Cato Handbook for Policymakers

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36. Monetary Policy and Financial Regulation

Congress should

- amend the Full Employment and Balanced Growth Act of 1978 to clarify the congressional guidance on the conduct of monetary policy,
- repeal the Community Reinvestment Act of 1977,
- encourage the Treasury to use its new powers as a conservator of Fannie Mae and Freddie Mac to liquidate these firms, and
- repeal the $700 billion bailout legislation.

Monetary Policy

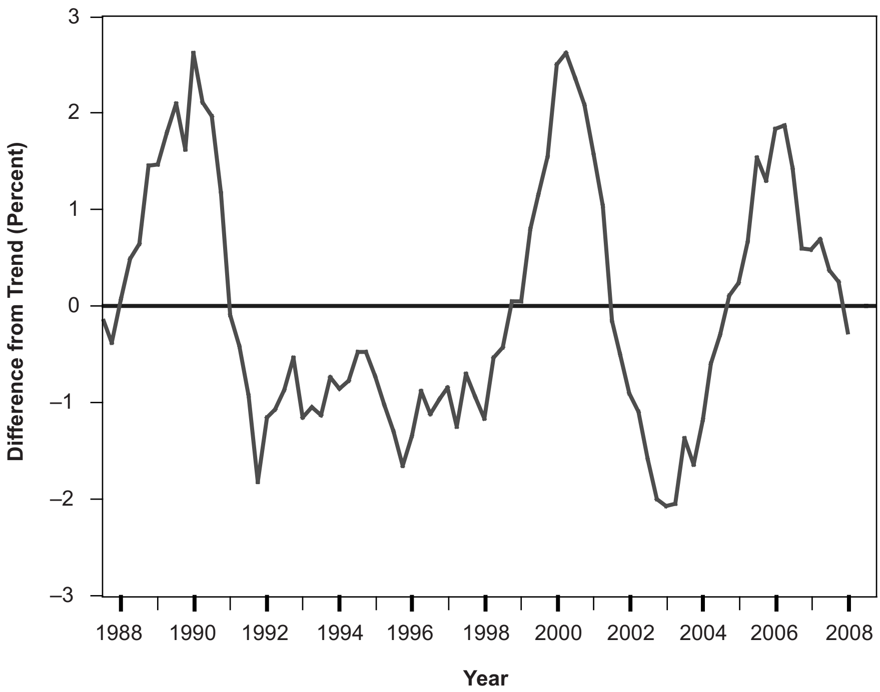
For the past 30 years, the Full Employment and Balanced Growth Act of 1978 instructed the Board of Governors of the Federal Reserve to establish a monetary policy to maintain long-term economic growth and minimum inflation. As these two goals are sometimes inconsistent, this congressional guidance has not been very effective. The Federal Reserve has had almost full discretion in the conduct of monetary policy, subject only to the balance of current political concerns.

The intent of Congress would be better served and monetary policy would be more effective if Congress instructed the Federal Reserve to establish a monetary policy that reflects both their concerns in a *single* target. The best such target, I suggest, would be the nominal final sales to domestic purchasers—the sum of nominal gross domestic product plus imports minus exports minus the change in private inventories. First, this is a feasible target: nominal final sales to U.S.-based purchasers are almost completely determined by U.S. monetary policy, whereas the rate of economic growth and the inflation rate are separately affected by a variety of domestic and foreign conditions. Second, this target provides the correct incentives: for any rate of increase in final sales, a reduction of the inflation rate increases the rate of economic growth.

Congress is best advised (1) to specify a target rate of increase of final sales and (2) to instruct the Federal Reserve to minimize the variance around this target rate. The target rate of increase of final sales may best be about 5 percent a year, sufficient to finance a realistic rate of economic growth of 3 percent and an acceptable rate of inflation of about 2 percent. For the past 20 years, actual final sales increased at a 5.4 percent annual rate with an average inflation rate of 2.4 percent, illustrating that a 5 percent annual increase of final sales would be both feasible and a slightly superior target. The primary problem of U.S. monetary policy during this period, as illustrated by Figure 36.1, is that the Federal Reserve overreacted to three financial crises, creating three ''bubbles'' of aggregate demand—the correction of which caused two subsequent shallow recessions and, most likely, a third.

The first bubble during the past 20 years was a consequence of the Fed's overreaction to the sharp decline in U.S. equity prices in October

Figure 36.1
Nominal Final Sales to Domestic Purchasers



1987, only two months after Alan Greenspan was confirmed as chairman of the Federal Reserve Board. In turn, the Fed's tightening in response to this demand bubble and the implementation of the first Basel agreement on bank capital standards led to the shallow recession of 1991.

The second unusually large increase in demand was clearly a consequence of the Fed's response to a series of financial crises beginning with the Asian financial crisis of 1997, sustained by the collapse of Long-Term Capital Management and the Russian default in 1998, and the Brazilian devaluation and the anticipated Y2K crisis of 1999. The Fed's easy money policy during this period led to a second bubble in aggregate demand and contributed to the nearly coincident bubble in high-tech stocks. The Fed's tightening to deflate this demand bubble led to the shallow recession of 2001 and contributed to the sharp reduction in equity prices.

