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3-2010

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Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

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Testimony, House Financial Services Committee

March 17, 2010

By Allan H. Meltzer

Last year the *New York Times* ran several articles about the end of capitalism. Others picked up the theme and reinforced it with claims that greedy bankers and deregulated financial markets had brought the world to the brink of another Great Depression. Allegedly we were saved by timely, forceful, and intelligent government actions. And the next phase had to be more government regulation of financial and economic life.

Unbelievable! Certainly there were many mistakes in the financial sector and a massive response by the Federal Reserve. Left out is the government's disastrous mortgage and housing policy. Without the policies followed by Fannie Mae, Freddie Mac, and the destructive changes in government housing and mortgage policies, the crisis would not have happened. Also, without warning, a 30-year policy changed when Lehman Brothers failed, followed by a hesitant and uncertain lead from Treasury Secretary Paulson. These actions converted a garden-variety recession into a world-wide crisis. The Federal Reserve acted forcefully and determinedly to lessen the fallout from its Lehman error, but much damage was done. Let's not overlook government failure. Let's try to prevent more of the same.

Would bankers have made so many errors if there had never been a too-big-to-fail policy? Not all bankers overinvested in mortgages but some "got up to dance" believing that they would profit and the rest of us would pay to prevent failures. Has the government learned from its mistakes by closing Fannie and Freddie and agreeing to put any housing subsidy on the budget, as a proper policy would require? Do you hear the president, the Treasury, or the Federal Reserve insisting on an end to too-big-to-fail?

This is the age of Madoff, Stanford, AIG, and many others. Regulation failed in all these instances. Failure is not unusual. Regulation often fails either because regulators are better at announcing rules than at enforcing them or because the regulated circumvent the regulations.

The Basel Accord was supposed to reduce banking risk. Financial markets circumvented it. Unusual? Not at all. In 1991 Congress passed the FDIC Improvement Act that authorized regulators to close banks before they lost all their capital. Regulators ignored it. Unusual? Not at all. Regulation is static and markets are dynamic. If markets don't circumvent costly regulation at first, they will find a way later. Congress should recall these failures before passing new regulations. It should choose regulations that give the regulated incentives for compliance.

During the Great Depression Congress authorized section 13 (3) that told the Federal Reserve to lend directly to small and medium sized firms that could not get accommodation from the banks. In this crisis, Section 13(3) was used to lend to AIG. This stretched the original purpose beyond any reasonable interpretation. Congress should remove this authority. It is now a source of large loans to failing enterprises, an undesirable extension of too-big-to-fail and a misuse of the intent of 13(3).

We cannot have deposit insurance without restricting what banks can do. The right answer is to use regulation to change incentives—making the bankers and their shareholders bear the losses. Beyond some minimum size, perhaps $ 10 billion of assets, Congress should require banks to increase their capital more than in proportion to the increase in their assets. Let the bankers choose their size and asset composition. Trust stockholders' incentives not regulators rules. Incentives are not perfect, but they are better.

Secretaries Geithner and Paulson told the AIG hearing that they faced a choice—a bailout or another Great Depression. Not true. Classical central banking offered a better alternative, used many times in the past. Classical policy called for letting AIG fail and lending to counterparties against good collateral. That policy supports the prudent and lets the failures fail.

I have watched and at times participated in discussions of crisis policy. The issue is almost always decided by those who tell the Treasury Secretary that without a bailout, crisis is likely, and the crisis will go into the history books with his name on it. The result: we make the taxpayers, your constituents, pay the cost of bankers' errors of judgment. And we invite some to choose imprudent behavior knowing they are too-big-to-fail.

The market is not perfect. It is run by humans, who make mistakes. They should pay for them. But the same humans run government where they make different, often more costly mistakes for which the public pays. At the moment, we see excessive spending and promises to spend that cannot be kept. This is a major problem in California and Greece but soon to be followed by others including the federal government. At all levels of government, promises to pay state and local pensions, old age retirement, and to provide healthcare far outstrip capacity to pay. The Congressional Budget Office and many others have been warning for years about the $50 or $60 trillion dollars of unfunded liability. Government's answer—offer an expensive drug benefit followed currently by a more expensive "reform" that increases the unfunded Medicare Medicaid liability. Dissemble about the real costs.

Regulators talk a lot about systemic risk. They do not, and I believe cannot, give a tight operational definition. Setting up an agency to prevent systemic risk without a precise, operational definition is just another way to pick the public's purse. Systemic risk will forever remain in the eye of the viewer. Instead of shifting losses onto those that caused them, systemic risk regulation will continue to transfer cost to the taxpayers. The regulators protect the bankers. They continue to lose sight of their responsibility to protect the public. Your responsibility is to

stop that. Protect the public. Let's go back to a system that required imprudent bankers to fail. Failure does not mean eradication. It transfers management and ownership to more prudent owners and managers. That should be our aim.

