

Statement of Professor James K. Galbraith¹ to the Subcommittee on Domestic Monetary Policy and Technology, Committee on Financial Services, U.S. House of Representatives, 2128 Rayburn House Office Building, July 9, 2009, 1:30 PM.

Chairman Watt, Ranking Member Paul, Chairman Frank and Ranking Member Bachus, as an alumnus of this committee's staff it is again a pleasure and a privilege to appear before you.

This hearing is directed at specific questions concerning the functions of the Federal Reserve under the administration's proposals for reform of financial regulation. Let me address those points directly from the beginning:

"To what extent, if any, would the newly proposed role of systemic risk regulator be in conflict... with the Fed's traditional role as the independent authority on monetary policy?"

A Constitutional Question

First, the Federal Reserve is not established as an "independent authority on monetary policy" *per se*. It is an agency created by Congress – a creature of Congress – intended to be independent of the executive branch in all of its functions, just as other regulatory agencies of the progressive era were so intended, including the ICC, the FTC, and many others. There is no intrinsic difference between the independence (from the executive branch) accorded to the Federal Reserve Board on monetary policy and that accorded to it on regulation, except as noted in the next paragraph.

The one significant difference is that the Federal Reserve Board is not the ultimate decision-maker on monetary policy. That body is the Federal Open Market Committee, which is constituted of the seven members of the Board of Governors, and the 12 Presidents of the regional Federal Reserve Banks, of whom five vote at any given time. Though the regional Federal Reserve banks are public agencies, their Presidents report to boards of directors constituted in part from their member banks, which therefore enjoy special access to the formation and conduct of monetary policy.

The constitutionality of this arrangement was challenged by the Chairman of this committee in the 1970s, Henry Reuss. The issue posed in *Reuss v. Bolles* was whether the voting status of the Federal Reserve Bank Presidents on the FOMC violates the appointments clause of the Constitution. Unfortunately neither Reuss, nor later Senator Riegle could establish standing to sue, and ultimately (when Senator Baucus did establish standing) the Supreme Court denied cert in the matter, so the issue was never tested in court. Nevertheless, there is little doubt that

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Reuss was right on the merits. The FOMC is a constitutional anomaly, whose voting members are not all duly constituted “officers of the United States” as the Constitution requires.

Does the role of a systemic risk regulator conflict with the conduct of monetary policy, vested in the FOMC and partly therefore under the influence of the regulated banks? Clearly, in principle, the interests of the member banks could differ from the public interest in system stability. Member bank interests could also come into conflict with those of other financial holding companies, whose representatives do not sit on those boards of directors, but which would come under the purview of this system. This raises the question of a perceived conflict, at the level of institutional design.

It is difficult to say how serious that conflict might be in practice. But perception is an important problem. The fact that systemic risk examiners would be actually be located inside the regional banks (and not at the Board) adds to the difficulty. The credibility of their function will rest on the perceived effectiveness of internal firewalls separating them from the Directors. Given the institutional set-up, many outside observers will never be convinced.

One way forward would be to eliminate the boards of directors of regional Federal Reserve banks – as should have been done anyway long ago. They could be converted, without loss, into broadly-based advisory boards. Another approach would be to remove the voting power of the regional bank presidents on the FOMC, while locating the systemic risk examiners at the Board rather than within the regional banks. Either measure would eliminate the constitutional anomaly, while also resolving the perception of conflict.

Institutional Conflicts

The difficulty with this solution is that, leaving aside the FOMC, the Federal Reserve Board itself has two large conflicts when it comes to serving effectively as a systemic regulator. The first is institutional. The Board’s primary mission is macroeconomic. Rigorous enforcement of safety and soundness regulation is never going to be the first priority of the agency in the run-up to a financial crisis. The issue is whether this problem can be overcome, whether systemic risk regulation can be made a sufficient priority by internal organizational reform.

It would be all too easy for the Federal Reserve Board to open an internal Office of Systemic Risk Assessment, to staff it with mathematical risk modelers, and to let the matter rest there. Then, when the next crisis hits, the Fed would say that it was something “no one could have foreseen” – just because their internal model-builders failed to foresee it. This is probably not the outcome Congress seeks. Nor is it the outcome the administration has in mind.