The primary cause of the third demand bubble was that the Fed maintained unusually low interest rates for three years following the 2001 recession. This led to the rapid increase in the prices and expenditures for new homes until early 2006. As I write, it is less clear what will happen to this third bubble. The Fed maintained high interest rates through July 2007, contributing to a sharp reduction in real growth through the first quarter of 2008 but as yet without a recession. More important, it is much less clear what will be the effects of the sharp reduction of interest rates since July 2007, the several measures to avoid a collapse of the mortgage market, and the substantial increase in inflation. The rapid increase in consumer and producer prices in summer 2008 should have been ample warning to the Fed not to be diverted from its primary mission. This story is not yet over.

The major lesson from Figure 36.1 is that most of the variation in demand during the past 20 years has been triggered by the Fed's response to financial crises. A second lesson is that the Fed seems to overreact. A reasonable standard by which to judge the Fed's response to a financial crisis would be to avoid a *decline* in the growth of demand relative to the target path. Instead, the Fed's response to financial crises has led demand to increase relative to the target path. A third lesson is that the necessary measures to deflate the demand bubbles caused by overreacting to financial crises should be expected to lead to a recession.

Some of the more important institutional measures that Congress and the Federal Reserve should address are whether and how much the Fed should respond to a financial crisis. The conventional perspective on this issue is that the Fed faces a tradeoff among the potential near-term contagion effects of a financial crisis and the longer-term problem of moral hazard, and that the Fed is biased in favor of reducing the near-term contagion effects. The record of the past 20 years suggests that there is another potential mid-term cost of the Fed's response to a financial crisis—the increased probability of a recession caused by deflating the bubble caused by overreacting to a crisis.

I do not mean to imply that the Fed should never respond to a financial crisis. My objective is to induce more analysis about how to minimize the combined effects of a financial crisis and the Fed's response to it on the Fed's primary mission: how to maintain a steady increase in aggregate demand consistent with a low target rate of inflation.

Financial Regulation

For just over 30 years, the Community Reinvestment Act of 1977 has required commercial and savings banks to offer credit throughout their market area, with the objective of making loans to individuals and small businesses with an income or credit rating that would otherwise deny them access to credit. This act is enforced by requiring a satisfactory record of community service as a condition for approving a bank's application for a merger, an acquisition, or a new branch—a record that is closely monitored by local community organizations. This led to the development of subprime loans, characteristically with a low down payment, a low initial interest rate, and a higher subsequent rate. Changes in the implementing regulations in 1995 allowed the securitization of these subprime loans. Following a 2002 review of the CRA regulations, several regulatory agencies substantially reduced the regulations to which the smaller banks are subject, effective in 2005. The combination of regulatory pressure on the banks to make subprime loans and the increased securitization of subprime loans contributed to some increase in home-ownership rates, especially among those under age 25 and over age 65 and by nonfamily households.

For some years, many politicians and community organizations regarded this process as a successful experiment in political credit allocation, increasing home-ownership rates among those with a poor credit rating without jeopardizing the lenders. But the developments in the financial markets since housing investment peaked early in 2006 should have shattered that illusion. Countrywide, the bank with the largest portfolio of CRA loans, faced bankruptcy until purchased by the Bank of America in early 2008. Bear Stearns was only one of many domestic and foreign securities firms that faced huge losses on their portfolios of mortgage-backed securities.

The several major developments in the mortgage market substantially reduced the incentive of most of the market participants to be concerned about risks. The combination of low down payments and the non-recourse status of most mortgages greatly reduced the risks to the borrower. The mortgage brokers had little reason to be concerned about the risks of the mortgage because they do not hold the loan in their own portfolio; they make their money on the volume of the mortgages they sell to a bank or in a mortgage-backed security. The securities firms that buy the mortgage-backed securities are almost entirely dependent on the few authorized credit-rating firms to rate the risk of these securities. And the home-ownership rates have now dropped below their peak level during the housing boom. In a *New York Times* column, Paul Krugman concludes that ''homeownership isn't for everyone. In fact, given the way U.S. policy favors owning over renting, you can make a good case that America already has too many homeowners,'' a position later endorsed in a *Washington Post* column by Robert Samuelson. The Community Reinvestment Act was a bad idea when it was first approved. The record of the past few years should be sufficient evidence to make the case for its repeal.

In March 2008, following the near collapse of Bear Stearns, the Federal Reserve opened the discount window to make low-interest credit available to securities firms (investment banks) for the first time. This expansion of Federal Reserve credit to the securities firms led to a broad demand to increase the regulation of these firms, which are loosely regulated by the Securities and Exchange Commission. In response, members of the Fed staff were assigned to work with the SEC in the four largest securities firms to increase their information about their financial status, and an information-sharing arrangement was formally approved by a memorandum of understanding between the Fed and the SEC in early July. Access to the discount window by the securities firms was initially scheduled to expire in September 2008. In late July, however, Fed Chairman Ben Bernanke extended the broader access to the discount window through January 2009. In mid-July, the Fed also opened the discount window to Fannie Mae and Freddie Mac, as part of a Treasury proposal for authority to prevent the collapse of these two huge government-sponsored mortgage firms.

