Testimony of Allan H. Meltzer,

The Allan H. Meltzer University Professor of Political Economy,

Carnegie Mellon University,

Before the Congressional Oversight Panel

Washington, D.C.

March 4, 2011

The invitation to this hearing like most discussion of the TARP program asks whether TARP succeeded in preventing major financial failures. My answer is, Yes. TARP avoided a potential financial disaster.

My concern is with the question. Congress should not start with the crisis that followed Lehman Brothers failure. Instead it must ask and demand answers to two other questions. Why was it necessary to issue about $1 trillion of public money to prevent financial collapse? What, if anything, has been done to reduce to insignificance the prospect that another TARP will follow at some unknown time in the future.

Like many other bad decisions, the use of public funds to prevent failures began small. In the 1970s, the Federal Reserve began the policy that became too-big-to-fail (TBTF) by preventing the failure of First Pennsylvania Bank. That was followed by other bailouts. Soon bankers and financial firms recognized that becoming large was a way to reduce risk. Some recognized that they could take more risk. This is known as moral hazard.

The process works like this: Bankers and Treasury or Federal Reserve staff warn the principal policymakers that permitting the failure invites a domestic or world financial crisis. I have never found any way of overcoming that warning when the crisis occurs or seems imminent. It did not help to point out that on the few occasions when there was no bailout, financial failure occurred, but no crisis followed.

One example is the failure of the Penn Central Railroad in June 1970. Penn Central was a major issuer of commercial paper. The commercial paper market closed to most issuers. Federal Reserve Chairman Arthur Burns was anxious to protect the commercial paper market by bailing out Penn Central. Budget director George Shultz opposed. President Nixon made the mistake of appointing an outside counsel from his old law firm. Congressional leaders, led by Congressman Wright Patman, viewed that as an effort to assist the Republican party. That ended the bailout. The taxpayers were lucky that time.

The commercial paper market declined, but borrowers got accommodation at banks. No crisis occurred. After a few months, the commercial paper market revived.

Drexel Burnham Lambert, the major issuer of non-investment grade debt became bankrupt. No bailout and no crisis. Other financial firms took over the business that Drexel had done.

The main reason that policymakers resort to TBTF in ever larger amounts is regulatory failure. Regulators do not require financial firms to hold enough capital. In the 1920s large banks held capital equal to 15 to 20% of their assets. Many small banks, but no large banks failed. Even in the early years of the Great Depression, very few large banks failed. Stockholders, not the general public, bore the losses that occurred. That is as it should be.

After the recent crisis, Congress passed the Dodd-Frank bill. Dodd-Frank did nothing to increase capital requirements. The international regulators at Basel did better, but did not increase capital enough. Further, Dodd-Frank put the Secretary of the Treasury at the head of a committee to decide on TBTF. That decision embeds two errors in the law. First, the time to prevent bailouts is not when the crisis occurs. It has to be established policy, not a judgment made when failure threatens. We profess to believe in the rule of law. We need a law that embeds a rule and a policy that applies it. Second, the Secretary of the Treasury is very often the person who favors TBTF. Nothing in Dodd-Frank changes his incentives. It continues bailouts.

I will repeat the proposal I have made in several previous hearings. After some minimum size to protect community banks, Congress should require banks to increase capital relative to their assets as asset size increases. For example, if a bank increases assets by 10 percent, capital must increase by more than 10 percent.

This proposal has three major benefits. First, stockholders and managers bear the losses, not taxpayers and the public. Second, the rule encourages prudence and eliminates the imprudent by replacing owners of failed banks. Third, Congress can eliminate many of the regulations included in Dodd-Frank. Regulation will not strengthen financial institutions. More capital will.

In the most recent crisis, Bear Stearns was the first big failure, instead of letting it fail, the Federal Reserve took some of the worst assets onto its balance sheet, shifting many losses to the public. The market read the decision as a sign that TBTF remained the policy. They got a big shock when, without much warning, Lehman Bros. was allowed to fail. This sudden policy change without warning in the midst of a recession created massive uncertainty. I believe Secretary Paulson and Chairman Bernanke were wrong to change policy without warning. But I praise the prompt response called TARP that provided liquidity to all parts of the market. After making a huge error, TARP avoided compounding it.

Notice however what has happened. Chairman Bernanke told us that the TARP funds were short-term. They would run off in due course thereby shrinking the Federal Reserve balance sheet. But instead of shrinking the Fed bought mortgages more than offsetting the original TARP funds. Again, chairman Bernanke told us that the mortgages would start to be repaid, so the balance sheet would shrink. Again, that didn't happen. QE 2 purchase more than offset the reduction in mortgages.

I do not believe the Federal Reserve has a credible strategy to reduce its balance sheet. We face the prospect of high inflation, not immediately but in the next few years. The best estimates we have imply that it takes as much as two years from the time the Fed starts to slow money growth until inflation falls.

Three last remarks. First, how can Congress justify a system that makes the public pay for bankers' mistakes? Second, remember that capitalism without failure is like religion without sin. It doesn't work. Third, Congress should demand a detailed statement of how the Fed plans to prevent inflation including an estimate of how high market interest rates will have to rise.