

Federal Reserve Board Oral History Project

Interview with

Sherman J. Maisel

Former Member, Board of Governors of the Federal Reserve System

Date: July 8, 2009

Location: San Francisco, California

Interviewer: David H. Small

Federal Reserve Board Oral History Project

In connection with the centennial anniversary of the Federal Reserve in 2013, the Board undertook an oral history project to collect personal recollections of a range of former Governors and senior staff members, including their background and education before working at the Board; important economic, monetary policy, and regulatory developments during their careers; and impressions of the institution's culture.

Following the interview, each participant was given the opportunity to edit and revise the transcript. In some cases, the Board staff also removed confidential FOMC and Board material in accordance with records retention and disposition schedules covering FOMC and Board records that were approved by the National Archives and Records Administration.

Note that the views of the participants and interviewers are their own and are not in any way approved or endorsed by the Board of Governors of the Federal Reserve System. Because the conversations are based on personal recollections, they may include misstatements and errors.

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MR. SMALL. Today is Wednesday, July 8, 2009. I am David Small from the FOMC (Federal Open Market Committee) Secretariat in the Board's Division of Monetary Affairs. I am in San Francisco interviewing former Board Governor Sherman J. Maisel. Governor Maisel served on the Board from 1965 to 1972.

MR. MAISEL. My 91st birthday.

MR. SMALL. Congratulations.

Personal and Educational Background

MR. SMALL. Governor Maisel, let's start with a discussion of your background, particularly your education and your journey through economics leading up to your reaching the Board. You were born in Buffalo, New York. Did you attend a public high school?

MR. MAISEL. No, I went to Country Day—the Nichols School. It was a good school.

MR. SMALL. Were you a good student at that point?

MR. MAISEL. Yes. In fact, I skipped my senior year. I had done enough reading on the side in history and things to receive credit for a couple of courses. Because of that, by my junior year, I could graduate, so I did. Then I went to Harvard. I only applied to Harvard because I didn't know to apply to more than one school! [Laughter]

MR. SMALL. You went to Harvard in what year?

MR. MAISEL. 1935. I graduated in the class of 1939.

MR. SMALL. At that time, were you aware of the legislation in 1935 and 1936 and what was going on related to the Federal Reserve?

MR. MAISEL. In my senior year, I took a graduate class from Alvin H. Hansen, so by then I knew something of what was going on with the Fed.

MR. SMALL. Those must have been exciting intellectual days in Keynesian economics. Alvin Hansen probably was the best-known American proponent of Keynesian economics.

MR. MAISEL. Yes. I thought I was going to be interested in government, but I didn't think the government department at Harvard was very good. In my sophomore year, I decided to major in economics mainly because I didn't like the government studies that I thought I was going to major in. I had never taken an economics course.

MR. SMALL. Did you read the *General Theory* at that time?

MR. MAISEL. By my senior year, yes.

MR. SMALL. Did Harvard offer distinct courses in microeconomics and macroeconomics at that time?

MR. MAISEL. Yes. We had John Kenneth "Ken" Galbraith, for example, and others taught industrial organization. Edward S. "Ed" Mason, Edward H. "Ed" Chamberlin, and Wassily W. Leontif taught the theory. I was in a very good class. My class probably turned out more good, professional economists than maybe anywhere. James "Jim" Tobin was in my class. And, if my memory were better, I could name others. There were 20 professional economists in the class.

MR. SMALL. Do you remember doing problem sets with Jim Tobin?

MR. MAISEL. Yes, on and off. The same was true when I came back to graduate school. Among the best of the economists were there. In graduate school there was Tobin, James Duesenberry, Carl Kaysen, Sidney S. "Sid" Alexander, and Robert M. "Bob" Solow.

MR. SMALL. Was Harvard known for its Keynesian perspective?

MR. MAISEL. Yes.

MR. SMALL. And the competing schools of thought?

