

REFLECTIONS ON THE FINANCIAL CRISIS

Allan H. Meltzer

I am going to make several unrelated points, and then I am going to discuss how we got into this financial crisis and some needed changes to reduce the risk of future crises.

Some Observations

First, we should close down as promptly as possible Fannie Mae and Freddie Mac. There never was a reason for those two institutions, other than to avoid the congressional budget process. The benefit that people got from Fannie and Freddie came from the subsidy to the mortgage interest rate. Congress could have passed that subsidy over and over again. They avoided passing it by taking the program off budget. That led to a benefit to members of Congress who participated in the profits of Fannie Mae and Freddie Mac. It is an example of bad government policy.

Second, looking ahead, the debt of the United States as a share of GDP is going to go from 40 percent to at least 60 percent. If you look at Japan, Italy, or Belgium, that doesn't seem like a startling number. The difference is that much of that debt is owed to foreigners. Looking ahead, get used to the idea that we're going to have to export more and probably see consumption grow at a slower rate. After years of rising expenditure on consumption in the United States, we are going to have to learn to tighten our belts a bit. That's not going to be an easy thing to do politically; woe to the president who presides over that period.

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Third, I get a lot of questions from the press every day, and one of the questions these days is deflation. The last time somebody asked me that question—it must have been the 15th time I'd heard it—I said that was one of the most stupid question I'd heard in 40 years of dealing with the press. It's time that the people who talk about deflation went back to school and learned about the difference between maintained rates of change and one-time changes in level. The so-called deflation that we're going to have is the decline in oil and food prices that are the reverse of the increase in oil and food prices. Those are changes in the level of prices, but not in the sustained rate of change of prices. Deflation properly understood refers only to a sustained decline in the rate of change of prices. Incidentally, in Federal Reserve history, there are six or seven periods in which we had deflation. Only one of them was a disaster: the Great Depression. It was a disaster because while the deflation was going on, money growth was falling, so that the expectation was that deflation would continue. In the others cases of deflation, if you look at the footprints of those recoveries you wouldn't be able to distinguish them from any other recovery.

Fourth, is the bankruptcy law. There's a lot of pressure to change the bankruptcy law to adjust to the current circumstance. If we do that, the simple fact is, we won't have a bankruptcy law. The benefit of the bankruptcy law is it gives people some ideas as to what they can expect under troublesome circumstances. If we change it in relation to those circumstances, we violate the rule of law.

Finally, I believe that the Congress and the administration are working on the wrong problem. You can solve the mortgage problem by solving the housing problem. But you can't solve the housing problem by adjusting the mortgage market. Let me expand on that a little bit. A major problem that the economy faces in the housing and mortgage market is that the price decline in houses stimulates defaults. And the expected decline for 2009, which the market puts at 11 percent, means there are going to be many, many more defaults as the price of houses falls even further below the mortgage value. You want to solve that problem.

The difficulty is that if policymakers seek to benefit people by reducing the value of their mortgage, or the interest rate on their mortgage, then other people will be encouraged to come and ask for help. To solve the problem caused by declining house prices, and the

future problem of the mortgage market, there needs to be an increase in the demand for houses. If 2008 were a normal year, roughly 1.5 million houses would have been sold rather than 500,000. So there's a lot of room to increase demand, and we have to find a way to stimulate demand.

My proposal is simple and transparent. Instead of depending upon government bureaucrats to decide who's in and who's out, it allows individuals to make their own choice about what they want to do. If a buyer makes a down payment on a house between now and the end of 2009, he or she gets a tax credit for the amount of the down payment, or enough of it to make it attractive. If the buyer doesn't pay taxes, they get the credit anyway. I don't care whether they're buying their first, second, third, or in the case of John McCain, their eighth house. The important thing is to remove the excess supply. That will do two things: It will slow or stop the decline in prices and therefore work on future defaults; it will also eventually stimulate the return to work of the people in the building trades, who are a big part of the economy.

The problem in the mortgage market is that mortgages are being sold at very low prices: about \$45 per \$100. Why so low? Because nobody knows how far those prices are going to fall, they take a big discount. If Secretary Paulson went through with his original plan, and actually bought up mortgages, he would have bankrupted many of the people who sold him the mortgages. They don't have enough equity to sell their mortgage portfolios for \$45. We need to work directly on the excess supply of housing by increasing demand.

Deregulation Did Not Cause the Financial Crisis

Now I would like to turn to one of the problems that annoys me greatly. The Congress blames everyone they can think of for the problems that it helped to create. They talk a great deal about deregulation. I would challenge anybody to point to something important that was deregulated during the last eight years. Nothing much was deregulated. The last major financial deregulation was the 1999 act that President Clinton signed, removing the Glass-Steagall provisions separating commercial and investment banking. No other country in the world separates commercial and investment banking, and none of them have problems on that account. Nor have we had problems on that account. George Benston (1990), years and years

ago, wrote a paper pointing out that all of the arguments in favor of Glass-Steagall were based on somebody's conjecture. Everyone else who talked about it referred to the conjecture. No one produced evidence showing that the combination of commercial and investment banking was a cause of the Great Depression. And of course, we now understand that the Federal Reserve was the main cause of the Great Depression.

