

# Are We Asking the Right Questions?

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Shadow Open Market Committee  
Princeton Club, New York City, New York  
May 5, 2017

**E21** Manhattan  
Institute

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**ECONOMIC POLICIES FOR THE 21ST CENTURY**

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\* This paper is prepared for the May 5, 2017 meeting of the Shadow Open Market Committee. No portions of this paper may be reprinted or used without the author's permission.

As a college president, I don't have the time to follow the tick-by-tick intrigue of the FOMC dot-plots, or the latest down revision to the "risk free" neutral rate of interest, or the latest developments in how wage growth and labor force participation rates cause inflation.

However, while I am drinking my morning coffee and watching my friends and former colleagues on Bloomberg TV, I try to ask myself if policymakers are collectively asking the best questions – the right questions – in order to ensure that our policies underpin economic opportunity in the U.S. I also want to be reassured that we have learned from the mistakes that led to the last financial crisis, and that we have correspondingly implemented appropriate institutional reforms.

Sadly (the new vernacular), I do not believe that we have. Almost 10 years after the financial crisis, we continue to show a lack of urgency in dealing with the problems that caused the crisis, and which in turn may beget the next one.

In no particular order, I attribute three policy failures as proximate causes of the 2008 Financial Crisis (in no particular order) – the FOMC's monetary policy decisions during the period prior to the financial crisis institutional; weakness in the design of Fannie Mae and Freddie Mac; and insufficient regulatory supervision and oversight of financial institutions. To my mind, these three policy failures formed a potent cocktail that drove and exacerbated the boom-bust cycle that we still continue to recover from.

Let's begin with the FOMC's monetary policy decision-making. The last 15 years of monetary policy has been an evolving shift from the historic debate of "rules versus discretion" to the new incarnation of "rules and discretion." To my mind, this began for the FOMC during the period of 2003-2005, when the FOMC's target federal funds rate significantly deviated from a more predictable and historical policy rule, e.g. the Taylor Rule (Taylor 1993). The reason the FOMC gave for deviating at the time was the notion that the federal funds rate should be kept lower than might typically be warranted because of the fear that deflation could take hold in the U.S. Many economists, though not all, believe that the FOMC's additional monetary policy thrust during this time period accelerated the rise of asset prices (such as equity prices and housing) above fundamentals, which contributed to the onset of the financial crisis of 2008.

Could the FOMC be repeating this mistake? The good news is that the language of monetary policy rules predominates in the FOMC's current policy conversations – e.g. inflation expectations that are well anchored. This is a good thing!

Unfortunately, the language of rules is once again being used to justify discretionary decision making. This sleight of hand, namely, the narrative that we are following a rule when in reality we are often following a different rule, is facilitated in myriad ways: exogenous shifts in the "risk free" rate of interest, the target rate of inflation, or an ever-

changing universal monetary policy justification of “data dependency.” As we have learned, however, monetary policy without a primary and disciplined commitment to price stability never ends well. As such, the FOMC should adopt a principled, modestly counter-cyclical, stable, reference-based rule and describe its policy deviations from it, rather than its current practice of constantly changing and deviating the rule it is presumably following.<sup>1</sup> This would improve the FOMC’s credibility and ability to communicate, and also demonstrate that it has learned lessons from the past. The resulting normalization of policy would deflate fears that we are again unnecessarily elevating asset prices for equities and housing to sustain a level of aggregate demand that cannot ultimately be sustained.

The second policy failure surrounds the Government Sponsored Enterprises Fannie Mae and Freddie Mac. Much has been written on Fannie and Freddie’s history of accounting scandals, portfolio duration issues, alarmingly low capital buffers, and Herculean political lobbying exploits that significantly predate the 2008 Financial Crisis.<sup>2</sup> We knew there were problems, yet we lacked the will and urgency to deal with them. We learned the hard way how risks were not being intermediated through Fannie’s and Freddie’s securitization efforts. Rather, due to the implicit government guarantee of Fannie’s and Freddie’s assets, their market advantages for both selling securities and attracting funding, their lower capital standards and the leverage they put on their portfolios, exacerbated the weak underwriting standards of the underlying housing loans, which ultimately bankrupted both institutions.