MR. MAISEL. In undergraduate school, the idea of the business cycle was just starting, and I wrote my dissertation on it. My dissertation was on the relationship between consumer durables and the business cycle. The National Bureau of Economic Research (NBER) had just brought out specific things about the GNP (gross national product). Simon Kuznets's work on national income accounting was beginning to come out, but the government still had no GNP figures. I took Kuznets's work and related it to credit and so on with my undergraduate thesis.

MR. SMALL. How did you do the analysis in econometrics or computer statistics? With hand charts, hand calculations—

MR. MAISEL. No, just statistics—showing ups and downs.

MR. SMALL. Mainly hand calculations?

MR. MAISEL. Yes, sure. That was all there was.

MR. SMALL. Was econometrics and the computer starting to come into use?

MR. MAISEL. No. Not even in graduate school.

MR. SMALL. What did you do between undergraduate and graduate school?

Working at the Federal Reserve Board in the 1940s

MR. MAISEL. After getting my undergraduate degree in 1939, I went to work for the Federal Reserve Board in the International Research Section. Walter Gardner was head of the section, and Chan Morse was deputy head. Andrew M. "Andy" Kamarck and Bill Salant had been there, but they went back to Harvard to graduate school. And the man who made the GNP figures at the Department of Commerce, George Jaszi, left to go back to graduate school. When war broke out in Europe, the Board desperately needed a junior economist, and I was sent a wire: "Please come immediately."

MR. SMALL. One could think they wouldn't care about exchange rates, trade flows, and the like, given the war.

MR. MAISEL. Well, that was all a question of what would be the effect on the American economy of the change in the demand from England and so on. I was the first, but later that year J. Burke Knapp and then Charlie Kindleberger came, and it became a large section.

MR. SMALL. How long were you there?

MR. MAISEL. I've got to figure this out. In the middle of 1941, Chan Morse went over to what eventually became OSS (Office of Strategic Services)—it was called Export Control at that time—and he asked me to go with him. We were the first two economists at Export Control. I was there about three months, and then I went into the army. So I was at the Board about a year and a half.

Service in the Army

MR. SMALL. Did you serve in the army until the end of the war?

MR. MAISEL. Yes, I was in the army for five years. I started out as an infantryman carrying a mortar as a private, but I ended up as a captain of ordnance. I was at Albuquerque at the end of the war, and was the deputy—S4—in charge of transportation, bombs, and airplane fueling.

MR. SMALL. Geographically, where were you lugging these mortars as a private?

MR. MAISEL. I was at Fort Meade and then I went to OCS (Officer Candidate School) at Aberdeen, Maryland. Then I was commissioned and went out to the West Coast. I was at Santa Ana and then at Albuquerque.

MR. SMALL. Did you go overseas?

MR. MAISEL. No, because I became a captain so fast. They weren't interested in anything but second lieutenants. They wanted to promote their own people. I tried to go and I kept volunteering, but they had no interest in anybody who wasn't a second lieutenant.

Working at the State Department after the War

MR. MAISEL. When the war was over, I spent a year in the State Department. Starting out, I backed up the reparations conference that was going on in Paris. That set up the Inter-Allied Reparations Agency in Brussels.¹ I was the first employee of the American delegation. We set up the reparations thing, but it turned out that nothing happened because the United States was supporting Germany, and taking the plants out of Germany didn't make any sense when we were pouring money in to keep them from going hungry. So that concept failed.

There was a so-called gold pot. We divided up the gold we found in the German mines. We thought we had a definite finish to that, but it turned out that we didn't want to give the gold back to Czechoslovakia. France, England, and the United States were responsible for distributing the gold. They kept meeting in Brussels for something like 30 years [laughter] until the last bit of gold from Fort Knox went back to Czechoslovakia. Everything else we solved in the first two months or so of the thing.

MR. SMALL. You said that the reparations didn't go far. Was that, in part, because of the Marshall Plan?

