loosen their standards further to reach the targets. Because they were the dominant players in the market, all underwriting standards deteriorated.

What little he knew about Fannie and Freddie appears to come straight from the left's history of the financial crisis. He writes that from 2004-06, "anxious about competition posed by private-label [mortgage-backed securities], and eager for the high returns that lower quality mortgages seemed to promise, they bought and held private label MBS that included subprime and other low-quality mortgages."

Learn more: The slow economic recovery explained (http://www.aei.org/publication/the-slow-economic-recovery-explained/)

Yet by 2002 Fannie and Freddie had acquired $1.2 trillion in subprime and other weak mortgages. By the time he became Fed chairman, they'd racked up $3.4 trillion. By 2008, apparently unknown to the Fed or Mr. Bernanke, 31 million loans—more than half of all U.S. mortgages—were subprime or otherwise weak, and 76% of those sat on the books of government agencies, principally Fannie and Freddie. This shows, beyond question, where the demand for these subprime and risky loans originated.

So it came as no surprise, given his limited knowledge, that he and Hank Paulson, then-

Treasury secretary, were, as Mr. Bernanke put it, "eager to focus Congress on the gaps in financial regulation" when they testified before the House Financial Services Committee in July 2008. After that, the Democratic-controlled Congress, working with the Obama administration, produced the overreaching Dodd-Frank Act, signed into law in 2010 and named after the two strongest congressional proponents of affordable-housing goals, former Rep. Barney Frank and Sen. Chris Dodd.

It is thanks to Dodd-Frank that the five-year growth rate has averaged about 2.2%. Dodd-Frank has had this effect primarily because of the new regulatory costs and lending standards it imposed on financial firms, particularly small banks. New regulations from the Consumer Financial Protection Bureau and other Dodd-Frank inventions have forced many small banks out of business, forced others to merge with larger competitors, and reduced the rate of new bank formation from an average of 100 a year before 2010 to only three afterward.

The regulations and restrictions on small banks have most acutely affected small businesses, particularly startups. Though most new employment in the U.S. economy comes from small business, entrepreneurial startups provide most small-business employment growth. A 2013 study published in the Review of Economics and Statistics shows that over time firms aged 0-5 years account for 20% of total job creation in the U.S.

Learn more: The Dodd-Frank Act five years later: Are we more prosperous? (http://www.aei.org/publication/the-dodd-frank-act-five-years-later-are-we-more-prosperous/)

This part of the economy has been hit hardest by Dodd-Frank rules that have driven up costs for small banks, reduced their number and applied large bank lending standards to the small outfits that have always met their communities' needs with the flexible standards startups require.

A 2015 Goldman Sachs study shows that large firms—500 employees or more—have grown at a pace consistent with past recoveries, but small businesses have remained stagnant. The study concludes that, since Dodd-Frank, small businesses—which rely largely on small banks—have been unable to find the credit necessary for growth, while large firms have access to credit through the capital markets.

If Mr. Bernanke had used his academic skills and the Fed's data to determine what actually caused the crisis, he might not have pushed Congress to fill "the gaps in financial regulation." Had he advocated instead changing destructive housing policies, Dodd-Frank might never have happened and the economic recovery would have been far more robust.

Mr. Wallison is a senior fellow at the American Enterprise Institute and the author of "Hidden In Plain Sight: What Caused the World's Worst Financial Crisis and Why it Could Happen Again" (Encounter, 2015).

2008 financial crisis, Ben Bernanke, Federal reserve