The Treasury proposal would approach systemic risk regulation in two basic steps. The first is to identify “Tier One Financial Holding Companies,” considered to be so large and interconnected as to endanger the system in the event of failure. The second would be the institution of a regime of examination and regulation, as well as capital and liquidity

requirements, for the practices of those companies, to ensure that they are safely operated and adequately capitalized.

Note that the two steps are separable. One is analytical: it involves identifying the institutions that are “systemically risky.” It might well be appropriate for this task to be under the purview of an office at the Federal Reserve Board, comprised of lawyers, historians, economists, criminologists, statisticians and mathematicians, who would take evidence and referrals from throughout the government – but especially from the regional Federal Reserve Banks – and make determinations as to who is, and who is not, subject to the T1-FHC regime. Since the idea is to identify large institutions, the numbers would not be large and could be handled, in principle, by a small office, applying general criteria established in law.

To avert the development of dangerous practices within large institutions, systemic risk regulation needs to be deeply integrated into ongoing examination and supervision. Essentially, the job is to recognize emerging patterns of dangerous behavior. This function is best taken on by an agency with experience, expertise, and focus on these functions, an agency with no record of regulatory capture or institutional identification with the interests of the regulated sector.

That agency is the FDIC. The FDIC could establish a bureau for T1-FHCs and stock it with the most experienced examiners, accountants, criminologists and statisticians, whose purpose would be to identify dangerous practices in systemically dangerous institutions and to stop them. Their function would not differ greatly from what the FDIC already does, except insofar as the supervised entities are not covered by the deposit insurance. But the point of designating T1-FHCs is to admit that there is taxpayer exposure in the failure of such institutions, so that from a functional point of view this is a distinction without a difference.

In short, if systemic risk is to be subject to consolidated prudential regulation, why not place that responsibility in the hands of an agency for whom it is the first priority? Heading off systemic risks requires a culture of examination, of accounting, and of actual enforcement, including criminal referrals where fraud is suspected. The FDIC and related entities are better suited to the job of examination and regulation, because they specialize in it.

A Problem of Leadership

The second problem with vesting systemic risk regulation at the Federal Reserve concerns the leadership of the Federal Reserve. The Chair of the Federal Reserve Board is a very high-profile appointment, largely chosen over the years from among people who are close to the banking industry and to the financial sector. Where exceptions are made – as in the case of Chairman Bernanke, an academic – it is considered axiomatic, for the effectiveness of monetary policy, that the outsider win the “confidence of the markets.” All of this means that, in a word, Brooksley Born will never be appointed to chair the Federal Reserve Board. And

those who do come to lead at the Federal Reserve, from Benjamin Strong in the 1920s² to Alan Greenspan in the 1990s and 2000s, are very likely sooner or later to be swept away in the euphoria of a financial boom, and to come up with every argument as to why they *should not* effectively regulate systemic risk.

Already in 1955, in his classic *The Great Crash, 1929* my father identified this problem:

“No one can doubt that the American people remain susceptible to the speculative mood – to the conviction that enterprise can be attended by unlimited rewards in which they, individually, were meant to share. A rising market can still bring the reality of riches. This in turn can draw more and more people to participate. The government preventatives and controls are ready. In the hands of a determined government their efficacy cannot be doubted. There are, however, a hundred reasons why a government will determine not to use them.”

In the run-up to the financial collapse of August 2007, it was plain to disinterested observers that there was an unsustainable bubble in housing prices. It was plain to the FBI, as early as late 2004, that behind the then-emerging bubble lay an “epidemic of mortgage fraud.” It should have been plain to regulators, in an industry where terms like “liars’ loans,” “neutron loans” and “toxic waste” were part of the business language, that there was a pervasive problem of reckless irresponsibility and fraud in the financial sector, and particularly in the origination and securitization of home mortgages. Federal Reserve economists wrote about systemic risk, but - -- blinded by the doctrine of efficient markets --- they failed to identify the epidemic of mortgage fraud. Among insiders only Edward Gramlich clearly saw the emerging problem.

