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Twenty Years after the Fall of the Berlin Wall: Rethinking the Role of Money and Markets in the Global Economy*

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ABSTRACT

Many of the hopes arising from the 1989 fall of the Berlin Wall were still unrealized in 2010 and remain so today, especially in monetary policy and financial supervision. The major players that helped bring on the 2008 financial crisis still exist, with rising levels of moral hazard, including Fannie Mae, Freddie Mac, the too-big-to-fail banks, and even AIG. In monetary policy, the Federal Reserve has only just begun to reduce its vastly increased balance sheet, while the European Central Bank has yet to begin. The Dodd-Frank Act of 2010 imposed new conditions on but did not contract the greatly expanded federal safety net and failed to reduce the substantial increase in moral hazard. The larger budget deficits since 2008 were simply decisions to spend at higher levels instead of rational responses to the crisis. Only an increased reliance on market discipline in financial services, avoidance of Federal Reserve market interventions to rescue financial players while doing little or nothing for households and firms, and elimination of the Treasury's backdoor borrowings that conceal the real costs of increasing budget deficits can enable the American public to achieve the meaningful improvements in living standards that were reasonably expected when the Berlin Wall fell.

KEYWORDS: Too Big To Fail; Moral Hazard; Section 13(3); Credit Allocation; Domestic Price Level Stability

JEL CLASSIFICATIONS: E42; E52; E58; E61; E63

My comments focus on the continuing failure of regulations to limit disruptions in financial markets and the concomitant increase in moral hazard, as well as the purely discretionary monetary policy conducted by the Federal Reserve. State-managed intervention in financial markets and a disruptive monetary policy combined to impose large costs on the economy. Yet Congress is likely to reward the Fed with more power and continues to rely on regulatory intervention.[1] Lawmakers and regulators do not follow thoughtful economic advice that focuses on market solutions because it is rarely in their self-interest to do so. Only a citizenry, educated about the values of free markets, private enterprise, and a stable monetary order, can roll back the tide of government intervention by exercising its power at the ballot box.

THEN

The Berlin Wall fell on November 9, 1989. The United States was embroiled in a financial disruption involving commercial banks and savings and loan associations. When it was over, some 1,400 banks and over 1,000 savings and loan associations failed at a then-estimated present value cost of $150 billion dollars to taxpayers. Two pieces of legislation were passed to deal with the problem. The Financial Institutions Reform Recovery and Enforcement Act was enacted in August 1989, followed by the Federal Deposit Insurance Corporation Improvement Act in December 1991.

These statutes were enacted to deal with the worst collapse of financial institutions since the 1930s (at the time). They relied on more regulation, more capital, and more diligent regulators. Yet it was clear that this set of regulations would fare no better than the mountain of regulations already on the books. Loopholes would develop, and regulators would forbear. At the time, those of us who were hopeful about reform thought that the regulators would heed the message from Congress, especially the House of Representatives. The too-big-to-fail doctrine, in which the regulators colluded throughout the 1980s, was declared against public policy by the words of the 1991 statute.

[1] The Dodd–Frank Act of 2010 was adopted in July 2010, approximately three months after Mr. Hoskins delivered these remarks.

Representatives of large banks (lobbyists), however, acting through the regulators and the Treasury Department, managed to have the “systemic risk exception” codified. That exception has been invoked several times now since early 2008. Simultaneously, Senator Christopher Dodd, acting on behalf of lobbyists for the Securities Industry Association, introduced an amendment of Section 13(3) of the Federal Reserve Act that appeared to enable the Fed to make emergency loans to securities firms and other nonbanks, a power that had not been used since 1936. In the next session of Congress, the lobbyists began their multidecade rout of the forces of reform by enacting the Riegle–Neel Act of 1993.

The Founding Fathers of the Republic might have been misguided, but they were persuaded profoundly that a system of checks and balances, including preservation of the capacity of minority forces (which they called “factions”) to push back against excess on the part of other forces, was essential to preserve the forms and processes of a constitutional republic.[2] They clearly did not contemplate that one force or faction always would win all the battles for decades on end. Those who wanted to game the system did, in fact, win all the legislative and regulatory battles from 1992 forward. The outcome of their victories is plain for all to see after 2008.[3]

What, if anything, should those who do not want to be serfs or slaves do about this situation? Classical constitutional theory, which is at odds with utilitarian economic theories of efficiency on this point, says, “Make sure that those who would resist the gamers retain the capacity to push back effectively within the legitimate processes of the system.” It is not necessarily more efficient, and certainly not constitutional, to argue that nothing should stand in the way of those who advocate more and bigger games at public risk or public expense.

