INTERVIEW

Allan Meltzer

Allan Meltzer has long been one of the most prominent monetary economists and historians, contributing significantly to our knowledge of how to achieve price stability and economic growth through his academic work, his role as a policy adviser, and his popular writings. In 2004, he published the first volume of his history of the Federal Reserve System, which covered the period from the Fed's founding to its accord with the Treasury Department in 1951. The long-awaited second volume of his history will appear in two parts this autumn.

Since 1957, Meltzer has taught at Carnegie Mellon University (then known as the Carnegie Institute of Technology). He co-founded the Carnegie-Rochester Conference on Political Economy, where scholars from academia, government, and business present papers on important public policy issues, and the Shadow Open Market Committee, which comments upon the policies of the Federal Reserve. He also served as an acting member of the Council of Economic Advisers during the Reagan administration and was chair of the International Financial Institution Advisory Commission, better known as the "Meltzer Commission," during the 1990s. In addition, Meltzer is a visiting scholar at the American Enterprise Institute for Public Policy Research in Washington, D.C.

Meltzer has been quite critical of the Federal Reserve's actions immediately preceding and during the financial crisis. In his view, the failure of the Federal Reserve and other agencies to curb the assumption that some institutions were "too big to fail" played a major role in fueling the crisis. In addition, he believes that many of the Fed's lending programs, initiated since the crisis began, were misguided, threatening the Fed's independence and risking its ability to control inflation over the long run.

Aaron Steelman interviewed Meltzer at his office at Carnegie Mellon on May 7, 2009.

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RF: What's the status of the second volume of your history of the Federal Reserve?

Meltzer: I just completed the last pages of the manuscript. The book will appear in October in two parts. I got a number of comments from readers, but the main comment was that the book is 1,400 pages long and we don't print 1,400-page books. So we ended up dividing it into two volumes: 2.1 and 2.2, which will come out simultaneously.

RF: Chronologically, how far did you go with the second volume?

Meltzer: The second volume goes to 1986. I chose 1986 because it was pretty clear by then that rampant inflation was over and that expected inflation was low. I have some comments about the current episode, but the editor asked me to include those as an epilogue. The most important message of the epilogue is that you won't get rid of crises until you get rid of "too big to fail."

RF: What do you think could reasonably be done to reduce the scope of the federal financial safety net?

Meltzer: How would I get rid of too big to fail? I would have bank reserves rise with the size of the bank. I think it's in the

public interest to say, if you want to be big, you must hold more reserves so that you will be forced to bear a loss if you make a mistake. We cannot continue to have a system where profits are privatized and losses are socialized.

I should point out that much of this is in Walter Bagehot, of course, who was an early rational expectationist. He said that if central banks are going to lend, they should do so at a penalty rate against good collateral and that this policy should be made well-known in advance of a crisis. That system worked for the better part of a century. There were banking problems and failures along the way, but they never spread. The reason was bankers knew they had to hold collateral to protect themselves, and so they did. We have abandoned that system, to our detriment.

RF: In addition to addressing the too big to fail problem, what other current policy issues do you think are particularly important?

Meltzer: There are quite a few. One of the most important ones is to get rid of Fannie Mae and Freddie Mac. The only thing they do is to subsidize mortgages. We should put that subsidy on the budget. That's where it belongs. Having Fannie and Freddie do this encourages corruption and encourages excessive zeal to help particular parts of the housing system.

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I also would make the Federal Deposit Insurance Corporation Improvement Act (FDICIA) applicable to all financial institutions. The purpose was to have structured early intervention — that is, to close down commercial banks before they used all of their capital. Then, the shareholders could be made to bear the losses and the institution could be sold. FDICIA was supposed to do that, but the regulators haven't followed through effectively. They should — and FDICIA should be extended to investment banks as well.

The next one is less of a specific policy proposal and more of a general recommendation. We should pay more attention to the fat tails in the distribution of risk. What are those fat tails? Things like the Russian default, the failure of Long Term Capital Management, the enormous climb in housing prices. Our current models of risk distribution — and how they can affect the economy — don't take adequate account of them.

RF: What do you think of the idea of establishing a systemic risk regulator?

