

THE FED'S FATAL CONCEIT

John A. Allison

I strongly believe that the recent financial crisis, ensuing recession, and slow recovery were primarily caused by government policy. The Federal Reserve made some very bad monetary decisions that created a bubble, i.e., a massive malinvestment. The bubble ended up being focused in the housing market largely because of government affordable housing policies—specifically, the actions of Freddie Mac and Fannie Mae, government-sponsored enterprises that would not exist in a free market. When Freddie and Fannie failed, they owed \$5.5 trillion including \$2 trillion in affordable housing (subprime) loans. It's true that a number of banks made serious mistakes, and I would have let them fail, but their mistakes were secondary and within the context of government policy.

I've known many people in the Federal Reserve, in monetary policy. They are very smart people. They are highly committed people. However, in my experience, they are guilty of what F. A. Hayek (1989) called “the fatal conceit”—that is, the belief that smart people can do the impossible. I don't care how smart you are or how great your mathematical models are, you cannot coordinate the economic activity of seven billion people on this planet.

The real issue is: What does government policy incentivize real-world human beings to do? I'm going to share with you my own experiences in that regard and also my insights into the actions of other financial company CEOs.

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The Federal Reserve: A Banker's Perspective

As a banker, I see the Fed as having three primary roles: (1) to control the payments system, (2) act as the number-one regulator, and, of course, (3) conduct monetary policy.

The Payments System

There is no private payments system in the United States. The payments system is controlled by the Fed and, ultimately, the so-called “shadow banking” system has to get back to the payments system. Troubles in the monetary economy, by definition, are caused by the Federal Reserve.

The Fed controls the clearing mechanism for the banks in the United States. The reason it does so is because the Fed subsidizes the banking business, especially small banks and nonbanks, who are inefficient providers. This arrangement has slowed technological advances in the banking industry because the big banks have to wait for the little banks and the nonbanks to be able to implement new technology. Furthermore, it has caused a lot of quality control problems because many nonbanks get a free ride into the payments system. Typically, privacy issues aren't created by banks—they are created by nonbanks using the Fed's operating system. It's a perfect analogy with the post office. You can compare the post office to FedEx and UPS. In fact, if you think the post office is a good thing, you ought to feel really good about the Fed controlling the clearing mechanism. The good news is that the post office is going to go out of business because of e-mail, and the Fed clearing system is going to basically go away largely because of electronic transactions.

Regulation

Regulation is a huge subject. It is also related to monetary policy and sometimes people disconnect the two and forget about the impact of the regulatory role on the Fed's effectiveness. First, the foundation for regulation in the banking industry is FDIC insurance. FDIC insurance is used as the excuse to justify many regulations because the banks are being “protected by the federal government.” In my opinion, FDIC insurance is the third contributor to the recent financial crisis, after Fed monetary policy and government affordable housing policy. FDIC insurance destroys market discipline in the banking system. Golden West, Washington Mutual, Indy Mac,

Country Wide, and other large financial institutions that failed, all financed their lending business using FDIC insured deposits. They absolutely could not have done that in the private market. And it became a vicious cycle: as Freddie and Fannie drove down the lending standards in the subprime business, these other private competitors had to be more aggressive, because they had to leverage their high-risk loan portfolio to pay for their high-cost certificates of deposit.

Bert Ely (1994) developed a private insurance model that absolutely would have worked. I believe if that model had been in place, the financial crisis would have been dramatically less than it was. The model was not implemented because of lobbying by large NYC banks and also community banks. If you ran the numbers that Ely was looking at, several of the large banks needed at least double and probably triple their capital or they weren't going to get into the private insurance pool. The Federal Reserve was allowing Citi, et al, to operate with very insufficient capital. Under private insurance standards, Citi, et al, would have significantly increased their capital and would not have failed.