MR. MAISEL. No, the Marshall Plan was later. It had finished before the Marshall Plan. For example, we divided up the ships. The French very much wanted a transatlantic liner. Both of theirs had been destroyed during the war. We gave them the transatlantic liner they

¹ The Inter-Allied Reparations Agency was established by the Paris Agreement, which was signed on January 14, 1946. The agency's function was to ensure an equitable distribution, in accordance with provisions of the Paris Agreement, of the assets declared available as reparations from Germany among the 18 member nations entitled to reparations to compensate for losses caused by Germany during the war.

wanted and some other freighters, whatever was found in Germany. But the main plan had been to divide up plants from Germany. Forty percent were to go to Russia. Russia took them but couldn't ever use them. Russia couldn't put them together. I think we gave three plants or something like that to the United States, which wanted aluminum foil. We had no aluminum foil plants then, and I think we got an aluminum foil plant, but that was all. And then it just ended. Anyway, I had left by that point.

I went back to Harvard after Brussels. I took the job because I didn't assume one could enter graduate school midyear, so I waited until the next September and started graduate school then.

Building a National Model of the Economy: Modeling Monetary Policy

MR. SMALL. How long were you at graduate school?

MR. MAISEL. Two years.

MR. SMALL. Two years, and then you went to Berkeley?

MR. MAISEL. Right.

MR. SMALL. And you worked with the Social Science Research team?

MR. MAISEL. That was later. I was hired at Berkeley for urban economics and real estate finance, and I did a major study of the house-building industry. In fact, that study still applies. It turned out to be the best that, I think, has ever been done of an industry study of house building. I did that in 1950 and then got interested in financing construction and spent most of my time on that. My Social Science Research work started in 1960. In that year, Lawrence R. "Larry" Klein and Jim Duesenberry realized that the computer would change economics. When Klein built his first model, I think he had 12 or maybe 14 equations, and to invert a matrix was a three-day job, so that required months of work by people with hand calculators.

But Duesenberry realized that, with the new computer—the IBM 650 was the first one—you could handle a large number of equations. So they brought together about 15 people and said, “What would a major model of the economy look like?” They got the Social Science Research Council (SSRC) to put up the money for it, and, as I said, 15 of us met.

In 1961, we all agreed to go to Dartmouth for a month to start putting together the different sectors of what a national model would look like. It seemed logical to get the Fed to come in and do the monetary part of it. Daniel H. “Dan” Brill, who was an associate adviser in the Board’s Division of Research and Statistics then, came representing the Fed. He was extremely embarrassed when he realized, after the first week, that he had nothing to offer, and that the Fed as a whole had nothing to offer about how you put monetary theory into a national model. He went back to the Fed, and that’s what started the model building at the Fed. When Brill returned to the Board from Dartmouth, he realized that there was a gap and brought in Frank de Leeuw, who eventually headed the modeling effort. I think Edward M. “Ned” Gramlich was part of the group, too. They put together the first monetary model, or they continued what was done at the SSRC.

We met two summers, and the computer still wasn’t quite good enough. We had to have statisticians or mathematicians to solve the problem because the computer would only do about a third of the equations at a time, and these people had to figure out how you could do it in parts, and so on. We finished our individual parts. I did the commercial and residential construction and the consumption of housing services section. People did each of about 25 parts.

We finished, I guess, in 1964. Then it took three or four people about six months to put it together to get the first result. That came out, I think, in the middle of 1965. Then it turned out that you couldn’t run the model, because nobody knew how to gather the current data needed as

inputs, so the Brookings Institution took it over and set up a group of about three or four people. I think Gary Fromm was the guy who was in charge. They figured out how you gathered information so that you could solve a model. Nobody had ever thought of getting simultaneous information to keep it up to date. It took them a year and a half to put together the simple handling of numbers.

MR. SMALL. Updating the database, so to speak?

MR. MAISEL. Yes. Otto Eckstein then set up DRI (Data Resources, Inc.) and made a business of distributing economic data. The business was selling a database and computer time to use it.