Meltzer: The administration's proposal to make the Fed a super-regulatory body is a mistake for two reasons. The first is the Fed has a poor record of anticipating crises. The second is it would further remove responsibility from the banks. A regulator of last resort would worsen the too big to fail problem.

I believe there are a few relatively straightforward rules of regulation. First, regulation is written by lawyers and bureaucrats, and over time markets learn to circumvent regulation. The Basel Accord is a great example of that. Banks were supposed to hold more capital in order to take on more risk. But, instead, they took those risks off their balance sheets and didn't hold more capital. In that case, both the regulation and the circumvention failed. Regulation Q of the Glass-Steagall Act, which prevented banks from paying interest on demand deposits, is another good example. We wouldn't have money market funds if it weren't for Regulation Q. There are lots of examples of markets circumventing regulation — and not only in banking and finance. The second rule is that regulation can be beneficial when private costs and social costs are not aligned. For instance, there is arguably a good case for regulation of banks if you have deposit insurance — otherwise, banks might take excessive risk knowing that they will not bear the full costs associated with a failure. The third is that if regulations are not circumvented, the reason is because they are either beneficial or they are enforced with Draconian measures.

RF: Looking at the Fed's actions over the past year or so, how well do you think it has done handling the crisis once it was upon us?

Meltzer: In the history of the Federal Reserve System, there are three enormous mistakes, in my opinion. The first one was the Great Depression, of course. The second one was the Great Inflation of the 1970s. And the third one was the failure of Lehman Brothers in September 2008. As I said, in principle, I'm in favor of permitting institutions to fail when they have acted incautiously and are insolvent as a result. But this was a failure that occurred after 30 years of bailing out just about every institution of any size, with no prior announcement that the policy had changed. Suddenly the Fed changed what had been the standard procedure and allowed a big firm to fail. That was a mistake. It created uncertainty in financial markets. And then, of course, the Fed changed course shortly afterward, back to its long-established policy of bailing out institutions.

RF: So would you have recommended allowing Bear Stearns to fail in March 2008? That possibly could have sent a signal to the market that policy had changed and, as a result, the failure of Lehman later in the year

wouldn't have come as such a surprise.

Meltzer: I don't think you change policy in a crisis. That is likely to make things worse. At the same time, I don't think the Fed should have engaged in many of the fiscal actions it has taken. I believe that the Fed has sacrificed its independence. It hasn't always been independent, but Volcker and, to some extent, Greenspan built up independence for the institution. That has been squandered in the current crisis. The Fed has become a financing arm of the Treasury Department. Now that it has alerted Congress that it is willing to go along with just about anything, it is going to have a hard time digging its way out.

RF: Do you think the recent actions of the Fed have reduced its credibility as an inflation fighter and that it will have more difficulty pursuing policies consistent with price stability when the economy rebounds?

Meltzer: Yes. I've had this discussion with members of the Board of Governors and some members of the Fed's staff. They argue that the lending programs have been structured in a way that will permit them to remove liquidity from the system when needed. I have no doubt, as I've told them, about their technical ability to do that. It's the political problem. I just don't see them overcoming the political problem. Where will the political problem come from? Probably Congress and the administration, but also the business community. They're going to say, "The economy is just beginning to recover. And you're going to tighten policy now?" It's not going to be an easy sell.

Consider monetary policy during the 1970s. The people at the Fed were not idiots. They knew what they were doing. They would swear to themselves that they were not going to let inflation get out of line. But then the unemployment rate rose, and all of that went out the window. They expanded the money supply rapidly.

Volcker was finally able to put a stop to it for two reasons. First, by then inflation had become such a problem that everyone knew something had to be done about it; there was considerably more popular and political support for taking a hard line against inflation. Second, he demonstrated enormous courage when the tightening was accompanied by very high and rising unemployment.

In January 1982, when the recession was at its worst point and new construction had basically stopped, Volcker gave a talk to a home builders association. Basically, he told them, "I know you're hurting, but you have to understand, if we don't do this now and finish it, we're going to have to do it again and it will be even harder the next time because we gave up on this one." They gave him a standing ovation, not because they admired his policy but because they admired his courage. He kept raising rates when everyone thought he would not have the will to do so. For instance, I recall Jim Tobin saying that it would take 10 years to get rid of inflation, when in fact it took much less time.