For decades before the 2016 election, a large section of the public was asking for a choice other than, “Decide whose boots you want to lick.” At least at the beginning, around 2010, the Tea Parties essentially were saying, “We don’t want to lick bankers’ boots.” The Republican leaders, unfortunately, essentially began to say, “When you lick, we’ll make them taste better.” The Democrat leaders of that day gave lip service to part of the public’s pleas (they enacted the

[2] See, e.g., Madison (1787).
[3] The Dodd–Frank Act of 2010 was a no better than halfway response to the provocations of the 2008 crisis, but even that was too much for most representatives of the banking industry; see, e.g., Todd (2016: chapter 12).

Consumer Financial Protection Board [CFPB]), but they did not really want to turn aside bankers' financial offerings as campaign contributions either (they structured the CFPB so as to leave it vulnerable to constitutional challenge).

The only good news was that government authorities still had the backbone as late as the early 1990s to let large financial institutions fail and to punish their shareholders, counterparties, and creditors. Of course, most of the institutions that failed were relatively small. Three months after the Berlin Wall went down, Drexel Burnham, a large investment bank that served as the lynchpin for the junk bond market, was allowed to fail with the blessings of the Treasury and the Federal Reserve's Board of Governors. At the March 1990 Federal Open Market Committee (FOMC) meeting, Peter Sternlight of the New York Fed (FRBNY) remarked on how smoothly the markets handled the Drexel bankruptcy. Yet too-big-to-fail policy already began for large commercial banks, beginning with Franklin National Bank of New York in 1974 and culminating with the failure of Continental Illinois in 1984. The moral hazard problem associated with bank bailouts became well-known.

Many academics and at least two Federal Reserve Bank presidents argued in the early 1990s for limiting federal deposit insurance and pricing it for the risk of the institution, as well as reducing the rest of the federal safety net, in particular dumping the too-big-to-fail policy. The essence of financial exchange is creditor and counterparty scrutiny—knowing one's customer and bearing the costs and benefits of doing so. Government intervention that shields depositors, creditors, and counterparties from losses weakens the market restraint on inappropriate risk-taking. By the mid-1990s, the federal safety net no longer was reduced; instead, more regulation and more empowered (but more spineless) regulators was the congressional solution. This choice by Congress in the 1990s proved to be a bad one, for in fewer than two decades we arrived at another "worst banking crisis since the 1930s."

When the Berlin Wall fell, central banks were focusing on lower inflation rates and exchange rate stability. At the December 1989 FOMC meeting, the Board's staff presented a model simulation of the cost of reaching zero inflation by 1995 from the then-prevalent 4.5 percent inflation rate. The Committee had not agreed on a target inflation rate, but most members seemed to prefer something between zero and 2 percent.

At the same FOMC meeting, Sam Cross of the FRBNY reported that the German mark (this was in pre-euro days) had soared against the dollar and that there was some speculation in the market that the Fed might intervene. The Fed already had intervened to the tune of $20 billion, and the Treasury, using its Exchange Stabilization Fund and the Fed's warehousing facility, also held that same amount of foreign currency from interventions. This warehousing facility (the Fed lent the Treasury dollars in exchange for its foreign currencies) was simply a way for the Treasury to evade Congressional appropriations. In short, it was and still is a way for the Fed to fund the Treasury directly. While the warehouse is dormant now, it is still on the statute books and could be used again. The Fed's former sterilized interventions in currency markets produced nothing but uncertainty.

During the 1990s the Fed did manage to lower the inflation rate. It did so with no monetary rules or targets, nothing but pure discretion. But the Fed developed a pattern of lowering interest rates at every potential downturn in GDP and every dislocation in financial markets. This practice encouraged investors to take on riskier assets, knowing that the Fed would bail them out with lower interest rates should a problem occur. This practice came to be known as the "Greenspan put," and monetary policy began to produce moral hazard on a grand scale.

NOW

Today[4] we bear the fruits of state-managed intervention and seat-of-the-pants monetary policy. Many of the interventions from the 1930s are still with us—the Federal Housing Administration, Fannie Mae, and Freddie Mac, to name just a few—and they all played a major role in the housing bubble and its collapse in 2008.