Regulations contributed to the bubble and subprime market in a number of ways. "Fair lending" was supposed to eliminate racial discrimination in the banking business. I joined BB&T in 1971, and by that time there was no racial discrimination because every bank was trying to make money and you wanted to make all the good loans you could make. However, shortly before Bill Clinton got elected in 1992, the Federal Reserve of Boston did a research study that concluded there was a lot of racial discrimination in mortgage lending (Munnell et al. 1992) Turns out the study has been totally discredited (see, e.g., Liebowitz 1993, Zandi 1993). I call it a "childish study"—it only looked at debt to income ratios and didn't consider the reliability of the income, collateral, past payment history, or character type issues. No mature banker would have made a loan based on the meager standards used in the Boston Fed study.

Of course, now the Fed itself has discredited the study. But when Clinton got elected, he was absolutely convinced there was racial discrimination. He had a huge political debt to the African American community that got him elected, and he was really energized about this—both for ethical and political reasons. So basically a dictate came out, and the theory was that the banking examiners had missed the racial discrimination: let's go find banks guilty. And they did that.

I spoke to a number of CEOs who were found “guilty,” and they all said, “No, we didn’t engage in racial discrimination; however, it was easier just to pay the small fine, change processes, and then put out a press release that we were guilty of discrimination—and that made the politicians/regulators happy.”

Well, the regulators came to BB&T and we didn’t operate that way. They came to me and said we were guilty of racial discrimination, and I said, “Well, if that’s so, that’s against our fundamental ethics. Give me the names of the people who are discriminating. I’m going to go fire them now; I’ll do it personally.” They said, “No, nobody discriminated.” “Okay,” I said, “How about a system? Do we have a system or process that caused discrimination?” They said, “No, it just happened (magically?).” So I said, “Okay, let’s see your evidence.” We looked at the evidence and basically found that every loan we made, we should have made, and every loan we turned down, we should have turned down. There was no racial discrimination. Nevertheless, we were still advised to go ahead and admit guilt, because if we admitted it, we would simply pay a small fine and move on. We said, “No,” over principle, and the regulators stopped our mergers and acquisitions for months; we had several in process that never materialized. We were ready to go to court, and then a very interesting thing happened that will tell you a lot about the rule of law. The Republicans got elected to control Congress in a negative response to Clinton’s policies. Guess what the regulators did? The Republicans were elected on Tuesday, and on Thursday the regulators all went home and we never heard from them again. Fair Lending evolved into “forced” lending to low-income minorities.

Another big factor, psychologically, was the Community Reinvestment Act (CRA). This law was supposed to eliminate “redlining” and also forced banks to get into the low-income home lending business—a business we were not designed to be in. Additionally, CRA was a moral crusade; bankers were ethically supposed to do low-income lending. Now I know there’s a lot of greed on Wall Street but when you combine “this is the right thing to do” and “you can make a bunch of money doing it,” you create a huge incentive.

One of the myths out there was that the banking industry was deregulated during the Bush administration. Nothing could be further from the truth. We were grossly *misregulated*. There were three major regulatory programs during the Bush administration. The first

was the Privacy Act, where we send hundreds of millions of notices to our clients about privacy that no one reads and that was a complete waste of time. The second was Sarbanes-Oxley, which was a redundant system, another tremendous waste of time. And then there was the Patriot Act, which was supposed to catch terrorists. I've talked to many people in government and they all do this dancing act, but the fact is there has never been a single terrorist caught and convicted because of the Patriot Act. The Act cost the banking industry more than \$5 billion annually, and I would argue that no one is going to be caught. If you are dumb enough to get caught under the Patriot Act, you are going to get caught anyway. The only significant conviction of the Patriot Act was Eliot Spitzer, the governor of New York, who was convicted of soliciting prostitutes under a law designed to catch terrorists. You should worry about your civil liberties.

