THE FEDERAL RESERVE AND THE FINANCIAL CRISIS

CHAIRMAN BERNANKE'S COLLEGE LECTURE SERIES

Instructor Resource:
Questions for Classroom Discussion

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Note to instructors: The four lectures are divided into video clips covering specific subjects discussed by Chairman Bernanke. Most of the clips range from one to four minutes in length, with a few as long as 10 minutes. Video time codes and subjects are listed for each clip.

Questions are provided to assist instructors in guiding class discussion following the viewing of a clip. The questions could be distributed prior to showing a clip if so desired. The majority of the questions focus on material contained within each clip; some extend the discussion by asking students to consider the implications of the material within each clip or to explain how a specific policy might work.

Contents

LECTURE ONE: ORIGINS AND MISSION OF THE FEDERAL RESERVE 1

LECTURE TWO: THE FEDERAL RESERVE AFTER WWII 6

LECTURE THREE: THE FEDERAL RESERVE'S RESPONSE TO THE FINANCIAL CRISIS 12

LECTURE FOUR: THE AFTERMATH OF THE CRISIS 15

LECTURE ONE: ORIGINS AND MISSION OF THE FEDERAL RESERVE

Lecture 1, Video Clip 1: A central bank and its mission

Time: 6:27 to 8:42

Length: 2 minutes; 15 seconds

Questions for Classroom Discussion:

1. What is the mission of a central bank?
2. What is the difference between the economic stability and the financial stability parts of the mission of a central bank?
3. Explain and give examples of how those missions are related to each other.

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Lecture 1, Video Clip 2: The policy tools of central banks
Time: 8:42 to 12:45
Length: 4 minutes; 3 seconds
Questions for Classroom Discussion:

1. What are the policy tools that central banks have?
2. Explain how monetary policy can function to achieve economic stability. What is the role of interest rates? Explain the process of how the Fed changes interest rates and how those changes encourage an appropriate increase or decrease in spending in the economy?
3. Analyze how a second tool, the provision of liquidity, can help to promote financial stability. Describe how the lender-of-last-resort function of a central bank can reduce runs on banks.
4. Discuss the regulatory role of a central bank. What is its purpose?

Lecture 1, Video Clip 3: Origins of central banking
Time: 12:46 to 15:03
Length: 2 minutes; 17 seconds
Questions for Classroom Discussion:

1. Why were the first central banks established?

Lecture 1, Video Clip 4: Financial panics
Time: 15:04 to 19:49
Length: 4 minutes; 45 seconds
Questions for Classroom Discussion:

1. How would long-term illiquid assets and short-term liquid liabilities contribute to conditions for a financial panic?
2. Why is a bank run so difficult to stop?
3. What is a financial panic and what can cause a financial panic?
4. Describe how a financial panic can lead to loss of income and employment in sectors of the economy seemingly unrelated to the financial sector.

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Lecture 1, Video Clip 5: Lender of last resort
Time: 19:50 to 23:19
Length: 3 minutes; 29 seconds
Questions for Classroom Discussion:

1. What does "lender of last resort" mean?
2. Analyze why liquidity is such an important issue.
3. What is the difference between illiquid banks and insolvent banks? How does that difference affect the lender-of-last-resort role of central banks?
4. How does the lender of last resort help prevent bank runs? And by doing so, the chances of a broader financial panic?
5. Why might a bank run worsen if a bank has to sell assets in response to depositors' withdrawals?

Lecture 1, Video Clip 6: Financial stability prior to the Fed
Time: 24:00 to 28:04
Length: 4 minutes; 4 seconds
Questions for Classroom Discussion:

1. Describe the need for financial and economic stability that led to the establishment of the Federal Reserve in 1914.
2. Summarize the role of monetary policy in affecting short-term interest rates.