RF: Do you believe that the Fed was too easy for too long following the recession of 2001?

Meltzer: Well that's one where I have some scars. I was a visitor at the Fed in 2003. Alan Greenspan invited me down to talk to him about deflation, which he was quite concerned about at the time. He had read and commented on the first volume of my book and had some questions. I told him that there had been six periods of deflation in Federal Reserve history that didn't hurt anything and one that did, the Great Depression. I told him that I did not think the evidence suggested that deflation — especially a harmful deflation — was likely. For instance, I pointed out that countries that have large budget deficits, active money growth, and the probability of a declining exchange rate are very unlikely to experience deflation. So I was very much opposed to the policy at that point and tried to talk him into adopting a more restrained policy. But I was not able to persuade him. Having said that, let me also say that while I think the blame he gets for that is correct, I think that it's been overdone. He didn't tell the bankers to use that money to buy bad mortgages.

RF: Many commentators — and even some economists — have argued that the financial crisis was the result of a fundamental failure of the market system. What is your opinion of that claim?

Meltzer: I have had several journalists call to ask me about that issue. I think the answer is obviously no. Just look

Allan Meltzer

Present Position

The Allan H. Meltzer University Professor of Political Economy, Carnegie Mellon University

Education

A.B. (1948), Duke University; Ph.D. (1958), University of California at Los Angeles

Selected Publications

Author of *A History of the Federal Reserve: Volume 1* (2004) and *A History of the Federal Reserve: Volumes 2.1* and *2.2* (2009); author or co-author of numerous papers in such journals as the *American Economic Review*, *Journal of Political Economy*, *Quarterly Journal of Economics*, *Journal of Law & Economics*, *Journal of Finance*, and *Journal of Money, Credit and Banking*

Awards and Offices

Co-organizer, Carnegie-Rochester Conference on Political Economy; co-founder and co-chairman, Shadow Open Market Committee; past president, Western Economic Association; Distinguished Fellow, American Economic Association

around. Capitalism has spread from western Europe and North America to the rest of the world. Now, why is that? It's the only system man has come up with that provides both freedom and growth. No other system does as well. All of the other systems are generally someone's idea of utopia. But it's not everyone's idea of utopia. And when people look at the recent crisis and say that the market failed, they are not getting to the right issue. The market didn't fail. What failed were the incentives that we — human beings — created. At the top of that list is too big to fail.

RF: How did you and Karl Brunner come up with the idea of creating the Shadow Open Market Committee and what were your goals for it?

Meltzer: We did that at a time when wage and price controls recently had been adopted. Karl and I organized about a dozen economists to sign a statement that we published in the *Wall Street Journal* saying that the controls were a bad idea and would not work. To get that statement written — this was before fax machines and personal computers — we had to spend hours on the telephone. Any time we had to make a change to accommodate somebody, we had to call the others and tell them what the change was. Obviously that was not a very good way to do things. We decided that we needed to have a meeting.

What was our objective? Karl and I were both disturbed — I knew I was very disturbed — because of the way the problem of inflation was being discussed generally. For instance, there was a lot of talk that we either needed to go back to the gold standard on the one hand or that inflation wasn't really anything to worry about on the other. We didn't think these views represented anything close to the consensus of the good academic work that was being done then. So we put together a group of both business and academic economists, and we tried to inform people and build a constituency for a quite different policy. That's how we started. And we were fortunate in that the *New York Times*, *Washington Post*, and *Wall Street Journal* all gave that first meeting a lot of attention. So we were well-launched. The committee has continued to meet since then — although I left in 1990 — and I think it has enjoyed some success in pushing the debate about inflation in the correct direction.

RF: What was the Meltzer Commission? What was its purpose? And which conclusions did it arrive at?

Meltzer: The Commission got started mainly because in 1998 some members of Congress were not in favor of continued funding of the International Monetary Fund (IMF). They agreed to vote for funding if the president would agree to have a commission to study the effectiveness of the IMF and similar organizations. So that's how it got started. Its official name was the International Financial Institution Advisory Commission but became known as the Meltzer Commission because I chaired it. (I was not, by the way, the first choice to chair it. Originally, I was just supposed to be a member, but a couple of other people could not do it, so I wound up taking it on.) I requested papers on a number of topics and the people who had worked on them would explain to the other Commission members what the relevant issues were. For example, I knew very little about the Bank for International Settlements — what it did or whether it was a good thing. We eventually issued a report with a series of recommendations.