The intense focus from the regulators—particularly on Sarbanes-Oxley and the Patriot Act—dramatically misdirected risk management focus in the financial industry. Regulators were threatening to put CEOs in jail and levy large fines on board members, which impacted our behavior radically, and made us put a lot less focus on traditional risk management. I guarantee this happened across the whole industry. The industry was not deregulated, it was massively misregulated.

The cost of regulation is huge. In fact, if you asked me if I would rather eliminate taxes on banks or regulations on banks, it's a no brainer—regulations. BB&T alone has added nearly 1,000 people in the past year to handle regulatory matters. And, of course, what we've done is to reduce production, because we couldn't afford to hire 1,000 people so we shifted people from production into regulation. Moreover, the mental price is high. You can only do so many things and if you are trying to make some regulatory person happy, instead of being productive, creative, and innovative, you become less of a creative and productive person.

With regard to “safety and soundness” regulations, I do not know of a single case where the regulators identified a significant financial problem before the market knew. Now, I know they've gotten involved a lot of times, and when they've gotten involved, they've consistently made the problem worse, not better. I don't view the regulators as actually stopping problems from happening. And why is that? Those who have studied Public Choice theory know that in good times regulators always *underregulate*.

For example, BB&T took over a failed financial institution called Colonial, and we only did it because we had an FDIC guarantee on the credit risk. We had been following Colonial for 15 years. BB&T did a lot of mergers and acquisitions and Colonial fit in our acquisition model. We consciously chose not to buy the company without government assistance. Why was that? First, they were rolling up lots of small weak banks in Florida, and if you roll up a lot of small weak banks, you end up with a big weak bank. Second, they were making many large high-risk real estate loans. Third, we met the CEO, and the CEO was very arrogant. He had an airplane that could probably hold 30 people and he would fly alone from Mobile to Birmingham. We looked at this company, and we said, "These guys are going broke someday. We are not going to buy them." The examiners didn't identify this problem. Why not? First, probably the examiners didn't join the agency until 1995; they had never seen bad times. They didn't understand the business. If they had, what would they have done? Probably nothing. Why is that? This CEO had huge political clout: he was connected to the governor and senators. If the regulators had started problems, he would have gone to the politicians and they would have brought heat on the agency. Why take that chance? So we can look for underregulation in the good times. What about in the bad times?

When things turn negative, regulators typically *overregulate*. This has happened every time we've had a correction in my career: it happened in the early 1980s; it happened in spades in the early 1990s; and it's the worst this time. The regulators inevitably tighten lending standards, including for financial institutions that have good credit histories. They did that at BB&T, tightening our lending standards dramatically. Today BB&T doesn't make loans that we would have made if it were not for the regulatory process, and we put people out of business that we would not have put out of business if it was not for the regulatory process. So on one hand the Federal Reserve is printing money like crazy trying to boost the economy, and on the other hand the banking regulators have tightened up like crazy. Why is that?

If you're a local regulator you don't care what the people in Washington say—the only way you can get in trouble is if your bank gets in trouble. It's a one-sided bet. It's classic Public Choice theory. This time was worse because the leadership of the FDIC was worse, and the attack on community banking from the FDIC was worse

than in the early 1980s and early 1990s. I do not think regulatory behavior will change.

Monetary Policy

Over the years I've taken the opportunity to talk to a number of members of the Federal Reserve that are on the Open Market Committee. They're all smart, good human beings, and well-intended. I've talked to Alan Greenspan several times on this issue over the years. I asked them a basic question: "Do you believe in price controls? Do you think the government, for example, can set the proper price for automobiles?" To a person—and with a lot of energy—they said, "Absolutely not, price controls never work—they are destructive." And then I've asked a follow-up question: "When the Federal Reserve sets interest rates isn't that really a price control? Isn't the interest rate perhaps the most important price in the economy?" And not one of them has given me a credible answer. Price controls don't work. The Federal Reserve's attempt to control the price of money does not work. It is hubris to think it does.