Lecture 1, Video Clip 7: The gold standard
Time: 28:04 to 40:07
Length: 12 minutes; 3 seconds
Questions for Classroom Discussion:

1. What is a gold standard?
2. Identify two possible problems with a gold standard and explain why those problems are created by a gold standard.
3. Explain how shocks can spread among countries under an international gold standard.
4. If interest rates are different in two countries that are both on an international gold standard, what will likely happen?
5. What might cause a run on gold in a country? What are the consequences of a run?
6. How can a gold standard create stable prices over a long-run period?
7. How can a gold standard cause a deflationary period? What is undesirable about falling prices?
8. Compare the costs and the benefits of a gold standard.

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Questions for Classroom Discussion

Lecture 1, Video Clip 8: Establishment of the Federal Reserve
Time: 40:18 to 43:48
Length: 3 minutes; 30 seconds
Questions for Classroom Discussion:

1. What economic conditions led to the establishment of the Fed in 1913?
2. How would you describe the economic and financial stability mission of the Fed?
3. What is the decentralized structure of the Fed and why was it designed in that fashion? Has this made the Fed a more stable, longer-lasting institution? Why or why not?

Lecture 1, Video Clip 9: The Great Depression
Time: 43:48 to 51:39
Length: 7 minutes; 51 seconds
Questions for Classroom Discussion:

1. Summarize the economic conditions and events during the Great Depression. Discuss the stock market crash, the change in price levels, the fall in output, the rise in unemployment, and the increase in the number of bank failures.
2. Describe the major causes of the Great Depression and explain how each of them may have contributed.

Lecture 1, Video Clip 10: Policy during the Great Depression
Time: 51:48 to 55:37
Length: 3 minutes; 49 seconds
Questions for Classroom Discussion:

1. Describe monetary policy during the Great Depression.
2. What monetary policy errors were made? Why were those errors committed?
3. Summarize the Fed's policy as a lender of last resort during the Great Depression and evaluate its effects.
4. Discuss the role of the gold standard during the Depression and the resulting level of interest rates in the economy.

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Questions for Classroom Discussion

Lecture 1, Video Clip 11: President Roosevelt's economic policies
Time: 55:38 to 57:29
Length: 1 minute; 51 seconds
Questions for Classroom Discussion:

1. Summarize the role of deposit insurance in ensuring financial stability.
2. Why would the abandonment of a gold standard positively affect economic conditions?
3. List the primary monetary and fiscal policies that were used during the Depression. Evaluate the effectiveness of those policies. What can we learn about policy today from that experience? What would be a more effective set of solutions?

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CHAIRMAN BERNANKE'S COLLEGE LECTURE SERIES

Instructor Resource:
Questions for Classroom Discussion

LECTURE TWO: THE FEDERAL RESERVE AFTER WWII

Lecture 2, Video Clip 12: Monetary policy during and after WWII
Time: 3:29 to 4:51
Length: 1 minute; 22 seconds
Questions for Classroom Discussion:

1. How did the Fed cooperate with the U.S. Treasury during and immediately after World War II?
2. What were the economic consequences of keeping interest rates low?

Lecture 2, Video Clip 13: The Fed-Treasury Accord and central bank independence
Time: 4:51 to 6:08
Length: 1 minute; 17 seconds
Questions for Classroom Discussion:

1. Describe the Fed-Treasury Accord and evaluate whether it was effective in improving economic conditions. Discuss the implications of the agreement.
2. Identify the various ways in which the Federal Reserve is insulated from political influence.
3. Compare the costs and benefits to society of central bank independence.

Lecture 2, Video Clip 14: Monetary policy in the '50s and early '60s
Time: 6:10 to 8:22
Length: 2 minutes; 12 seconds
Questions for Classroom Discussion:

1. What was a "lean against the wind" policy? Was it effective in the 1950s and early 1960s?
2. Describe monetary policy in the mid-1960s and into the 1970s? What was the rationale of the policy?
3. Was the trade-off between inflation and unemployment relevant to the choice of policy? Why or why not?

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Questions for Classroom Discussion

Lecture 2, Video Clip 15: Mid-'60s and '70s monetary policy
Time: 8:23 to 15:21
Length: 6 minutes; 58 seconds
Questions for Classroom Discussion:

1. Evaluate the appropriateness of policy in the mid-1960s and into the 1970s and explain how policy impacted economic conditions.
2. Describe exacerbating factors other than monetary policy that may have contributed to the high rates of inflation and numerous recessions from the mid-1960s through the 1970s.