Yet one searches vainly for evidence that his or any of the outside warnings were taken seriously at the top. Chairman Greenspan actively encouraged consumers to sign up for the innovative adjustable-rate mortgage products that would, eventually, destroy the system. Right up to July, 2007 in public statements and testimony before Congress, Chairman Bernanke continued to say that problems in the housing sector were manageable, and that the “predominant risk” was inflation. No doubt this emphasis reflected the macroeconomic priorities of the Federal Reserve at the time. Perhaps there was, also, a calculated desire to maintain public confidence. But that is precisely the problem. An effective systemic-risk regulator would not have those conflicting considerations.

My answer to the first question is therefore, “yes.” There are ways in which the macro-economic role of the Federal Reserve could come into perceived or actual conflict with its capacity to regulate systemic risk effectively.

² Strong was not chair of the Board, but Governor of the FRB of New York, and chair of the Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities by Federal Reserve Banks. In this capacity he dominated policy in those years.

Would it be necessary to insulate the Fed's traditional independence in executing monetary policy from its new role as systemic risk regulator, and if so, how could that be accomplished?

I find this question difficult to understand. The Federal Reserve should not of course *ever* conduct monetary policy in ways that undermine systemic stability and sustainability. Unfortunately on occasion it has done so. The Fed's failure to use the regulatory tools it has – including margin requirements in the 1990s information technology boom and the bully pulpit as well as its examination authority in the housing bubble of the past few years, are precisely failures to take account of systemic risk in the work of monetary policy.

If the Federal Reserve is to have control of systemic risk regulation, then the goal of institutional design should be to give that regulation priority, and to ensure that it is integrated into, and not separated from, the execution of monetary policy. For the reasons given earlier in this testimony, this is intrinsically very difficult goal to achieve. It would be better, therefore, to vest the regulation of systemic risk in an agency that is focused on that objective.

What are public policy considerations for and against making the Fed the systemic risk regulator, given its role as central banker and independent authority on monetary policy?

There is an argument in favor of consolidating systemic risk regulation into the Federal Reserve's existing role as lender of last resort. The lender of last resort function is there to keep the financial system from collapsing in panic when systemic regulation fails. It may make sense for the same agency to be charged with both establishing the fire code and dispatching the fire trucks. But – to make my earlier point once again – it is clear that such an agency should not be, in any way, under the influence of the arsonists. The Federal Reserve's institutional structure and political history raise doubts about its independence in this respect.

A principal public policy consideration is the actual track record of the agency in predicting and averting systemic risk. By any standard, the record of the Federal Reserve in this area, from Greenspan's "New Paradigm" in advance of the 2000 technology crash to Bernanke's "predominant risk of inflation" in advance of the Great Crisis, is poor. (As I documented in a review of Bob Woodward's book on Greenspan in 2001³, the Fed's leadership was also poor in slumps, always fearing inflation when none actually threatened, dragging its heels in providing support for the economy when that would have been most useful, and anticipating recoveries long before they occurred.) It does not seem reasonable to add an additional task to the burdens of an agency that has difficulty, even in relatively ordinary times, in handling the macroeconomic role of central banker and "independent authority on monetary policy."

³ "Watching Greenspan Grow: Justin Martin, Greenspan: The Man Behind Money, and Bob Woodward, Maestro: Alan Greenspan and the American Boom," The American Prospect, Vol. 12, No. 2, January 29, 2001, pp. 36-38.

The final question is whether the Fed “should relinquish any roles and why”?

The administration proposes to remove the role of consumer protection from the Federal Reserve, and to give that function to a new Consumer Financial Product Commission. In line with the view that important regulatory functions should go to entities that specialize in those functions, I’m inclined to support this proposal. Everything depends, of course, on powers, staffing, leadership and implementation.

More broadly, the administration’s proposal sets out to restore the shadow banking system and all the various securities markets that have arisen in the past fifteen years or so, including credit default swaps. The underlying presumption is that these markets serve public purpose, that they can be restored, and that they should, in fact, be restored.