The major recommendation that we made regarding the IMF was that it needed to be more discriminating in allocating funds. If countries adopt good policies, the IMF should consider helping them. If they don't, it should not. Also, the loans that are issued should be issued at a penalty rate. That gives countries a strong incentive to pursue wise policies and avoid the need for IMF assistance in the first place. The banks were a much harder problem because their record of accomplishment is very poor. Many countries that have received significant funding from them have not fared very well. Meanwhile, others that have gotten relatively little funding — such as China — have seen millions of their citizens lifted out of poverty as they have liberalized and adopted more market-oriented policies, something that the World Bank does not do a good job of encouraging.

The report didn't say this, but I think the World Bank should close. What the report said instead is that there should be an independent audit to find out which programs work and which do not. Then it could either improve the ones that don't work or get rid of them. The World Bank is full of people who want to do good things for the poor people of the world. But they don't understand which things will help them and which things won't. They do not generally appreciate that the only system that produces growth and freedom is capitalism. Also, they have no follow-up on their programs. Their whole system is geared to the idea that a program is successful once the final set of funds has been discharged. So if they're building schools in Africa, when the school is built, they declare it a success. But they don't know whether there's a road to connect to the school, how many kids go to the school, or if they are learning anything.

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Recently, there has been interest in pushing for better evaluations of the World Bank and the African Development Bank, and that's a very positive development. So I think we're having some sort of slow, long-term effect on the banks. But I believe they need to move faster in telling countries that if you want to grow, open up to the world market.

RF: During the late 1970s and early 1980s, you did quite a bit of work on public choice questions. In particular, you and Scott Richard published an influential paper in the *Journal of Political Economy* titled "A Rational Theory of the Size of Government." What were the principal arguments of that paper?

Meltzer: I think that paper has probably gotten more attention by other academics than any paper I have ever written, including my work on money, which has been the focus of most of my professional life. The paper says that the principal factor determining the size of government is the distribution of income. In a system of majority rule, the voter with median income — not necessarily median ideological views — is decisive. Voters with income above the median favor lower taxes and less redistribution, while those with income below the median favor higher taxes and more redistribution. There are shocks, both political and economic, that can change the position of the median voter and, as a result, public policy. For instance, the expansion of the right to vote in the late 19th and early 20th centuries greatly increased the number of voters with low income, shifting the decisive voter down the income distribution. This, we argue, was one of the big reasons why taxes and government grew during the 20th century.

Scott Richard and I wrote another paper on how redistribution is actually carried out in the United States. Specifically, we wanted to explain why we have never adopted the negative income tax, despite it being a popular idea with economists and arguably the most efficient way to transfer resources to poor people. The answer we gave is that the decisive voter believes the amount that people work can be increased by giving in-kind benefits rather than cash benefits. If you look at the welfare system, for example, the major cash benefits are issued in the form of unemployment compensation and pensions to senior citizens. In short, those benefits go to people who have worked. But for those who do not work or have not worked, we give food stamps, housing subsidies, and a variety of other transfers — but we don't give cash. And even when we have something that's a modified version of the negative income tax, such as the earned income tax credit, it goes to people who work.

RF: You have served in the government on a couple of occasions. Do you think that policymakers pay much attention to the advice they solicit?

Meltzer: It very much depends on the politician. For example, Nixon didn't care much about economics. He really relied on George Shultz to a considerable extent. As budget director, George got to learn what Nixon's priorities and preferences were and he made a lot of the decisions based on that, without consulting Nixon on specific questions because Nixon simply wasn't interested. Gerry Ford, who I got to know quite well, was entirely different. First of all, he knew the budget inside and out because he had been in Congress. But he also listened to his advisers. He took what they said into consideration and was willing to do what he thought was right, even if it cost him some political support. Reagan was a slightly different case. He may not have known the details of a piece of legislation as well as, say, Ford. But he had strong convictions and if the goals and likely effects of a bill coincided with what he believed, he would get behind it even if it was unpopular. **RF**