Lecture 2, Video Clip 16: Central bankers have imperfect knowledge
Time: 15:21 to 16:41
Length: 1 minute; 20 seconds
Questions for Classroom Discussion:

1. Why was the idea of a permanent tradeoff between unemployment and inflation so important in contributing to inflationary conditions? How did that lead to a concept of "fine-tuning"?
2. Why were the estimates of full-employment levels of unemployment so important?
3. Explain the roles and importance of data collection and forecasting in monetary policy. Why is accuracy in forecasting so important?

Lecture 2, Video Clip 17: Volcker disinflation
Time: 16:41 to 21:33
Length: 4 minutes; 52 seconds
Questions for Classroom Discussion:

1. What does "disinflation" mean? Is it desirable? Why or why not?
2. What was the role of monetary policy in contributing to disinflation in the late 1970s and early 1980s?
3. Describe the conditions leading up to the 1981-82 recession.
4. Summarize monetary policy before and during the recession. What were Chairman Volker's goals?
5. Why was there significant political pressure against the policy?
6. How did this experience affect monetary policy after the recession and even today? Will the U.S. ever have a similar phenomenon to the Great Inflation? Why or why not?

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Lecture 2, Video Clip 18: The Great Moderation
Time: 21:36 to 25:35
Length: 3 minutes; 59 seconds
Questions for Classroom Discussion:

1. Define the term "Great Moderation." Give examples of its characteristics?
2. What happened to the rate of growth of real GDP? What happened to inflation rates?
3. What happened to the length and frequency of recessionary periods?

Lecture 2, Video Clip 19: Causes of the Great Moderation
Time: 25:35 to 29:58
Length: 4 minutes; 23 seconds
Questions for Classroom Discussion:

1. What was the role of monetary policy during the Great Moderation?
2. How could changes in business practices, such as improved inventory management, make a difference in recessionary pressures and inflation?
3. Were there financial crises during the Great Moderation? What were the effects?
4. What can we learn from the Great Moderation? How does that period affect monetary and fiscal policy today?
5. Compare monetary policy since the Volcker era to monetary policy in the 1960s and 1970s. What are the key differences? Which was the more effective, and why?
6. Explain why financial crises became less of a concern during the Great Moderation? Did they disappear?

Lecture 2, Video Clip 20: The housing bubble
Time: 30:24 to 32:39
Length: 2 minutes; 15 seconds
Questions for Classroom Discussion:

1. How large was the increase in housing prices?
2. Describe what caused the rapid rise in housing prices.
3. What is a bubble? Why are rising asset prices not necessarily a positive event for everyone?
4. What are several possible causes of the bubble?

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Questions for Classroom Discussion

Lecture 2, Video Clip 21: Deterioration in lending standards
Time: 32:39 to 35:29
Length: 2 minutes; 50 seconds
Questions for Classroom Discussion:

1. Describe the characteristics of the decline in lending standards.
2. Explain why lending standards seemed to deteriorate. Give examples of changing incentives.
3. How could deterioration in lending standards be caused by a bubble and at the same time contribute to the housing bubble?

Lecture 2, Video Clip 22: Bursting of the bubble: Declining demand, falling prices
Time: 35:30 to 39:46
Length: 4 minutes; 16 seconds
Questions for Classroom Discussion:

1. List several causes of the bursting of the housing bubble. Explain how each could contribute to the decline in housing prices.
2. What were the effects of the bursting housing-price bubble on the rest of the economy?

Lecture 2, Video Clip 23: Financial crisis triggers vs. vulnerabilities
Time: 39:47 to 42:58
Length: 3 minutes; 11 seconds
Questions for Classroom Discussion:

1. Define a financial crisis trigger and give examples.
2. Define a financial crisis vulnerability and give examples.
3. How did the triggers and vulnerabilities lead to serious declines in economic conditions? Why was the collapse in housing prices so much more serious than the collapse of dot-com stock prices in 2001? How did the Great Moderation affect the vulnerability of the economy to a serious financial trigger?