The incentives the Fed created by keeping interest rates too low for too long led to the recent financial crisis. It started with Alan Greenspan in the early 2000s. He was the maestro, the hero, and did not want to have bad times on the way out the door. So he created *negative* real interest rates. What that meant is that you could borrow money at less than the inflation rate. That was a big deal in the residential real estate market because residential real estate prices were appreciating very rapidly. There was a huge incentive to expand residential construction and push home sales. Near the end of his term Greenspan started finally raising interest rates, and then Bernanke followed. In a two-year period they raised the Fed funds rate 425 percent. The rate rise was unexpected because Greenspan had been telling the world that the big problem was excessive savings, and that we're going to have deflation. Banks therefore did not expect interest rates to go up and had large losses in their bond portfolios when that happened.

In that process, Bernanke did something incredibly destructive. He inverted the yield curve. Banks make money by borrowing short and lending long. When the yield curve is inverted, short-term rates are higher than long-term rates. Banks margins went negative. Not a great time to be in the banking business when you've already taken

losses in your bond portfolios. What did banks do? We're in a funny kind of business: you can make higher returns by taking more risks. Banks went out on the risk spectrum and most of the bad loans were made in this last part of the cycle under the inverted yield curve. By the way, this was one of the longest inversions in history—it was over a year.

Markets *never* invert yield curves. So this was a government policy inversion of yield curves. At the same time Bernanke and the economists at the Federal Reserve were adamant we were not going to have a recession. They didn't predict the recession until after it already happened. Academics talk about perfect information and acting in the long term. Well, in the real world you don't have perfect information and you have to stay in business in the short term to get to the long term, so banks went out on the risk spectrum and made many of the bad loans.

The Greenspan 2000 inflation was particularly destructive. In human history, there are random periods when we suddenly have major advances in our ability to produce for a variety of reasons. In the 1920s, we were having a technological boom (in automobiles, telephones, radio, and electricity). And what should have been happening, what would have happened in a truly private banking system, is that prices would have been *falling* because we were able to produce better goods at lower cost. But the Federal Reserve held prices up to achieve "price stability." The market didn't realize, however, that what was really going on was inflation; it was a bad signal, and people created a bubble in the stock market which then burst, and the Fed piled on (and even Bernanke will admit this) by creating huge liquidity problems—contributing dramatically to the depression. The Fed set the stage for the Great Depression by holding prices up when they should have been falling (see Selgin 2008).

The same thing should have happened in the early 2000s, because of new technology and the rise of China and India in the global economy. For the first time in a long time, billions of people in China and India were more productive, more creative, and more innovative. Our standard of living should have been going up and prices should have been falling. But Greenspan did not want prices to fall.

People in the capital markets and investment business didn't see this hidden inflation, which resulted in lots of bad decisions. Thomas Sargent, an economist at New York University and a Nobel Prize winner, has done a lot of study about inflation expectations

and has shown that if people hold “rational expectations,” then the Fed’s attempt to affect the real economy by inflating the money supply will not work (see, e.g., Sargent 1986). The problem is we couldn’t project inflation in this case, because the inflation was hidden. It got even worse because it was the wrong price signal to the Chinese. By holding prices up, and interest rates down, we were telling the Chinese to produce like crazy; driving manufacturing jobs out of the United States, and incentivizing consumption in the United States—remember housing is consumption.

Based on many conversations with bank CEOs and other market participants over the years, I am strongly convinced that private bankers, in a fully competitive market would have created a very different interest rate scenario than the Federal Reserve. We would have never driven interest rates down as low as Greenspan took them and never have raised them as fast, and we never would have inverted the yield curve. Each of us independently, thinking about our own well-being and about profit maximization—and not a bit concerned for the common good—would have competitively created a very different interest rate environment that in hindsight clearly would have eliminated a lot of the problems that we experienced in our economy. Private interest, as Adam Smith said, would have promoted the common good.