The presumption is not correct. The sub-prime and alt-a mortgages that caused the crisis could never have been securitized had there not been a systematic failure of the credit rating agencies to examine the documentation behind the loans, and a reliance instead on statistical models in giving out ratings. Now the ratings agencies have lost credibility entirely. It is by no means clear that these markets can now be restored, because trust in the underlying documentation cannot be conjured out of thin air. It would be necessary to establish, credibly, that the residential mortgage backed securities held by the banking system are not hopelessly contaminated by misrepresentation, missing documentation, imperfect assignments of title, and fraud. Yet the evidence that we have, so far, leads prudent observers in the opposite direction.⁴

Similarly, the market in over-the-counter credit default swaps is less than a decade old, having been legalized only in 2000. These instruments are intrinsically dangerous; Warren Buffett’s characterization as “weapons of financial mass destruction” is apt. Why tolerate their existence? Humanity got along quite well for thousands of years without them.

Would the country be worse off with a smaller, simpler financial system, largely operating out of institutions called banks and thrifts, themselves reorganized, downsized, broken up, more competitive and less profitable than the financial sector has been in recent years? I can see no reason to permit the continued existence, let alone to foster the market dominance, of financial institutions so large as to be unmanageable by their own top leadership, let alone efficiently regulated by public authority. Edward Liddy, CEO of AIG, has written that he realized quite early on that the firm was “too complex, too unwieldy and too opaque” to manage as a going concern. In general, “too big to fail” is a synonym for “too big to manage” and “too big to regulate.” Such institutions exist, in part, to help with international tax evasion, to evade

⁴ For months, Congressman Doggett has been pressing the Treasury department to conduct an evaluation of the quality of the documentation behind the mortgage-backed securities held by the banking system. Despite a promise in March to do so, Secretary Geithner has not responded to Congressman Doggett’s request.

regulations, to project political power, to facilitate the kind of “financial innovation” that is the essence of systemic risk.. They are intrinsically unsafe. An appropriate goal of public policy would be to shrink them, permitting other institutions of more reasonable size, more conservative practice and greater alignment with public purpose to grow into their market space.

Unlike scientific knowledge, in this case the genie *can* be put back into the bottle. If a contract is declared unenforceable, it generally will not be made. If institutions like hedge and private equity funds are to be considered as posing systemic risks similar to banks, they can be declared to be banks, and regulated as such. Money market mutual funds, which are now subject to insurance, can be reconstituted and regulated as narrow banks, as I believe Chairman Volcker has advocated. The problem of regulation will be simplified, if we recognize that the crisis presents an opportunity to simplify, restructure and downsize the entire structure financial system. Then some of the complex tasks envisioned for the regulatory agencies in the Obama plan would become much easier. Having given the task of regulating systematically-dangerous institutions to the FDIC, one medium-term goal of regulatory policy would be, in as many cases as possible, to alter those institutions, so that after five years or so they can be declared no-longer-dangerous, and removed from the T1-FHC list.

Moreover, there is precedent for reorganization of this kind. An exotic but very clear example is the reorganization of airlines in China. In that country, as travelers from the old days may recall, there used to be a single, national airline, which was an inefficient, obsolete and dangerous state monopoly. The response of the government was not to privatize the monopoly, but to break up the company, and to allow other parts of the government, at the provincial and municipality level, to form their own competing airlines. The result was a riot of competition, a huge increase in efficiency, and improvement in service quality as travelers in modern China observe every day. There is nothing uniquely Chinese about this: as it happens the idea originated in the early 1980s with an American physicist, John Archibald Wheeler, and was relayed to the Chinese government by a Chinese physicist then working in the United States.

Competition generally improves efficiency, lowers profitability due to market power, and can reduce the rent-seeking, lobby-driven politics associated with the relationship between industry and government. If large banks and other large financial holding companies pose systemic risks, then why not require them to shrink, to divest, and otherwise reduce the concentration of power that presently exists in the financial sector? I do not argue that this would be, by itself, sufficient to control all systemic risks. But it would help, over time, bring the scale of financial activity into line with the capacity of supervisory authorities to regulate it, and the result would be a somewhat safer system.

Thank you for your time and attention.