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MINNPOST

A key weakness in Ben Bernanke's view on long-run economic growth

By [Louis D. Johnston](#) | 09/09/11



REUTERS/Eric Miller

U.S. Federal Reserve Chairman Ben Bernanke laughing with former U.S. Rep. Tim Penny at a meeting of the Economic Club of Minnesota on Thursday.

President Obama and Federal Reserve Chairman Ben Bernanke each gave speeches Thursday. The president's speech focused on policies to reduce unemployment and was covered widely. Bernanke, speaking to the Economic Club of Minnesota, did not receive the same attention, but two points he made – on the prospects for U.S. economic growth and the stability of the financial system — deserve more emphasis and analysis.

Back to normal?

Mohamed A. El-Erian, CEO of PIMCO, coined the term "**new normal**" for his view of the economic recovery. He argues that industrialized economies such as the United States will experience slower economic growth for the foreseeable future as they deal with the aftereffects of the financial crisis and recession. El-Erian believes that growth rate of potential output — the maximum sustainable amount of real GDP that an economy can produce — will be permanently lower. This implies that even when the economy recovers, we will see standards of living growing at a slower rate than we have experienced over the past 30 years.

El-Erian's views have attracted much attention and support, but Bernanke, near the end of his speech,



rejected this idea. He did it in a way that was subtle and easy to miss: "I do not expect the long-run growth potential of the U.S. economy to be materially affected by the financial crisis and the recession if — and I stress if — our country takes the necessary steps to secure that outcome."

This is a pretty bland statement on its face. Yet what Bernanke is saying is critically important: The long-run productive capacity of the U.S. economy will continue to grow at its historical rate of 3 percent a year despite the trauma inflicted during the past three years. This implies that economic policy needs to focus on getting

the economy back on to this long-run growth path. Once that is accomplished, everything will be back to normal.

How stable is the financial system?

An important element in getting the economy back to potential — one of Bernanke's "ifs" — is the smooth functioning of the financial system. I was taken aback when Bernanke's said that looking back over the past three years, "In the financial sphere, our banking system and financial markets are significantly stronger and more stable." He attributes this improvement to structural reforms and improved regulation of the system.

I don't believe that this is the case. In particular, the "too-big-to-fail" problem has not been solved and may even be worse.

A financial institution is too big to fail when that institution is so important to the functioning of the financial system that if it were to collapse there would be serious damage to the general economy. Citibank, Bank of America and J.P. Morgan, to name three of the largest banks in the United States, were too-big-to-fail in 2008 — and are now even bigger than they were then.

Minneapolis Federal Reserve Bank President Gary Stern gave a speech to the Economic Club of Minnesota in March 2009 in which he set out what needed to be done to mitigate the too-big-to-fail problem. These policies include early identification of potential weaknesses in too-big-to-fail banks, prompt corrective action when weaknesses are found and clear communication of these actions by policymakers.

These ideas were not included in the Dodd-Frank reforms that were passed in the wake of the financial crisis. Instead, Congress and the president opted to create "living wills," pre-arranged plans for liquidating a troubled bank. Bernanke thinks that this will enhance the stability and strength of the

banking system.

I disagree. It would be extremely difficult and disruptive to liquidate a bank the size of Citibank or Bank of America, even with a plan in place to do so. The U.S. Treasury and the Federal Reserve would be forced to bail out the troubled bank, just as they did in 2008.

We'll see if Bernanke's views on long-run growth and financial stability are correct. I hope he is right. If he isn't, we are in for a long period of slower growth and continued financial market volatility.

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