In the meantime, there was considerable disagreement on this issue within the government. In a speech in early June, New York Federal Reserve Bank President Tim Geithner remarked:

> We have to recognize that poorly designed regulation has the potential to make things worse. We have to distinguish between problems the markets

> will solve on their own and those markets cannot solve. We have to acknowledge not just that regulation comes with costs, but that if not carefully crafted it can distort incentives in ways that make the system less safe. And we have to focus on ways regulation can mitigate the moral hazard risk created by actions central banks and governments have taken and may take in the future to avert systemic financial crises.

In a speech in late June, however, Treasury Secretary Henry Paulson concluded:

> We should quickly consider how to most appropriately give the Fed the authority to access necessary information from highly complex financial institutions and the responsibility to intervene to protect the system so they can carry out the role our nation has come to expect—stabilizing the overall system when it is threatened.

The answer is that Congress should *not* add any powers and obligations for the Federal Reserve to regulate the securities firms. Additional regulations are not necessary; the government allowed two large securities firms, Drexel Burnham and Kidder Peabody, to fail in the 1990s without any general financial crisis. Additional regulations would also not be sufficient; about 1,600 commercial banks and about one-third of savings banks failed about 20 years ago despite extensive regulation, because the combination of deposit insurance and access to the discount window created a serious level of moral hazard that reduced the incentive of both depositors and banks to avoid adverse risks. Adding the securities firms and the government-sponsored mortgage firms to the list of financial firms eligible for access to the discount window and subject to regulation by the Federal Reserve would expand the level of moral hazard in the financial system by orders of magnitude.

Allan Meltzer, the leading historian of the Federal Reserve, observes:

> In its ninety-five-year history, the Fed has never made a clear statement of its policy for dealing with failures. Sometimes it offered assistance to keep the bank or investment bank afloat. Other times it closed the institution. Troubled institutions have no way to know in advance whether they will be saved or strangled. The absence of a clear policy statement increases uncertainty and encourages problem institutions to demand loans and assistance. Large banks ask Congress to pressure the regulators. Taxpayers pay for the mistakes.

The clear implication of this review is that the government should allow the temporary access to the discount window by the securities firms and the Fed's temporary role to regulate these firms to expire. And, indirectly, that is what happened; after the collapse of Lehman Brothers, the three remaining U.S. securities firms chose to be absorbed by a commercial bank or chose a charter as a bank holding company, choosing more regulation in exchange for continued access to the discount window. More important, to avoid a repetition of the conditions that led to the demand for increased regulation of the securities firms and the government-sponsored mortgage firms, Congress should consider amending the Federal Reserve Act of 1913 to restrict access to the discount window to depositary institutions only.

But the Treasury did not wait, seeking and winning congressional authority to become the conservator of Fannie Mae and Freddie Mac with a potential cost to U.S. taxpayers of up to $200 billion. Paulson described this action as a means to restore these firms to financial health by reducing their most vulnerable mortgage-backed securities over a period of years. But these government-sponsored enterprises are based on a profoundly flawed business model, with their profits owned by their executives and shareholders and their losses a debt of the taxpayers. The Treasury should use its authority to *liquidate* these firms and end the costly experiment with government-sponsored private firms. A direct mortgage subsidy would be a much more efficient policy to increase the homeownership rates among targeted groups if there is a continued political demand for this objective.

And the Treasury's demands exploded in late September when it submitted a three-page bill requesting congressional authority to spend up to $700 billion to purchase mortgage-backed securities from the major domestic and selected foreign banks. The basic structure of this proposal received very little review. In the first round of review, the Senate added several oversight bodies, authorized the additional spending by installment, and set a limit on the compensation of the executives of the banks that sell their mortgage paper to the Treasury, but the Senate did not address the basic structure of the Treasury proposal or any alternative. After a considerable public protest, however, this bill narrowly failed to pass in the House. In response to the House vote, the Senate added a substantially higher limit on insured deposits and more than $100 billion to extend and expand many individual and business tax breaks, including tax credits for the production and use of renewable energy and tax relief to victims of recent floods and storms—changes that were sufficient for approval by the House on October 3.

This bailout plan is almost sure to be a disaster. The Treasury has had no experience in managing a huge portfolio of bad debt. Banks will have an incentive to sell their worst mortgage-backed securities to the Treasury. The Treasury, in turn, will be subject to strong political pressure to defer foreclosures and evictions. And this will probably lead some homeowners to cease paying on their mortgage. After a careful evaluation of the alternatives to this comprehensive bailout plan, Congress should *repeal* the legislation that it approved in October.

Suggested Readings

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O'Driscoll, Gerald P., Jr. ''Asset Bubbles and Their Consequences.'' Cato Briefing Paper no. 103, May 20, 2008.

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