Senate Banking is considering putting the Secretary of the Treasury in charge of a systemic risk council. Treasury Secretaries are the officials who authorized all or most of the bailouts since bailouts began with the mistaken policy to save First Pennsylvania in the 1970s. This is not financial reform; it puts the biggest wolf in charge of the henhouse. Real financial reform requires that bankers, not regulators, monitor the risk on their balance sheet and accept their losses from mistakes. We will not get sound banking until the CEOs of the large banks and their shareholders make prudent decisions and are forced to pay for the mistakes. That will make for more prudence. I repeat my frequent comment: Capitalism without failure is like religion without sin. It doesn't work well.

The Federal Reserve as Regulator

Issues about bank regulation go back at least until the 1930s. Do we want several regulators? Can the Federal Reserve manage both monetary policy and bank supervision or regulation? Should regulation be placed elsewhere? What is best?

Congress should recall that multiple regulators were important for developing the progressive, innovative, competitive U.S. financial system. That system helps the United States to finance innovation, new industries, new products, growth in living standards, and jobs. In the 1960s, President Kennedy appointed an innovative regulator, Mr. Saxon, as Comptroller of the Currency. He pushed, prodded, and pulled a reluctant Federal Reserve to innovate by permitting banks to sell certificates of deposit and to compete effectively with investment banks. That strength that comes from multiple regulators should be encouraged not discarded.

Countries differ about whether regulation, supervision and monetary policy should be separated or in the same institution. A few years ago Britain separated them, but it did not make clear how the system would work in a crisis. It may reverse its decision. Germany and many others separate regulation and supervision from monetary policy. The European Central Bank leaves regulation and supervision to the members.

It does not seem to matter much, if at all. A principle reason is that none of the arrangements has shown much ability to regulate systemic risks. A main reason is that large permanent changes are difficult to foresee and even harder to act against in a timely way. The principals at Long-term Capital Management did not see the Russian default as a major change. Although many warned about housing prices, only a very few profited from their decline. Most financial managers said that a housing price decline was unlikely.

These are not isolated examples. Sudden, permanent changes are a main reason why we have financial crises. We will not eliminate crises, or even reduce them, unless we impose prudence on the bankers and their stockholders.

Monetary Policy.

Congress gave the Federal Reserve a dual mandate. It generally ignores that mandate and works on one objective at a time. This is an inefficient way to achieve both objectives. And with rare exceptions, such as most of 1985-2003, the Federal Reserve has not given the public both low inflation and low unemployment.

I believe we are headed for high inflation, not immediately, but later. The Federal Reserve has issued more than $ 1 trillion of excess reserves. It does NOT have a coherent, operational plan to reduce the excess. Federal Reserve officials suggest that it can get banks to hold most of the excess reserves by raising the interest rate on reserves. I have asked them repeatedly how high the rate would have to go. Silence. At your recent hearing, one of your members, Congressman Hensarling asked Mr. Bernanke "how much one might have to pay on the interest rate on bank reserves?" I quote Mr. Bernanke's answer in full.

"We think that the interest rate we pay on reserves will bring along with it the federal funds rate. Within tens of basis points. Not a tremendous difference."

This is not an answer. It doesn't come close. I suspect that the Federal Reserve does not know the answer.

The correct answer is close to the crux of the issue about whether we can avoid inflation. The history of the 1970s has many examples of complaints from the business community, labor unions, Congress, the administration and the public about raising interest rates when the unemployment rate is about 7% or more. That makes me very skeptical that the Federal Reserve has a coherent, workable plan in the present circumstances and sufficient independence to persist in pursuit of both parts of the dual mandate. I do not doubt that at some interest rate, the banks will hold the excess reserves. I doubt very much that the interest rate is consistent with continued recovery and is politically acceptable.

You should be skeptical also. You should require the Federal Reserve to tell you how high they believe the interest rate would have to rise to get banks to hold more than $ 1 trillion of excess reserves. If they cannot answer, you should insist on a more complete plan. Now is the time to do that planning.

Finally, this committee has accepted Congressman Paul's proposal to audit Federal Reserve decisions. This is a mistake. Your constituents do not care how or why the Federal Reserve decides. They care about the outcomes—inflation and unemployment. You should

require a rule or quasi-rule that enforces outcomes. That's the way you can best improve Federal Reserve policy. I will be glad to expand on the rule in the question period.

Allan H. Meltzer is the Allan Meltzer University Professor of Political Economy at the Tepper School, Carnegie Mellon University and the author of *A History of the Federal Reserve*, University of Chicago Press, 2003 and 2010.