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Bernanke, Ben S., Timothy F. Geithner, Henry M. Paulson, Jr. 2019. *Firefighting: The Financial Crisis and Its Lessons*. New York: Penguin Books, 230.

"Importantly, in the 1930s, in the Great Depression, the Federal Reserve, despite its mandate, was quite passive and, as a result, financial crisis became very severe, lasted essentially from 1929 to 1933."

Ben S. Bernanke

Today many people believe that they understand what triggered the 2008 financial crisis and how it was resolved. However, only a few of them in fact performed the open-heart surgery on the American economy and prevented the lethal outcome. Among these few are the authors of this book: Ben S. Bernanke, the chairman of the Federal Reserve Board from 2006 to 2014, Henry M. Paulson Jr., the US Treasury secretary from 2006 to 2009, and Timothy F. Geithner, president of the Federal Reserve Bank of New York from 2003 to 2009. Before and during the financial crisis, the authors held some of the most influential decision-making positions in the world, which enabled them to observe the crisis from the very top, and not only to observe.

During the fourth quarter of 2008, the American economy was on the verge of collapse. The financial markets unexpectedly slumped – market value of almost all financial instruments plummeted, while credit was unavailable to anyone except the safest of borrowers. At the same time, in the real sector, more than 700,000 Americans lost their jobs, while world trade and industrial output were falling as fast as they had during the fourth quarter of 1929.[1] How did the economic downturn occur so suddenly? What were the regulators supposed to do, and what did they

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[1] A goldmine of relevant data and charts regarding the crisis can be found in the appendix of the book.

do? These are just some of the questions raised and answered in this book.

In the first chapter (out of five) of the book, the authors describe the initial spark of the financial crisis. In their opinion, the crisis started as a classic example of financial panic – a run on the financial system triggered by a crisis of confidence in mortgages. Furthermore, the problem of mortgages itself occurred due to lenders being systematically exposed to wrong incentives. They would approve almost any credit application, regardless of applicant's credit history, whether or not they were employed or provided any documents verifying their income.[2] The reason for such lenders' behaviour lies in innovative financial derivatives. Specifically, lenders were using mortgages to create mortgage-backed securities and selling them on the financial markets to investors looking for higher returns. Lenders vastly transformed mortgages into the complex securities, and rating agencies, dependent on issuers' fees, often rated them as AAA – effectively as safe as the US Treasury bonds.[3] In that way, through financial markets, bad mortgages started to underpin the pillars of the American economy.

The first stark warning before the crisis came with the BNP Paribas, France's largest bank, announcing a freeze on withdrawals from three funds holding securities backed by US subprime mortgages, due to the "complete evaporation of liquidity" in the securities markets.[4] In the second chapter, the authors honestly admit that they were concerned about BPN Paribas at the time, but they did not have a clue it will metastasize into the worst crisis in generations. Some of the readers might get an impression that the authors are trying to justify their passivity by explaining early intervention would have been criticized as a misguided overreaction that would rescue the reckless and ratchet up moral hazard. While the authors, in their professional capacity, were "talking to one another every day, usually multiple times", the European Central Bank (ECB) was the first to react, by buying securities in the open market and injecting $130 billion into frozen credit markets. The US Federal Reserve (Fed) followed that intervention by buying $62 billion worth of US Treasury bonds and issuing a statement encouraging banks to borrow from the discount window.

[2] Besides the complex economics phenomenon, the authors explain in detail popular slang during the crisis, such as – "NINJA (no income no job) loans", "liar loans", and "exploding ARMs (adjustable-rate mortgage) loans".

[3] Besides the monetary incentives, crucial reason behind rating agencies' behaviour, which the authors did not elaborate at length, were the lack of competition and transparency, as well as the type of their liability. For more details, see Lieven 2016, 26–31.

[4] The announcement was released on 9 August 2007. See: Boyd 2007.

Interestingly, the authors support and justify the Fed's initial reaction, even though they did not understand the cause of the crisis, at the time when the reaction took place. It may be the opinion of some of the readers that injecting additional liquidity into financial markets and allowing short-term borrowing from the Fed, without addressing the cause of the problem, only accelerated the process of lending and produced millions of new mortgage-backed securities in the US.[5] In other words, some readers may disagree with the authors and conclude that the Fed, by its initial reaction, partially accelerated the crisis that it had attempted to solve.

Following the Fed's initial intervention in the financial markets – not surprisingly for some readers – even more banks faced severe financial difficulties. Among others, Bear Stearns, an eighty-five-year-old investment bank, with more than $400 billion in assets, was on the verge of bankruptcy in March 2008. Its cash reserves had dwindled from $18 billion to $2 billion in just four days, and the only solution left was to file for bankruptcy. In the authors' opinion, the main problem was fragile confidence, causing a sudden run on Bear Stearns and other financial institutions. Nevertheless, the authors did not provide any clear answer to the question – why was confidence so fragile? In short, it seems that many participants in the financial markets were facing a severe and sudden lack of liquidity (unaware of the bad loans mortgages plummeting prices of financial instruments), and the only instinctive reaction was to ask for more money. In this sense, fragile confidence and run on Bear Stearns were not the cause of the crisis, but a mere consequence of the bad loans and mortgage-backed securities. However, one must agree with the authors that Bear Stearns was too interconnected to fail,[6] and thus regulators had a justifiable reason to react.

