

## The Thought Leader Interview: Allan Meltzer by Rob Norton

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by Rob Norton

**W**hen the United States Federal Reserve System becomes a fixture on page A1 of the *Wall Street Journal*, it means that either the U.S. economy is in trouble or the global financial system is under stress. As everyone reading this magazine knows, for the year and a half since the summer of 2007, it has meant both.

It is no wonder that fears about the future of the economy, the financial system, and the Fed's ability to perform its tasks have been widespread, and recent assessments from market commentators range from the gloomy to the very dark. Some have warned that the global economy is at the brink of the next Great Depression, with the U.S. leading the way; that only massive reregulation can save the banking industry; and that the Fed is no longer in control.

Much of this commentary, however, lacks perspective, and perhaps no one has a more complete perspective on the interrelationships between the economy, the financial system, and the Fed than Allan Meltzer, who holds an eponymous endowed chair as the Allan H.

Photograph by Jeff Swensen

## Allan Meltzer: The Thought Leader Interview

The world is not facing another Great Depression, says the noted economic historian, but the Federal Reserve is eroding its credibility.

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Meltzer University Professor of Political Economy at Carnegie Mellon University's Tepper School of Business. Meltzer, born in 1928, has been studying monetary economics since the late 1950s, and is completing his definitive *History of the Federal Reserve*. (The first volume, covering the years 1913 to 1951, was published by the University of Chicago Press in 2003 and ran 800 pages; the second installment, which will bring the history forward to 1986, is due to be published in two volumes running 1,400 pages in October 2009.)

In both of its major roles, the Fed has been (and is being) tested by the economic crisis of late 2008. The first test has to do with its role as the manager of U.S. monetary policy, setting short-term interest rates for interbank borrowing in the United States. The Fed is charged with striking the right balance between economic growth and inflation, and, given the size of the U.S. economy and the importance of the dollar in world trade, its decisions ripple out and affect financial institutions throughout the world. The second test has been connected to its role as lender of last resort, when the imminent failure of a financial

institution creates a potentially systemic risk in the markets. Even before the U.S. Congress began debating its Wall Street bailout plan in September, the Fed had made unusually aggressive forays into the credit markets to forestall the collapse of the mortgage finance industry, extending emergency loans through its "discount window" to investment banking companies, including Bear Stearns, which was shut down and sold to J.P. Morgan Chase & Company in March 2008, and to AIG, the troubled insurance company. No matter what the aftermath is on Wall Street, the U.S. economy is likely to face both recession and rising inflation, the latter for the first time in a generation. To someone currently seeking stability and reassurance, none of this is good news.

However, Allan Meltzer is impatient with comparisons of the current situation to the Great Depression. The economy circa 2008, in his view, is in a slowdown that appears to be modest, and from which it should recover in routine fashion. And although the financial system is under great stress, Meltzer does not think that anything we have seen so far suggests great dan-

ger. The Federal Reserve, he believes, has made only two major errors in its 94-year history. One was permitting the monetary deflation that worsened the Great Depression; the other was unleashing what economists call the Great Inflation, which saw the U.S. inflation rate rise from about 1 percent in early 1965 to nearly 14 percent in 1980. But in addition to these mortal sins of policymaking, the Fed, in Meltzer's view, has been guilty of many more venial ones.

He says the Fed has recently made several mistakes that fall into the latter category, including the way in which it conducted some of the recent bailouts and the way that it is allowing inflation to take root again. Both are evidence of a more endemic problem: The Federal Reserve, in Meltzer's opinion, is allowing itself to be driven by events and pushed around by Congress, squandering the hard-won reputation for institutional independence that it gained in the 1980s and 1990s. It is thus devaluing the only truly worthwhile currency that a central bank has: its credibility as a bulwark against inflation. The Fed's emergence as the über-regulator of the U.S. financial system — with

regulatory powers extending to Wall Street firms — is ill advised, according to Meltzer, because this will further politicize the Fed and divert its attention from its most critical role.

Meltzer sees some new regulation as inevitable, but he favors simple fixes. Imposing strict capital adequacy requirements on all financial institutions and establishing clear penalties for those that get into trouble would go a long way, he believes, toward limiting the damage from future financial-sector problems. The other reform he favors, however, can come only from the financial industry itself. That reform is an overall rethinking of the incentive and compensation structures that set the stage for the recent disasters.