Many new housing and mortgage programs were put in place during the recent troubles, and they will probably be around for the next financial disruption. Financial Services committee chairmen

[4] Remarks spoken in April 2010.

Dodd and Frank chose to travel the road of more regulation despite the fact that a mountain of regulation on the books failed to prevent the 1980s savings and loan and banking debacles, as well as the latest meltdown in financial markets. The integrated nature of global financial markets means that our problems quickly can become theirs. Governments around the globe are also going down the regulation road, despite the post-2007 failure of the Basel bank regulatory agreements and their own homegrown regulations.

Meanwhile, government guarantees and insurance programs for financial assets, along with bank bailouts, have produced, arguably, the largest increase in moral hazard in the history of financial markets. The Fed's zero interest rate policy lasted so long (2008–15) that it encouraged excessive risk-taking, certainly riding the yield curve for banks (funding short and lending long). Unless reversed, these policies will plant the seeds for the next bubble.[5] A major consequence of these policies has been a surge in the already troubling problem of growing federal debt. Public debt levels abroad also have increased as a result of these failed policies.

The bailouts by the Federal Reserve doubled its balance sheet (emergency lending) with dubious assets, but also made it more of a development bank than a modern central bank.[6] The bailouts of Bear Stearns and AIG put the Fed in the business of making fiscal policy, a function that belongs to Congress.[7] The Fed's purchase of $1.7 trillion of mortgage-backed securities was pure credit allocation that favored one sector of the economy over another. Will Congress learn that if the Fed can allocate credit for the mortgage market, it also can do so for the municipal securities market or small business loans? Credit allocation also is something that Congress does, usually unsuccessfully, as with Fannie Mae and Freddie Mac before 2008, which were predicted to cost taxpayers upward of $400 billion, ignoring subsequent recoveries, before the housing bust ran its course (Morgenson and Rosner 2011).

[5] It is now (in 2018) generally recognized that an asset pricing bubble did emerge in the aftermath of all the quantitative easing (QE) exercises of the Fed since 2008. Stocks in the Dow Jones Industrial Index were trading in April 2018 at a price-earnings ratio in excess of 25, for example (historically, a range of 8–12 was considered normal).
[6] See, e.g., Mehrling (2010).
[7] See Todd (2018).

The terrible decision to bail out the creditors of Bear Stearns set a precedent that did much damage. Other banks with troubled portfolios did not feel the urgency to clean themselves up. Creditors did not run on troubled institutions because they believed that they would be bailed out. Buyers of other troubled banks expected the Fed to be an investor for $30 billion, as it was with Bear Stearns, and sellers expected to receive $10 a share instead of nothing, the same as Bear's stockholders. This market expectation was not met with the failure of Lehman Brothers in September 2008, which is one very big reason why potential buyers of Lehman walked away.

Monetary policy at the Fed for nearly a decade now [2010] has been to hold short-term rates near zero until the unemployment rate falls. Because unemployment is a lagging indicator, the Fed ran the risks of rising inflation and inflation expectations. Because the Fed essentially operated as an arm of the Treasury, its credibility as an inflation fighter fell into doubt.

Unwinding the balance sheet is going to be tricky because of the mortgage-backed securities that dominate the Fed's balance sheet. As interest rates rise, these long-term assets will fall in value, leaving the Fed with large losses. The Fed needs to sell these assets now before it raises rates, as some in the Fed have argued. A governance issue for the Fed as it anticipates raising interest rates is which body within the Fed makes the decision on changes in excess reserve interest rates. Congress gave the power to the Board of Governors, not the FOMC, which makes monetary policy decisions. These decisions need to be linked (i.e., the same entity, preferably the FOMC, needs to decide on both monetary policy and excess reserve interest rates) if monetary policy is to have any chance of success.[8]

In sum, today we have a greatly expanded federal safety net, a substantial increase in moral hazard, and a surge in federal debt that can be attributed only partially to the recession. A higher inflation rate must seem appealing to many in Washington. Much the same can be said for the majority of our friends abroad. The universal response so far is a call for more regulation, more

[8] The Triparty Reverse Repurchase Agreement (Reverse Repo) facility, begun in 2012, poses a similar issue. All decisions regarding that facility should be made by the FOMC, not the Board alone, as long as the facility is aimed at the conduct of monetary policy and uses resources belonging to the Federal Reserve Banks to do so. One hears from the Board's staff that FRBNY staff tend to dominate Board–Reserve Bank conversations about that facility, with little or no input from the regional reserve banks. Also, the FOMC has been raising the Federal funds rate target by 25 basis points (bp), when it does so, six times since December 2015, lifting the ceiling rate from 0.25 percent (annualized) to the current 1.75 percent.

capital and more far-seeing regulators. The lessons from past banking busts go unlearned. Government managed intervention in financial markets around the world and unpredictable monetary policy continue to encourage inappropriate risk-taking.

