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Economics Group

WELLS FARGO SECURITIES

Special Commentary

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Comments Before Federal Reserve Advisory Panel[1]

I wish to thank Professor Kaufman for the opportunity to speak at this conference and with the chance to catch-up with some long-time friends.

In line with this conferences theme, I will highlight some of the ways that the rules have changed but, even more so and with great disappointment, how much the underlying economic and political forces have not changed.

First, in contrast to the views expressed by a previous speaker I see no reason why stress tests and risk simulations cannot account for the boom/bust cycles of the economy and the financial systems. Moreover, both economic and financial cycles can be and are integrated in a Bayesian Vector-Auto regression model which, in fact, we do work with at Wells Fargo. This approach to stress testing is far superior to the common approach of merely changing one input, often the federal funds rate or the unemployment rate, and then producing a scenario that represents a "valuable" test to a financial institution. Such one-variable tests are unrealistic as we know very well that the real world will often experience several economic series changes moving at the same time. For example, a (lower/higher) federal funds rate is accompanied by changes in inflation, growth, exchange rates as well.

Second, one factor in the economy that has not changed is the underlying social/political bias in public policy towards housing that has been part of our society for most of the post-WWII era. America's overinvestment in housing has been a chronic complaint with this overinvestment being assisted from federal and state tax laws, bank regulatory policy and credit/interest rate subsidies. This has not changed in recent years and, in fact, has continued this year with the increase in Federal Housing Authority (FHA) in recent months at below market rates/very low down payment requirements even as delinquency rates rise on these same FHA loans.

Third, we have witnessed change in the short-run but without resolution in the long-run of the Fed's role as policeman in the credit markets. Increased liquidity at the short-end of the yield curve has brought down Libor and TED spreads but are these short rates too low given that current yields are below that of the often-criticized pre-Lehman period? What about long-term rates? Currently, the Fed has indicated that they will reduce their support for Treasuries by the end of October and will gradually withdraw support for mortgage-backed and asset-backed securities by March of next year. Will the Fed's involvement in these markets really diminish in the face of relatively high unemployment and a likely upward move for interest rates in general?

Fourth, the zero interest rate policy at the Fed has already signaled a change in global financing as increasingly the U.S. finds itself as the source of borrowing in a global carry trade with lending and investing abroad. Moreover, this zero interest rate policy returns policy to the pre-1951 Treasury accord period and brings into question whether such a policy is consistent with an

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[1] **Comments made before the Twelfth Annual International Banking Conference, Federal Reserve Bank of Chicago, September 25, 2009.**

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independent central bank? At this time in the business cycle, Federal Reserve intervention has created a set of below-market interest rates in many financial instruments. These rates are likely to move up as the Federal Reserve exits. Therefore, it is very difficult to know if financial markets have indeed better accounted for risk in setting interest rates.

Fifth, the massive intervention and support for the housing market has brought into question whether public policy has really moved away from the over allocation of capital to housing. Almost ten years ago Wayne Abernathy, Linda Lord and I wrote the new legislation replacing the Humphrey –Hawkins language with new language on monetary policy and there was no special place for housing or consumer credit as a goal. Yet, the focus of policy today appears to place too strong an orientation to supporting these markets.

Sixth, as outlined by Charles Calomaris in his paper, there appears to be little change in the policy environment that gave rise to the subprime crisis as outlined in an earlier paper at this conference. As stated in that paper, "the risk-taking mistakes of financial managers were not the result of random mass insanity; rather, they reflected a policy environment that strongly encouraged financial managers to underestimate risk in the subprime mortgage market." In that paper Professor Calomaris cites the lending subsidies and policies that promote risky mortgages and yet such policies continue today.

Seventh, as outlined by Professor Goodhart, greater regulation of banking in America will generate several side effects which will include a movement of bank capital offshore, an increase in shadow banking and a move of trading operations in commodities and foreign exchange abroad. Limits on compensation for energy traders in New York, for example, will provide incentives to move such trading operations abroad.

Eight, American experience does support the view that regulation does crowd out good due diligence by the consumer as Professor Goodhart also mentioned in his presentation. Recent increases in the maximum coverage of deposit insurance has discouraged consumer vigilance and runs counter to the lessons of the savings and loan credit crunch as well as a long history of economic research. In addition, advocates of market discipline had historically called upon the use of subordinated bank debt as a discipline on risk-taking but that approach too has been forgotten. Instead, we have witnessed increasingly complex consumer regulations and the proliferation of complex, fine-print, disclosure documents on credit cards and mortgages that are seldom read by consumers. We can recall our own experience in recent years as we frequently just discard without reading the many privacy disclosure statements we receive.

Ninth, one comment at this conference reflected, at least to me, a significant change in attitude about the incentives associated with regulation. The commentator asserted that regulatory competition produces the worst result. In contrast, the belief had been that regulatory competition would avoid the worst tendencies of governments to over regulate. These same attitudes are reflected in many countries today with respect to the tax harmonization debate.

Ten, another change in attitude that has crept into our economics profession is the willingness to use "force" to get a result. This came up earlier in the discussion on international bank charters where banks that did not wish to have such a charter would be "forced" to accept such a charter and its attendant rules. For a profession that prides itself on "choice" such force suggests to me that the problem lies in the design of the charter and not in the willingness of banks not to join. Unfortunately, there has also been too much discussion about "force" in many of the political leadership in the past year.

Eleven, Vince Reinhart raised an important point stated by others as well, that the length and character of the protracted aftermath of a financial crisis reflects two separate forces; first, those forces associated with the crisis itself and, second, forces due to the policy response to that crisis. In this regard it is too early to know the strength and shape (L, U, W) of the economic recovery until the exit and regulatory policies of the federal government are defined.

Twelve, Allan Meltzer commented that the underlying changes in society's incentives and voting patterns have increased the challenge to democracy and independence of the Federal Reserve. The philosophy of "no taxation without representation" has become replaced with "representation

without taxation." Therefore, there is huge bias to federal spending and thereby political pressures to use the central bank to finance that spending.

Finally, the challenge we face in our society is not "too big to fail" but the inability politically to close the "too big to fail." These institutions/companies have already failed. We just have not the decency to bury them. Instead, such institutions persist to reallocate resources in our society to allocate capital to politically favored constituencies. This has not changed in response to the crisis and therefore suggests more future crises in the same places.

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