Meltzer's own intellectual progression follows the aphorism (attributed to the early-20th-century French Prime Minister Aristide Briand) that a man who is not a socialist at 20 has no heart, and a man who is still a socialist at 40 has no head. In the 1948 presidential election, Meltzer was a 20-year-old campaign volunteer for the Progressive Party, whose platform included full voting rights for African-Americans and universal

health insurance (the party's candidate, Henry Wallace, received 2.4 percent of the popular vote). Meltzer had graduated from Duke University that year with a bachelor's degree in economics. He shed his left-wing leanings during his graduate studies with economists such as Armen Alchian and Karl Brunner, earning his master's degree in 1955 and his doctorate in 1958 at the University of California at Los Angeles. Brunner, a Swiss émigré with an interest in monetary economics, became his mentor, and later his colleague and coauthor. Together they wrote dozens of articles and several books.

Meltzer and Brunner were influential figures in the economic school of monetarism, a disruptive innovation in the history of economic thought. Monetarism emphasized the importance of controlling the growth of the money supply to restrain inflation and promote stable growth, and is associated with the late Nobel laureate Milton Friedman. This idea was considered heretical by many economists in the 1960s and 1970s, and one of its central suggestions — that the discretionary policies of central banks be replaced by a simple rule for

monetary growth — never gained traction, although former Federal Reserve Chairman Paul Volcker described his own approach to ending inflation in the early 1980s as “practical monetarism.” Eventually monetarism withered as a distinct school of economic thought, but its central ideas about the importance of controlling the growth of the money supply have been absorbed into both the mainstream of economic thought and the practices of the Fed and other central banks.

In late July 2008, Meltzer spoke with *strategy+business* in his Pittsburgh office as he was preparing to attend the meeting of Federal Reserve officials and monetary economists held every August in Jackson Hole, Wyo. We spoke with him again in late September following the subsequent market collapse of Countrywide, Lehman Brothers, AIG, Merrill Lynch, Washington Mutual, and others. He updated a few of his answers, but his overall opinions were unchanged.

**S+B:** The financial system is in a very disturbed state, and the economy has not been doing well. How bad do you consider the situation, and how does it compare to earlier episodes?

**MELTZER:** The biggest banking problem in modern history, of course, was during the Great Depression, when we had waves of bank failures. So far, we have had a few failures, including some very large ones, but we haven't seen anything that could be called a wave of bank failures. The defaults we're seeing in the mortgage finance market are the biggest problem today, and the write-offs that we're seeing today are very large in dollar terms, but the financial system is much larger

**“The bigger problem is the perception — now held by the market and Congress — that the Fed can be pushed around.”**

than it was in the 1930s. Today, the defaults on mortgages are 6 percent and rising; during the Great Depression, they were 50 percent.

One somewhat similar crisis was in 1920 and 1921, when there was a wave of failures of agricultural banks. At the time, farmers represented a bigger part of the economy than they do now, and it was a serious problem. Farmers had bought land during World War I, and mortgaged it at high interest rates. Then came a big deflation of about 20 percent. As a result, Congress created the Federal Land Banks, which bought up the troubled loans and extended credit. Another somewhat similar case was the failures in the savings and loan industry in the late 1980s and the beginning of the 1990s, which dragged down a lot of the banking system. That wound up costing taxpayers an estimated \$150 billion. The current mortgage and credit crisis will probably cost taxpayers a lot more.

**S+B:** But you don't see this as a major threat to the economy?

**MELTZER:** I've always been skeptical that the housing crisis was going to cause a deep recession in the United States. The reason is that

it's localized, for the most part, in six communities: Southern California, Southern Nevada, Arizona, Southern Florida, and, for very different reasons, Cleveland and Detroit. This is a big economy, and six local problems can cause a wider problem. A downturn? Yes. A slowing in housing construction? Absolutely. But a major depression for the United States? Not at all. It's not likely.