TOMORROW

The principled economic position is to have government remove itself from intervening in financial markets and move to some form of a commodity standard for money or perhaps a regime of competitive money supplies. Over time, creditors, counterparties, and depositors would seek out prudent banks with high capital ratios. Weaker banks would adjust or fail. Some institutions might drop limited liability corporate charters and put stockholders at risk for capital calls. Existing clearing houses would provide risk-sharing arrangements and thus would play a much stronger role in supervising the practices of participating banks. There would be no central bank to feed bubbles and busts.[9]

Market disruptions still would occur, but they would be fewer, smaller, and quickly self-correcting. The day the public and politicians are ready to accept such a system is probably some time off—perhaps after the bankruptcy of some major governments.

In the meantime, doing what is politically achievable, guided by the principled economic position, is about our best hope. Start by debunking the notion that only the government can prevent systemic risk. There is no bank that is too big to fail. That idea exists in the minds of regulators and politicians. If the failure of a large, insolvent bank causes runs on solvent institutions, then a lender of last resort lends freely at penalty rates against sound collateral until the run stops.

The second source of systemic risk is related to the effects of a bank failure on the payment system. The fear is that the failure of a large bank could cause failure of other banks connected to

[9] It should be remembered that the United States did not have a central bank but somehow still managed to prosper in the years 1837–1913. Certain monetary policy functions that the Federal Reserve now performs were performed by the Treasury during those years.

the payment system. Participants in clearing houses routinely limit their risk to individual counterparties so that the loss for each bank would be small. Also, risk sharing arrangements are in place in many clearing houses. Congress needs to prohibit regulators from bailing out failed banks, other types of financial institutions, and nonfinancial institutions (or foreign banking systems), be they large or small.

Federal guarantees and deposit insurance need to be scaled back drastically. Mandatory closure rules are needed and should be enforced by bankruptcy judges and not a gaggle of regulators. Federal Reserve emergency lending powers should be removed [Section 13(3)]. This would prevent future bailouts of any company, banking or otherwise, by the Fed. The Fed also needs to have its warehousing relationship with the Treasury closed permanently. It is a nonstatutory arrangement that has been used since the 1960s for foreign exchange holdings of the Treasury, but it could be used for any Treasury asset for as long as this facility exists. All of these arrangements amount to backdoor Treasury borrowing. In the conduct of monetary policy, arrangements that provide backdoor funding for Treasury intervention in financial markets are particularly objectionable.

The Fed’s monetary policy should have a single objective—domestic price level stability. No more chasing after short-term fluctuations in the real economy with a Section 13(3) fire extinguisher or after financial market disruptions with the fire hose of large changes in interest rates.

The Fed’s policy independence should not be unconditional. It should be expected to achieve its monetary policy objective in a defined amount of time and should face a penalty for failure, such as replacing members of the FOMC (preferably those whose policy choices led to or exacerbated the failure).

[*Concluding prescient final paragraph, written in 2010*:] Pushing even the modest reforms proposed here through Congress will prove difficult without an educated public changing the political calculus at the ballot box. In the United States, an already restless public became even more so after 2008 regarding the size of government, the amount of debt (both foreign and domestic) that it is creating, and its intrusions into the private sector, particularly bank bailouts perceived as doing little or nothing to alleviate pressures on households and most firms. The midterm elections of 2010 (the first Tea Party election) offered the first opportunity for the public to send a message to politicians that it was in their self-interest to reduce the role of the state in our lives and in our economic affairs. The failure of the governing elites of both major parties to restrain the intrusive government that they had created led to the election of 2016, when the populist revolt erupted in both parties (Sanders for the Democrats and Trump for the Republicans). Those wishing for a different outcome in 2018 or 2020 need to explain what they propose to do about the factors causing public restlessness already in 2010.

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