I believe that what the Federal Reserve is doing today is very destructive. I think that it’s reducing economic productivity, not raising it. And I’ll tell you why. Recently, I was in New York talking to a number of private equity firms. And I was saying, “Well, you know, since the interest rates are so low, have you lowered your hurdle return rate for new projects?” They said, “Heck no. We know the Fed has been printing money like crazy. We know interest rates are going up in the future. We don’t know whether that means commodities prices are going up first or our sales prices are going up first, so we’ve kept our hurdle rate of return levels exactly the same.” So lower interest rates are not incentivizing real investment. They might be incentivizing some consumption in housing, but they’re not incentivizing productive investment.

But there’s a deeper issue, and I think this is a really important issue. The Federal Reserve says that they’re holding interest rates below market rates. What that means is that they are redistributing wealth from savers to borrowers. That is a very destructive, immoral decision. The arbitrary redistribution of wealth from savers to

borrowers, and particularly borrowers that committed lots of bad decisions, is unethical.

What Should We Do?

Like George Selgin (1988) and Larry White (1992), I'm for privatizing the banking system. I'm for getting rid of the Fed. I don't think you should have the Fed and private money/banking because I don't think private money can compete against the government. We tried to compete against Freddie Mac and Fannie Mae and you can't do it. Although we can't get rid of the Fed overnight, I'm quite sure that the free market would choose a private banking system based on a gold standard.¹

The reason we need to get rid of the Fed is that as long as it exists the temptation for Congress to borrow until we go broke is there. Believing that members of Congress will discipline themselves if they can print money is incredibly naïve.

From 1870 to 1913, the United States did not have a central bank, and yet we had a very successful economy; private banking systems actually have worked. But progress has been limited by the government's monopoly on currency and by regulation.

Markets are about experiments. Now some of the experiments don't work. But the existence of a government agency in any arena destroys the experimentation process and keeps people from learning. Without government impediments, private free markets would have already solved a long time ago the problem of providing sound money.

If you can't get rid of the Fed, then we should at least follow Milton Friedman's (1960) advice of limiting the growth of money to about 3 percent per year. End discretion and adopt a monetary rule, until we can end the Fed.

As a short-term and directionally correct solution for the banking system, I think we ought to raise capital requirements of the banks materially and take away the risk from the public and put it back on the shareholders. But to do that, you have to get rid of FDIC insurance; you have to privatize deposit insurance. And you have to make

¹See White (2011) on why "free banking" and a gold standard would increase monetary and financial stability and would have helped prevent the recent financial crisis.

it illegal for the Fed to bail out insolvent firms. You also have to eliminate 95 percent of the banking regulations; otherwise the banking industry cannot be competitive. As I said, regulations are more expensive than taxes in our industry. Dodd-Frank is a new regulatory cost structure which requires banks to both raise capital and incur radically increased regulatory cost. We end up with a nonviable financial industry. You've got to get rid of regulations if you want banks to maintain more capital.

Conclusion

As interesting as the economic analysis is, I believe that the fundamental fight is over philosophy—over ideas. And I think the Fed reflects that in many ways. How did we get in this mess in a philosophical sense? I think it's a combination of altruism and pragmatism. Everybody has a right to a house. Provided by whom? Everybody has a right to free medical care. Provided by whom? My right to free medical care is my "right" to coerce a doctor to provide me with that medical care or to coerce somebody else to pay that doctor. That is exactly the opposite of the American concept of rights. The American concept of rights is simple: you have the right to what you produce, what you create, but not what somebody else produces, not what somebody else creates. In business, we combine altruism with pragmatism, because you can't really be an altruist and be successful in business. Pragmatism leads to short-term decisionmaking. Negative amortization mortgages, subprime mortgages worked for years and then were a disaster.