In the third and fourth chapters, the authors describe how the flame of the crisis spread to other financial institutions and the entire American economy. The next weakest investment bank was Lehman Brothers, followed by Merrill Lynch, Morgan Stanley, Goldman Sachs, and others. Like a domino effect, the collapse of one or more colossal investment banks could severely endanger mortgage giants Fannie Mae and Freddie Mac, which could further amplify instability and break down of the entire financial system. The Fed initially wanted to prevent that causal link to materialise and, among other measures, launched an aggressive landing program called the Primary Dealer Credit Facility (PDCF), which

[5] Apart from the mortgage-backed securities, some contributions highlight two additional causes of the 2008 crisis: investment banks operated with an exceedingly high level of leverage, and they used to finance their assets through short-term loans. See, for example, Ball 2018, 19.

[6] Bear Stearns and its business ties with other participants in the market are also described in Abolafia 2020, 81–83.

accepted a broader range of collateral, including riskier assets, compared to previous regulations. In the author's words, this "intervention calmed the markets", and more than ten years later, economists agree that through this intervention the Fed prevented an international economic catastrophe.[7]

However, calming the markets was not a permanent regulatory solution because the additional lending provided by the Fed did not tackle the root of the crisis. On the contrary, additional lending made an impression that the crisis was only a temporary fluctuation, and all the participants had the same incentives as before the crisis − to continue their usual business activities, including selling and buying toxic assets. In that sense, one may conclude that the most valuable result of the Fed's initial intervention was the additional time that the regulators got to figure out what the real problem was, and how to resolve it permanently.

In the meantime, from March to October 2008, it becomes apparent what the toxic assets were, and why they were so toxic for their owners, and the US economy. In the author's words " [...] the branches of government officially recognized that the crisis poses a grave threat to the economy and gave crisis managers expanded authority to stabilize the financial system ". In the fifth chapter, the authors explain the regulation following the PDCF, which finally cut the roots of the crisis. Firstly, the US government enacted the Troubled Asset Relief Program (TARP), aiming to purchase the toxic assets and equity from private financial institutions and strengthen the financial sector.[8] On that occasion, Henry M. Paulson summoned the CEOs of the nine systemically important banks to the Treasury. As expected, one of the main obstacles for the TARP's implementation was the reluctance of the relatively successful banks to accept the government's equity investments. They were reasonably concerned that the program would reduce their return on equity (ROE) and make them look as their more imperilled competitors. However, the authors "[...] reminded them that none of them should be confident they have enough capital to survive the severe recession that lay ahead [...]". By relying solely on the descriptions from this book, one could conclude that the authors were extremely polite and gentle while fighting the worst economic crisis in decades. Faced with this extreme kindness, colossal banks did not have any other option except to support the government's program. The very same afternoon, the stock market posted its biggest single-day point gain in history.

The second major step in getting to the root of the problem was the enactment of the Home Affordable Refinance Program (HARP). The

[7] See, for example, Bernanke 2020, 84–86; Erdem 2020, 83–84.

[8] The TARP was enacted in compliance with the Emergency Economic Stabilization Act, and initially authorized expenditures of $700 billion for purchasing and/or insuring trouble assets by the US Treasury.

main aim of the program was to help "underwater" homeowners to refinance their mortgages, even though they owed more than their homes were worth at the time of the modification of their monthly payments. In the beginning, the scope of the program was limited, and the progressive left parties strongly opposed its implementation. However, this program ultimately reached more than 8 million homeowners and significantly contributed to the stabilization of the housing and the mortgage markets in the US. Interestingly, in the authors' opinion, "[...] solving the economic crisis was a necessary condition for solving the housing crisis, while the reverse was not necessarily true." Due to the lack of valid arguments for such a stance, the reader may end up wondering which came first: the chicken or the egg?

In the final chapter, the authors discuss what are the lessons from the financial crisis, and what regulators could do to prevent a similar one in the future. One of the main conclusions, completely justifying the authors in their professional capacity, is that – "financial crisis can be devastating even when the response is relatively aggressive and benefits from the formidable financial strength and credibility of the United States. The best strategy for a financial crisis is not to have one. And the best way to limit the damage if there is one is to make sure the crisis managers have the tools to fight before things got too bad." Speaking of the next financial crisis, the authors admit no one knows what it will look like but historically, in their opinion, crises have followed a similar mania-panic-crash pattern of excessive risk-taking and leverage. In this sense, the authors suggest stricter limits on the risk firms may take with borrowed money. They should be required to hold more loss-absorbing capital and take on less leverage. This implies more conservative liquidity requirements, forcing lenders to hold more cash and other liquid assets while relying less on short-term financing. Also, the authors suggest special (even stricter) constraints on risk-taking and funding for the largest firms, which could pose a threat for a whole financial system if they were to default on their obligations. Finally, the authors suggest that the new rules should be applied more broadly across the financial systems, not only in the US but also in other countries, in order to prevent "migration of risk" outside the perimeter of the rules toward more favourable regulatory residences.

In the end, reading between the lines, it seems the authors believe they were impeccable in their professional capacity. However, putting aside all subjective impressions and attitudes, one may conclude that the firefighting was truly demanding and eventually successful. One of the reasons why it was so demanding lies in the fact the firefighters initially used petrol instead of water. It is true that the regulators eventually helped in the process of recovery, but still, one should be cautious when glorifying the regulation and underestimating the invisible hand. That hand may take away something, but one should not forget – it provided everything.

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