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Questions for Classroom Discussion

Lecture 2, Video Clip 24: Private-sector vulnerabilities

Time: 43:16 to 46:42

Length: 3 minutes; 26 seconds

Questions for Classroom Discussion:

1. What were the private-sector vulnerabilities that amplified the effects of the triggers?
2. Explain how increased leverage, financial institutions' failure to monitor their own risk adequately, increased short-term funding, and new exotic financial instruments amplified the effects of the triggers.

Lecture 2, Video Clip 25: Public-sector vulnerabilities

Time: 46:42 to 51:43

Length: 5 minutes; 1 second

Questions for Classroom Discussion:

1. What were the public-sector vulnerabilities that amplified the effects of the triggers?
2. What were the gaps in the regulatory structure? How did those gaps lead to a worsening of the financial crisis?
3. What additional failures by regulatory agencies took place during the financial crisis? Explain how each contributed to a worsening of the crisis.
4. What are systemic problems?
5. How did systemic problems differ from problems with individual banks or small groups of banks? Why did they receive insufficient attention?

Lecture 2, Video Clip 26: Role of monetary policy in contributing to the crisis

Time: 51:52 to 58:19

Length: 6 minutes; 27 seconds

Questions for Classroom Discussion:

1. Summarize the evidence about the role of monetary policy in contributing to the crisis.
2. Is that evidence convincing one way or another?

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Questions for Classroom Discussion

Lecture 2, Video Clip 27: Economic consequences of the crisis
Time: 59:02 to 1:00:21
Length: 1 minute; 19 seconds
Questions for Classroom Discussion:

1. Summarize the effects of the financial crisis on financial markets.
2. How did the collapse of the housing bubble affect housing construction? Explain why.
3. Describe how and why unemployment changed during the bubble and the subsequent financial crisis.

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CHAIRMAN BERNANKE'S COLLEGE LECTURE SERIES

Instructor Resource:
Questions for Classroom Discussion

LECTURE THREE: THE FEDERAL RESERVE'S RESPONSE TO THE FINANCIAL CRISIS

Lecture 3, Video Clip 28: Public-sector vulnerability: GSEs
Time: 3:05 to 5:46
Length: 2 minutes; 41 seconds
Questions for Classroom Discussion:

1. Define government-sponsored enterprises (GSEs). What advantages do the GSEs offer borrowers and lenders?
2. Define securitization. Why would firms want to engage in securitization?
3. Why might securitization become a vulnerability?

Lecture 3, Video Clip 29: Bad mortgage products and practices were a key trigger
Time: 5:47 to 9:15
Length: 3 minutes; 28 seconds
Questions for Classroom Discussion:

1. Are bad mortgage products and practices a trigger or a vulnerability? Explain why.
2. Explain why housing prices had to keep increasing in order for adjustable-rate mortgages (ARMs) to make sense for borrowers and lenders.
3. What were the roles of option ARMs, stated income loans, and no-doc loans? How were they helpful for borrowers? How did they contribute to the housing-price bubble? How did they contribute to the bursting of the bubble?

Lecture 3, Video Clip 30: Financing of exotic and subprime mortgages, inappropriate ratings
Time: 9:15 to 13:57
Length: 4 minutes; 42 seconds
Questions for Classroom Discussion:

1. What is the role of ratings agencies in financial markets?
2. What are the incentives for rating agencies? How might those incentives contribute to the creation of a bubble?
3. What are the advantages and disadvantages of securitization of subprime mortgages for the borrowers, for the packagers of the securities, and for the buyers of the securities?
4. What was the role of insurance of those securities; that is, what was the role of credit default swaps?

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Questions for Classroom Discussion

Lecture 3, Video Clip 31: The crisis: Narrative of a classic financial panic
Time: 13:57 to 21:03
Length: 7 minutes; 6 seconds
Questions for Classroom Discussion:

1. Define a classic financial panic.
2. What happens in the short run? In the long run?
3. What is the difference between a solvency crisis and a liquidity crisis?
4. How can the entire system be endangered if just a few banks or financial institutions have solvency or liquidity problems?