**S+B:** Do you see further weakness in the credit markets beyond the mortgage market?

**MELTZER:** We will probably see difficulties in consumer credit and consumer loans somewhere along the line, but I don't think it will be a result of the housing situation. The current problems that consumers face are high energy and food prices, and the spreading of energy price increases to everything the consumer buys that moves by truck or airplane. Those prices are going up. Plus, consumers are going to suffer in the wintertime with rising heating and electricity prices. I think that is going to keep consumption growth slow.

There's no question that we're coming out of a period of very lax

credit standards, and they are being tightened. The bankers are probably overreacting, as they often do, going from one extreme to the other. This is hurting people with student loans, housing loans, and consumer loans — although credit, for the most part, is still expanding. Good prospects can get financed. Risky things are more difficult.

The biggest problem in the credit markets can't be solved, and won't be solved, until there is a pretty good idea as to where housing prices are going to settle. You can't value mortgages until you know what houses are worth. And no one really knows yet. Recently, bankers have marked down their portfolios of mortgage securities aggressively. I think that's a step toward a solution, so I don't regard that as terrible. The sooner those prices fall, the quicker this thing is going to be over.

Once people in the financial markets have an idea of where prices will settle — prices don't have to necessarily get there, but people have to have an idea of where they're going to go — the markets will be able to price the mortgages. So today a banker will lend to other bankers for one day or maybe one

week, but he won't lend for one month because there's just too much uncertainty about the value of the assets on a bank's portfolio. And until that problem is resolved, this so-called crisis is going to continue.

### Lenders of Last Resort

**S+B:** When you say “so-called crisis,” do you doubt that it's a crisis at this point, or again, is that just a question of terminology?

**MELTZER:** It's a crisis for the housing sector, but that sector is used to crises — it's a very up-and-down business. And it is a crisis for banks and the big Wall Street firms, particularly those banks that are heavily invested in mortgage securities, which turns out to be a large number of them.

**S+B:** One of the aspects of this crisis that seems distinctive is the way it has shaken the investment banking business and the insurance business, rather than just commercial banks or mortgage finance companies, beginning with the bailout of Bear Stearns. There has been much discussion about whether the Fed's role in that failure — as well as in some other recent instances — was appropriate, especially in acting as “lender of last resort” for an investment bank, with a 28-day emergency loan of and an agreement to guarantee \$30 billion in assets. [The deal included Bear Stearns's ultimate sale to J.P. Morgan Chase at \$10 per share.] How big a change does that episode represent?

**MELTZER:** Historically, there have been few failures of Wall Street firms, partly because they mark their portfolios to market every night. They have to borrow enough to balance their assets. If they can-

not borrow enough, the problems come to light pretty quickly. But most investment banks have not gotten into trouble in the past, and not all of them got into trouble this time. Some have taken losses — some of them very large losses — but that's the nature of their business.

The fact that the Fed acted as lender of last resort in the Bear Stearns case was not, by itself, inappropriate. They have done that in the past. The Fed *should* be lender of last resort to the whole financial system. In the past, if an investment bank became insolvent, if it posed a systemic risk to the markets, the Fed would provide liquidity to the market to avoid a contagion effect, and they would let the investment bank go out of business. In the Bear Stearns case, that's what they did. They stepped in, made credit available through the discount window, and then allowed Bear Stearns to fail, wiped out the equity, and replaced the management.

But they made a mistake in guaranteeing \$30 billion of Bear Stearns's portfolio. That transferred potential losses from the market to the taxpayer. As I said, the Fed should be the lender of last resort to the financial system. It in fact took them a long time to learn that, and they didn't really learn it until the [Penn Central] commercial paper crisis of 1970. But the Fed should not be the permanent financier of any individual — especially not people who are selling them risky, illiquid paper, as was the case with Bear Stearns and AIG. If the Fed had said to these institutions, “Sure, we'll lend to you through the discount window if you have Treasury bills or the equivalent,” that's one thing. But to say, “Come and sell

us,” or, “We'll lend to you against assets that no one else will buy,” that's a mistake. This is not what a central bank is supposed to do.

**S+B:** What are the risks of the Fed holding a large amount of these types of questionable assets on its balance sheet?