What Needs to Be Changed?

There are several things that need to be recognized and improved.

First, we need to do something about the government-sponsored enterprises like Fannie Mae and Freddie Mac. Congress passed the Community Reinvestment Act in 1977. At the time it wasn't innocuous, but it wasn't as harmful as it later became. The requirements of the CRA for home buyers kept getting easier. In 2005, the Housing and Urban Development Agency encouraged the use of no-down-payment mortgages. There was tremendous political pressure to put people into houses even if they couldn't pay the mortgage. That pressure and the government-sponsored financing agencies like Fannie Mae and Freddie Mac began to buy subprime loans, which often required no down payment.

The extent of the problem is revealed by what happened from 1980 to 2007. During that period, the amount of mortgages acquired by Fannie and Freddie went from something like \$200 million to \$4 trillion. We need to change incentives. If we are going to subsidize housing for the poor, then we should do it on budget and not in this roundabout method. One great reform in Congress that we'll never get is to take all of the off-budget agencies and close them. If Congress votes to keep them, it should make direct appropriations.

Second, we must note the role of the Federal Reserve in the financial crisis. Alan Greenspan did make a mistake. He kept interest rates too low, too long. He was afraid of deflation. That was a mistake. The risk of deflation in an economy with our budget deficit and the long-term prospect of the decline of the dollar seems to me to be minimal. In any case, he thought we faced deflation, so he kept monetary policy too easy for too long. But no one made the people in the banks and the financial institutions buy mortgages; they could have bought Treasury bills.

Thus, although the Fed helped to encourage an environment in which credit was plentiful, the decision to overleverage and to make

risky loans falls on the private sector. Financial institutions may have been encouraged by a belief in the so-called Greenspan put (namely, that if they got into trouble, the Fed would bail them out), but there is no hard evidence to support that contention.

In writing the history of the Fed, one of the things I found was that in 95 years the Fed never announced what its “lender of last resort” policy was (see Meltzer 2003, 2009). Sometimes it bailed out banks; sometimes it let them fail; and sometimes it did something intermediate. It negotiated some arrangements like those with Long-Term Capital Management and, more recently, Bear Stearns, where somebody would take them over. The Fed would not let them go bankrupt. Absence of a clear policy creates uncertainty, particularly in times like these.

In the case of Bear Stearns, the Fed semi-rescued the financial giant, but then let Lehman Brothers fail. If you are running a portfolio what are you supposed to believe is the next step? The next step may be that the Fed helps you or that they don't. Uncertainty increased. After Lehman failed, portfolio managers ran for Treasury bills and drove the Treasury bill rate down to something close to zero. Creating massive uncertainty was a mistake, a mistake that needs to be corrected. The Fed needs to announce, and insist upon—that's the hard part—its “lender of last resort” policy. It must get rid of “too big to fail.” If a bank is too big to fail, it's too big.

Third, I would say there is a problem about compensation. We had MBAs who were 5 years or 10 years out of the best business schools in the world buying and selling stuff that is junk. Why did they do it? They were well rewarded for doing it and they got fired if they didn't do it, so they did it and they made a lot of money. It didn't happen at all banks. JPMorgan Chase is obviously an example, as is Pittsburgh National. Bank of America was an example before it acquired Countrywide and Merrill Lynch. They didn't do what Citigroup and some of the others have done. Management has to think about the way in which they compensate people and to spread compensation over a longer period of time. Management and its employees must have something at stake when they transact. The fact that we have had two crises within a few years—the dot-com crisis and the banking-financial-housing crisis—has a lot to do with the way people are compensated. This is an issue for managements, not governments.

Fourth, the regulators never mention the fact that the Basel Accord contributed to the current problems. In my book, *A History*

of the *Federal Reserve* (2009), I say, and repeat very often these days, that lawyers and bureaucrats make regulations but markets learn to circumvent the expensive ones. The Basel Accord was an agreement which said to banks, if you hold more risky assets, you have to hold more capital. What did the banks do? They didn't hold more capital; they took the risky assets off their balance sheets. That's a good example of circumventing costly regulation. There are many other examples: Regulation Q was one. In my book I give other examples of circumvented regulation.

Fifth, Wall Street firms got too clever. They invented mortgage instruments that they can't now unwind. That contributes a lot to the present crisis. When Sheila Bair says we should just "forgive the people who default," she overlooks that it's not going to be easy to collect the pieces of those mortgages and put them back together again. They're not just sitting there the way they were in the days of the old savings and loan associations where there was a mortgage and even if it had been sold, it was sold in a piece. Today it's not clear who is responsible for putting together the package of the mortgages. People were much too clever for the circumstances that later developed.

Conclusion

If we are to prevent future financial crises, a good place to start would be to (1) get a "lender of last resort" standard; (2) get the Congress to appropriate on the record the amount of money that they are going to use to subsidize housing; (3) improve the compensation system in the market; (4) get rid of some of the worst of the Basel Capital standards; and (5) close down Fannie and Freddie.

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