Lecture 3, Video Clip 32: Overview of the policy response to the financial crisis
Time: 21:03 to 24:28
Length: 3 minutes; 25 seconds
Questions for Classroom Discussion:

1. Describe the various elements of the policy response to the financial crisis.

Lecture 3, Video Clip 33: Did the policy response work?
Time: 24:28 to 26:48
Length: 2 minutes; 20 seconds
Questions for Classroom Discussion:

1. What evidence is relevant to determining the success or failure of the policy response?
2. Can you summarize the evidence?

Lecture 3, Video Clip 34: Federal Reserve actions: The discount window and liquidity and credit facilities
Time: 26:49 to 31:20
Length: 4 minutes; 31 seconds
Questions for Classroom Discussion:

1. Describe the role of the traditional tool of the discount window in halting bank runs. Why was additional action needed?
2. What are the alternative tools? How were they intended to prevent potential bank runs?

Instructor Resource:
Questions for Classroom Discussion

Lecture 3, Video Clip 35: Case study of money market funds and the commercial paper market
Time: 32:10 to 42:20
Length: 10 minutes; 10 seconds
Questions for Classroom Discussion:

1. What are money market funds and the commercial paper market? What is the relationship between the two? Why are they important in this context?
2. What roles did they play in the financial crisis?
3. What is the importance of the federal guarantee of money market mutual funds? How is the money market connected to corporate costs of borrowing?
4. Why might there be a panic if depositors and lenders believe that there will be some small amount of trouble? Why would a customer want to be the first to withdraw funds? What are the consequences for the system?

Lecture 3, Video Clip 36: Support of critical institutions
Time: 42:48 to 48:58
Length: 6 minutes; 10 seconds
Questions for Classroom Discussion:

1. What is a "too-big-to-fail" financial institution?
2. Would it be better to let those institutions fail, so as to discourage future risky actions? Why or why not?

Lecture 3, Video Clip 37: Consequences of the crisis and comparison of the crisis to the effects of the Great Depression
Time: 48:58 to 53:27
Length: 4 minutes; 29 seconds
Questions for Classroom Discussion:

1. Summarize the effects of the financial crisis on the real economy. Compare and contrast those effects with the effects of financial crises during the Great Depression.
2. Summarize the effects on the stock market. Why is that relevant for the average U.S. worker who might not directly or even indirectly own shares of stock?

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CHAIRMAN BERNANKE'S COLLEGE LECTURE SERIES

Instructor Resource: Questions for Classroom Discussion

LECTURE FOUR: THE AFTERMATH OF THE CRISIS

Lecture 4, Video Clip 38: Evaluation of special lender-of-last-resort programs
Time: 6:15 to 8:10
Length: 1 minutes; 55 seconds
Questions for Classroom Discussion:

1. Summarize the effects of the special lender-of-last-resort programs.
2. What were the strengths of the lender-of-last-resort programs? Why were they not continued on a permanent basis?

Lecture 4, Video Clip 39: Structure of the FOMC
Time: 8:35 to 11:32
Length: 2 minutes; 57 seconds
Questions for Classroom Discussion:

1. Give a brief overview of the purposes of the Federal Open Market Committee (FOMC).
2. Who serves on the FOMC?

Lecture 4, Video Clip 40: Federal funds rate
Time: 11:32 to 12:44
Length: 1 minute; 12 seconds
Questions for Classroom Discussion:

1. Summarize the FOMC traditional monetary policy actions during the crisis.
2. Under what circumstances would the FOMC raise the federal funds rate? Why would the FOMC lower the rate? What does the Federal Reserve do to influence the federal funds rate?
3. Why can't the federal funds rate be lowered to below zero? What does it mean to say that “the effectiveness of the federal funds rate was exhausted”?