**MELTZER:** It limits their flexibility; it means there's less they can do. They can't sell those assets, so in effect they've cut their balance sheet in half, although they still have a big enough portfolio that they can engage in the operations that they want to. Also, it shifts the risk to the taxpayers because not all those assets may be paid when they are due, or even at all. The bigger problem, in my opinion, is the perception — now held by the market and Congress — that the Fed can be pushed around, which is not what a central bank in a well-run country wants to have. It affects its independence, and ultimately its credibility in conducting monetary policy.

### The Limits of Regulation

**S+B:** Before we discuss monetary policy, what's your view on the Federal Reserve's emerging role as supervisor of the big Wall Street firms — in addition to the commercial banks that they oversee?

**MELTZER:** I am very concerned with the Fed's role in regulating these institutions. The Fed is not equipped to do it; it won't do it well because it doesn't have a history of being a good regulator. It has a hard time understanding the complicated securities that are involved there.

The Fed did a terrible job, for example, of resolving the Latin American debt problem in the 1980s. The Latin American coun-

**“There can’t be a system where the bankers make the profits and the public takes the losses. Sooner or later that system has to change.”**

tries had large bank loans and were paying interest to the banks when the crisis started. When they couldn’t pay, the Fed arranged with the International Monetary Fund [IMF] that the IMF would lend the countries the money, and the money would be paid to the banks to keep the interest payments up to date. As a result, the debt kept getting bigger, the solution receded further into the future, and neither the Fed nor the IMF had any idea about how they were going to end the problem. Finally, in 1987, John Reed, the CEO at Citicorp — the predecessor of Citigroup — decided to write off his institution’s Latin American loans and get back to doing business. And that was the beginning of the end of the problem.

One of the things that gets too little attention is the fact that after 1974, when we had several commercial bank failures here and in Germany, the international regulators got together, and they established the Basel standards for bank capital. The Basel standards, like so much regulation, were written by bureaucrats and lawyers with little thought about the incentives they were creating. It was a familiar circumstance: The lawyers make the

rules, and the markets determine how to circumvent them. In this case the rule said that if a bank took on more risk, it had to put up more reserves. To circumvent that rule, the banks didn’t put the risk on their balance sheets. One way they avoided this was by packaging the loans they made into new types of securities that they could sell to other financial institutions.

We went from a system that was not well regulated, but at least was observed, to a system in which no one knew where the risks were. We still don’t know where all of the risks are. Tomorrow we may learn that somebody somewhere has a portfolio of securities that’s now deeply underwater. It’s not a very good system. It doesn’t speak well for the way in which the regulation was conducted.

That’s why I worry that Congress will overrespond to this crisis and put more regulation on the financial markets than is good for us, so that the markets will move, probably to London. The trading, in particular, will move to London. I think the Sarbanes-Oxley Act certainly was a step in that direction, and that’s a real risk here.

My concern is that instead of

the Fed making its role the protection of the public, it will make its role the protection of the bankers. That is hardly what you think of as the public interest. The agreement to open the discount window to nonbank financial institutions and the expansion of the Fed’s regulatory role both stem from pressure from Congress and Wall Street. It’s hard to see how the Fed can routinely respond to that pressure and still be credible. People on Wall Street and in Congress like it, but the public, ultimately, won’t like it. And it’s not a sustainable system. There can’t be a system where the bankers make the profits and the public takes the losses. Sooner or later that system has to change.

### **Anticipating Big Changes**

**S+B:** You were quoted in an interview several years ago saying that “big changes usually come after there is a crisis or a perceived failure of the old policy that can no longer be denied.”

**MELTZER:** Isn’t it the truth.

**S+B:** Are we at that point now?

**MELTZER:** Absolutely. The question that needs to be asked is, How

do we avoid problems like these in the future? I've indicated what I think should *not* happen — expanding the Fed's regulatory role. Instead, I think there are three steps that would go a long way toward correcting the problems.