By placing Fannie and Freddie in conservatorship in 2008, the U.S. government’s implicit guarantee of their debts simply became explicit. And, in the intervening 10 years, the government’s role in housing finance has only enlarged. Fannie and Freddie now account for an even larger fraction of the mortgage-backed security issuance than they did before the crisis, crowding out market-based, private sector activity. Not to be outdone, the FOMC has purchased a supersized share of these same securities issued by Fannie and Freddie in their quantitative easing, asset purchase programs. Payments on the securities to Fannie and Freddie now flow to the U.S. government as off-budget federal entities.

The current system for intermediating financial market risk for the U.S. housing market gives socialism a bad name. A U.S. government entity issues the securities; the Federal Reserve (also a U.S. government entity) buys the securities; the Federal Housing Finance Agency (another U.S. government entity) continues to encourage housing lenders to take on marginally risky borrowers, which undermines the ultimate quality of the securities that are being sold (The Economist 2014, and Goldfarb 2013); and, the U.S. government receives payments on these securities to fund its budget. We are the

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<sup>1</sup> See SOMC (2014) for other relevant changes we endorse.

<sup>2</sup> See, for instance, Hess (2004) and the references therein.

only nation in the world that intermediates family home purchasing risk in such a perverse and government-dominant way.

Will we lack the will once more to fix the institutional problems in the intermediation of home financing? We have certainly painted ourselves into a corner, and reducing the federal government's institutional footprint will be hard to achieve, particularly as we move the intermediation risk away from the public and back to private market discipline. It's hard to know where to start as we convert Fannie and Freddie to a model of private ownership, but the conversation must begin soon. Any path forward will likely require that Fannie and Freddie no longer receive preferential treatment from the U.S. government on any margin. And progress will also likely need to limit policies or regulations that have perverse incentives for private lenders to make loans to risky borrowers that deteriorates overall loan quality in ways that can destabilize our financial system (e.g. substantially lowering down payment requirements) without a compensating subsidy.

The final policy failure centers on financial regulation. While lax financial regulation and oversight were critical components that led to the 2008 Financial Crisis, some of the policies and regulations adopted in response (though not all) have been both obtrusive and obtuse in ways that have hampered our recovery and subsequent economic growth rate. Moreover, these policies and regulations have been reinforced and emboldened by the tone in Washington and by populists since 2008 — an overriding sentiment that Wall Street must be punished for its transgressions, even if we all must suffer as a consequence. The era of “pitchforks and torches,” though perhaps a natural follow-on to any financial crisis, must end for our own betterment. There is simply no Main Street without Wall Street anymore.

For better or for worse, Dodd-Frank will be revised in the next few years. One can only hope that appropriate stress testing of institutions and strong capital buffers will remain, and that community and local banks receive regulatory relief. While it is tempting to believe that “Too Big to Fail” can be solved by regulation and legislation, history suggests otherwise. If we have learned anything, it is that market structure continuously evolves in financial markets and that individual financial institutions take on implicit and explicit leadership roles due to market, regulatory, and legislative forces. In short, in financial regulation new moles always appear in the game of “Whack a Mole.” It is better to focus our attention on revisiting financial regulation by emphasizing clarity and market-based policies that create incentives for banks and bankers to face the true private and social costs of risky decisions. Moreover, our regulatory architecture must be sufficiently flexible to adjust to new realities that emerge from innovation and market competition.

I conclude with this simple thought. The 2008 Financial Crisis was painful. The saying “No Pain, No Gain” suggests that pain is a necessary condition for gain, not a sufficient

one. We simply must find the will and urgency to ask the right questions and to pursue answers that translate our experience into action so that our future experiences are far less painful.

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