Instructor Resource:
Questions for Classroom Discussion

Lecture 4, Video Clip 41: Large-scale asset purchases
Time: 12:44 to 19:14
Length: 6 minutes; 30 seconds
Questions for Classroom Discussion:

1. What are large-scale asset purchases (LSAPs), also sometimes called quantitative easing? What is the purpose?
2. How are bond prices and interest rates related?
3. Explain the effects of LSAPs on interest rates. Explain the relationship between housing prices and interest rates.

Lecture 4, Video Clip 42: Impact of LSAPs on the Federal Reserve's balance sheet
Time: 19:14 to 26:25
Length: 7 minutes; 11 seconds
Questions for Classroom Discussion:

1. How does the Federal Reserve pay for LSAPs? Does the Federal Reserve print money to buy the assets?
2. What were the effects of the LSAPs on Federal Reserve assets? On Federal Reserve liabilities?
3. What is the effect of LSAPs on the money supply? What are the risks of LSAPs?
4. What is the difference between monetary and fiscal policy? What did Chairman Bernanke mean by saying the federal government actually made a profit on LSAPs?

Lecture 4, Video Clip 43: Communication about monetary policy
Time: 26:25 to 28:52
Length: 2 minutes; 27 seconds
Questions for Classroom Discussion:

1. Summarize the steps that were taken by the Fed to improve communication.
2. How can improved communication make monetary policy more effective?
3. Explain how each of the following may contribute to the effectiveness of monetary policy: establishing news conferences following some FOMC meetings; announcing that the FOMC has an inflation goal of 2 percent in the medium term; and projecting the future path for the federal funds rate.

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Lecture 4, Video Clip 44: Economic recovery
Time: 29:05 to 32:05
Length: 3 minutes
Questions for Classroom Discussion:

1. Define a recession.
2. If the recession ended so long ago, why has the recovery not been stronger?
3. Compare the length of the recovery to the length of the recession.

Lecture 4, Video Clip 45: Housing is slowing the recovery
Time: 32:05 to 36:39
Length: 4 minutes; 34 seconds
Questions for Classroom Discussion:

1. How can low prices of housing slow the economy's recovery?
2. What is the relationship between current housing prices, expected housing prices, interest rates, and overall economic conditions?

Lecture 4, Video Clip 46: Financial and credit markets are slowing the recovery
Time: 36:40 to 39:43
Length: 3 minutes; 3 seconds
Questions for Classroom Discussion:

1. Why are credit markets so slow to recover? What are examples of continuing weaknesses in credit markets?
2. What are the limits of monetary policy in promoting economic recovery?
3. Explain how conditions in Europe can slow the U.S. recovery.
4. What are some examples of "headwinds" faced by the U.S. economy?

Lecture 4, Video Clip 47: Prospects for long-term economic growth in the U.S.
Time: 39:58 to 43:47
Length: 3 minutes; 49 seconds
Questions for Classroom Discussion:

1. Chairman Bernanke showed a graph of real GDP over the last century. What stands out as its most important feature?
2. Describe the determinants of long-term economic growth. Can the continuing sluggish economic conditions affect long-term growth in the economy?
3. How have past recessions affected long-term growth?

Instructor Resource:
Questions for Classroom Discussion

Lecture 4, Video Clip 48: Post-crisis regulatory changes; the Dodd-Frank Act
Time: 43:47 to 53:24
Length: 9 minutes; 37 seconds
Questions for Classroom Discussion:

1. Summarize the primary vulnerabilities that contributed to the financial crisis.
2. How does the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 approach the following issues?
    a. Regulators tracking and evaluating the entire financial system
    b. Key financial institutions
    c. Too-big-to-fail institutions
    d. Inefficiencies in markets of relatively new instruments (such as new forms of derivatives)
    e. Insufficient and ineffective consumer protection in some markets

Lecture 4, Video Clip 49: The effects of the crisis on central bank practice
Time: 53:24 to 57:12
Length: 3 minutes; 48 seconds
Questions for Classroom Discussion:

1. How has the crisis affected Federal Reserve policy? What changes are we likely to see in the future? Explain why those changes are being made.
2. Are there other changes that are not being made, but should be? Explain your position.