The first would be to make sure that all financial institutions are subject to minimum capital requirements and to the Federal Deposit Insurance Corporation Improvement Act [FDICIA], in the same way that commercial banks have been. This has already happened for the big New York investment banks that have changed recently into bank holding companies. Congress enacted FDICIA in 1991 to force the regulators to shut down failing banks before they lose all their capital. These kinds of rules have not been considered necessary for investment banks in the past — partly because, as I said, there haven't been many failures. There probably won't be that many failures going forward either, but capital requirements and the FDICIA procedures will reduce the prospect that there will be. That way, if the capital of one of the remaining investment banks gets to a low enough point relative to assets, we can stop it from paying dividends, get rid of the management, and push the losses on to the shareholders.

The second step is for the Fed to make a clear statement of its policy for dealing with failures. Throughout its history, it has never done that. Sometimes the Fed decides that it has to bail out the bank. Sometimes it decides it can let the bank fail. Sometimes it takes some intermediate step. You could avoid the uncertainty by having a clear and definite rule that is applied to everybody. When Walter Bagehot

wrote *Lombard Street* — his great book on central banking and the lender of last resort function in the 19th century — he didn't criticize the Bank of England for not doing the right thing. He criticized the Bank of England for not announcing in advance what it was going to do. And that's where the Fed has failed. It has never said what it wanted to do.

Both of those changes could be made by legislation, and it would be a big change in the regulation of financial markets.

The third thing we need to do is to change the incentives in the markets, and I think that would be best done by the markets and the companies themselves. These institutions need to change their compensation systems so that individual traders are more at risk, and salaries and bonuses are based on performance over a longer period of time than is the case now — something like basing bonuses on five-year average earnings.

**S+B:** How important is that final change?

**MELTZER:** I think it is essential. You have to ask yourself — as I have asked myself: Here are my students, and students from other quality institutions five or 10 years into their careers, and they are selling pieces of paper that they have to know aren't worth much. Why are they doing that? The answer is that they make a lot of money doing it, and if they don't make the money, they get fired. It's a rare firm — though there are a few — that resists the temptation to control the risky behavior that leads to eventual losses.

We have to remember in thinking about all of these things that the financial markets, for the most

part, lend long and borrow short. So there are always going to be periods, unavoidably, in which expectations change for one of a million different reasons and you find people in a position where it's hard to renew short-term loans to finance long-term debt. But we can reduce those problems by improving the incentives of the people who work in those markets.

## Hindsight and Resilience

**S+B:** Turning to the Fed's conduct of monetary policy, some critics trace the problems we are experiencing back to the 1990s, blaming the Fed for allowing the dot-com bubble to form by keeping monetary policy easy and interest rates too low for too long, and in turn creating the conditions for the housing bubble.

**MELTZER:** I don't like the idea of bubbles, especially applied to the dot-com episode. I know it's a very common view of the episode, but here are two reasons I disagree: First, it didn't affect all stocks. It affected stocks of new companies that were using the new technology. Second, for every buyer there was a seller. So if a buyer was enthused by the prospects of the future, there was a different attitude on the part of the sellers, right? I think a better explanation of what happened in the dot-com period was that people saw a new technology, and at least some people decided that new technology was going to be highly profitable. It turned out it wasn't. Entry was too easy, and the dot-coms were squeezing each other out. It took years for Amazon, which is one of the most successful dot-coms, to ever make a profit. That awareness eventually dawned on people in the market.

What could the Fed have done?

Can you raise the interest rate enough to stop this, or do you just kill the economy in the process? And I guess the Fed's answer, or at least Alan Greenspan's answer, was, "Well, we're not going to kill the economy. We're going to let these people make these mistakes." And as he said at the Jackson Hole conference at one point, "Then we'll mop up the problem that remains."

There are many who criticize Alan Greenspan for not taking more action. I'm a bit less sure that there was much the Fed could have done. People said, "Well, you could have put on margin requirements" to limit borrowing used to buy stocks. First of all, the stock purchases weren't heavily margined. And this is not 1929. There are so many ways that people can borrow to finance stock purchases today. Margin requirements have no chance of stopping that kind of activity.

The Fed has only a very blunt tool for dealing with problems like that. And as far as I'm concerned, there's nothing terrible about letting the people who make mistakes pay for them.

**S+B:** In effect, that's what happened when the dot-coms crashed. Many of

the people who invested in the dot-coms lost a lot of money, but it didn't cause a serious economic downturn.