Think about the Fed. It is a classic altruistic/pragmatic organization trying to save indebted borrowers and financial institutions that are failing, and it's using pragmatic standards: "Oh we're only doing this because this is an emergency; we won't ever do this again." Classic pragmatism. The problem with being a pragmatist is you can't be rational because rationality requires a long-term perspective. You can't have integrity either, because integrity is acting consistent with principles. Combine altruism with pragmatism and you get something I call the "free lunch mentality." Last presidential election, neither candidate offered any serious solution for Social Security or Medicare even though we have huge deficits, and if they had, they would not have been elected. What's the Fed trying to do? Drive rates down so borrowers can get out of trouble; that's the free lunch

mentality. Unfortunately, that mentality leads to a lack of personal responsibility, which is ultimately the death of democracies.

In fact, the central question in our society today that underlies all of these issues, and it relates to sound money is: Do we really believe in personal responsibility or not?⁹ It is a fundamental issue. The Founding Fathers talked about the tyranny of the majority. They were talking about the abuse of individual rights, freedom of speech, freedom of religion, but they also realized that when 51 percent of the people figured out they could vote a free lunch from the 49 percent, pretty soon the party's over. Because then 60 percent want a free lunch from 40 percent, then 70 percent want a free lunch from 30 percent, and the 30 percent quit producing.

Interestingly enough, the solution is also philosophical: "life, liberty, and the pursuit of happiness." Each individual's moral right to their own life. Each individual's moral right to the pursuit of their personal happiness. Each individual's moral right to the product of their labor. If they produce a lot, they get a lot, including the right to give it away to whomever they want to, on whatever terms they want to. That moral prerogative demands personal responsibility, because there is no free lunch.

Most people when they hear "life, liberty, and the pursuit of happiness," think about liberty. Liberty is very important because individuals have to be free to pursue happiness. Before Jefferson, before the Enlightenment, everybody existed for somebody else's good: the king, the state, the church. Nobody existed for their own good. What Jefferson said is each of us has a moral right to the pursuit of our personal happiness. We're not guaranteed success in that pursuit, but we have that right. That idea changed the world and created the most successful society—and the most benevolent society in history. When people have the right to freedom of choice, they're naturally nicer to other people and more productive.

If you're going to pursue your happiness, you have to earn self-esteem, and earning self-esteem requires that you live your life with integrity. But there's also another aspect of self-esteem that has social implications. For most people, the primary source of self-esteem is work because you spend a disproportionate amount of time, effort, and energy at work. Something I say to all the employees at BB&T: "It's really important to BB&T that you do your job well. However, it's far, far more important to you. You might fool me about how well you do your job, you might fool your boss about how well you do your

job, but you'll never fool you." If you don't do your work the best you can possibly do it, given your level of skill, given your level of knowledge, you will lower your self-esteem. The flip is also true. Do your work the best you can do it, given your level of skill, given your level of knowledge (you cannot do the impossible), and you will raise your self-esteem. And that's more important than getting more money or a promotion because it's about who you are."

There is a major societal issue related to this self-esteem concept. Take an entry level construction worker, a bricklayer. He has a tough life. Reminds me of my granddad. Tough life. But somehow he gets the job done, and he and his wife successfully raise their children. Maybe his granddaughter becomes the CEO of a public company, maybe not. He has a tough, hard life, but he gets something very precious from his work. He gets self-esteem. He gets to be proud of himself. Take that same bricklayer and give him welfare. He's better off financially, but he loses his pride. He loses his self-esteem. You know, there's a lot of focus in our society on security. The Federal Reserve was created to provide security, that is, to reduce "volatility" in the economy. To keep us from making mistakes. Americans care about security, but this is not the land of security. If you want to be secure, stay in Europe. People didn't get on a boat and come to Jamestown to be secure. The United States is the land of opportunity. The opportunity to be great. The opportunity to fail and try again. But most importantly the opportunity of that bricklayer to live life on his own terms. To pursue his personal happiness given his beliefs, his values. That is the American sense of life, and that is what is so precious to protect. The elitists in government, including elitists at the Fed, are a threat to the sense of life that made America great.

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