**MELTZER:** There was a short period in 2001 and 2002 when the economy was slow because people were uncertain about what was going to happen, but that's in the nature of the market economy.

**S+B:** What about the theory that the Fed kept interest rates too low after the dot-com crash, leaving too much money floating around, which migrated naturally into the mortgage market and created the conditions for the mortgage crisis. Is that too simple?

**MELTZER:** I don't know. I really don't know. At the time, you'll remember that the Fed was very concerned about the prospect of deflation. I think they overestimated the risk. I discuss deflation at length in the first volume of my history of the Fed. The U.S. had about six periods of deflation and recession before 1950, and if you look at the data, for five of them the recovery from those recessions is indistinguishable from any other recession. The only bad one was 1929 to 1933. That was a case in which the Fed's policy was deflationary. It was a very particular case. So the Fed's concern about deflation after the dot-com bubble burst was just a policy mistake — one of many.

**S+B:** And the result of that mistake was an overly easy monetary policy that created the conditions for the housing bubble that followed?

**MELTZER:** The Fed kept money growth too high, too long, and interest rates too low, too long. Having said that, it's important to add, as far as I'm concerned, that no one forced the bankers to make bad loans. That was their decision. So while the Fed was certainly a facilitator, the bankers were the ones who made the mistakes.

## Returning to Growth

**S+B:** What is your view of the Fed's monetary policy stance today?

**MELTZER:** I am not comfortable with the Fed's current stance. The economy doesn't seem to be in a recession, and if one does develop, it is not going to be a serious one. I think they were putting too much weight on the possibility of recession and too little weight on the prospect for inflation. I believe that the Fed panicked in January and February of this year, and overestimated the seriousness of what was happening. They talk about inflation, but talk is cheap. Back in the 1970s, Arthur Burns, then the Fed chairman, used to talk a strong anti-inflation game, but helped cause the largest peacetime inflationary episode in U.S. history. I think there's a danger that we're repeating those same mistakes.

In the 1980s and 1990s, under Paul Volcker and Alan Greenspan, the Fed managed to build its credibility and independence. Over the last few years, I fear that [current chairman] Ben Bernanke has thrown it away, and we are back

where we were in the 1970s.

I think the current Fed will make some effort to deal with inflation, but not until after the presidential election. The Fed doesn't like to act before the election, and has done it on only a very few occasions. The crisis atmosphere today makes it even less likely anytime soon.

The question is whether Congress will go along with an increase in interest rates of the magnitude that will be needed to bring inflation down. The inflation rate is currently around 4 or 5 percent, and that means you have to raise short-term interest rates up to 4 or 5 percent from 2 percent, where they are now, to have much of an effect. That's a big move, and it's hard to see it happening.

**S+B:** How much are increases in energy and food prices affecting inflation today?

**MELTZER:** Many economists and popular writers use the term "inflation" to refer to any increase in the price level. Like Milton Friedman, I define inflation as a sustained rate of change in a broad-based index. Food and energy prices, for me, are *relative* price changes. The only products of the Federal Reserve are money and credit. It cannot replace or supply oil or food. All it should do is make its best effort to prevent the oil- and food-price changes from becoming a reason for a sustained increase in the rate of price change. Alas, it has not done that.

**S+B:** You've said that the Fed's greatest mistakes were the Great Depression in the 1930s and the Great Inflation of the 1970s. Do you think what's happening now could be the third?

**MELTZER:** It's possible that they are creating another period of sustained inflation, but I don't think it is a high probability. There is enough concern among some of the Fed's policymakers that I think there will be limits to how expansive the Fed will be.

**S+B:** Given that outlook for monetary policy, and the problems in the housing and financial markets, what do you see happening in the economy over the intermediate term?

**MELTZER:** I think we will see slow growth through next year. The worst of the housing problem will begin to end when we see housing prices settle, or get an idea of where they're expected to settle. Then the economy will begin to recover. We will come out of this, although we will bear the loss of wealth. The great thing about the U.S. economy that you can't escape is its ability to reinvent itself. The mortgage finance situation will be remembered as a serious problem, but not *the* most serious problem. And sometime in 2009 or 2010, we will see a return to growth. +

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