After we ran the model the first time, it took another year or so to be able to run it the second time. Then, after they did this work at Brookings, it got so you could run it periodically. You could use the model to see how the economy worked and use it for making a forecast. The book there on the middle shelf by Duesenberry, Fromm, Klein, and Kuh explains the equations in the model.²

MR. SMALL. And you could do a forecast? You could do simulations?

MR. MAISEL. Yes. That was the first national model.

MR. SMALL. You mentioned your work on the housing sector at Berkeley. Back then and during your time at the Board, Regulation Q ceilings were important for the financing. Now we don't have those ceilings, and that has been forgotten about.

MR. MAISEL. Housing credit primarily came out of the savings banks, savings and loans, and some from banks. When Regulation Q ceilings (which only applied to member banks prior to September 1966) became lower than the market rates, savings and loan associations

² James S. Duesenberry, Gary Fromm, Lawrence R. Klein, and Edwin Kuh, eds. (1965), *The Brookings Quarterly Econometric Model of the United States* (Chicago, Ill.: Rand McNally and Co.).

(which funded themselves greatly through certificates of deposits and competed by paying just more on them than the Q limits) would lose their deposits to the market.³ This happened every few years. Their source of deposits disappeared.

I remember how mad S&Ls were at the *Wall Street Journal* for telling people in Peoria and elsewhere how to invest in the market—that they could buy U.S. government bills that would pay more than the S&Ls. So people all around the country were suddenly finding out that you didn't have to put your money in depository institutions, you could put your money in government bills instead.

Anyway, Brill's experience at Dartmouth was how the Board started to get interested in modeling and monetary theory because, at the same time, or just about the same time, Karl Brunner and Allan Meltzer—perhaps working for the House Banking Committee—testified that the Federal Reserve had no theory about what it was doing, which was not quite literally true.

Chairman Martin had a theory. It was that all the Fed could do was to look at the money markets and control the amount of credit. The Fed would try to increase the amount of credit if there didn't seem to be enough or decrease the amount of credit if there was too much. He would meet with all the big bankers in New York once a month for dinner, and they would tell him what they thought was happening to the money and credit markets. Then he would come back, and that was how the decisions were made. So he either raised or lowered free reserves on the assumption that they would control the amount of credit. The job of the Fed was to change free reserves and therefore, in some way, to change the amount of credit, and it didn't go beyond that.

³ For a review of Regulation Q deposit rate ceilings, see Charlotte E. Ruebling (1970), "The Administration of Regulation Q," Federal Reserve Bank of St. Louis, *Federal Reserve Bank of St. Louis Review* (February), pp. 29–40.

But with the criticism of Brunner, Meltzer, and the Congress that the Fed had no theory, the Fed felt it had to get a theory. So it set up the first Committee on the Directive. George Mitchell ran that. There must have been a report in 1964, just before I came to the Fed. I don't remember what they recommended because I wasn't there, but the Federal Open Market Committee (FOMC) voted it down. So the Fed was left with no theory—or, if you want to call it that, a theory of controlling credit by the feel of the markets.

Martin used to use the simile of rocks appearing in the flow of credit, and it was the Fed's job to push the rocks out of the way or else to increase the number of rocks if the amount of credit was too much.

Prohibition against Forecasting

MR. MAISEL. There was a rule that the staff couldn't produce a forecast of the economy. There was to be no forward looking because that didn't make sense. All you were concerned about was with the amount of credit at the moment, and you looked at that. If you were trying to forecast, you would come to the wrong conclusions. Therefore, it was wrong to look forward. The job of the staff was to let everybody know what was happening at the moment and not to go beyond that. I think that went back to Winfield Riefler, who was Martin's chief financial adviser for about 10 years.⁴ It was his rule. After I'd been there about six months, I insisted that the rule be changed, and it was done away with so that the staff could start looking forward instead of only back.

MR. SMALL. At that time, the United States was still on the gold standard.

MR. MAISEL. Yes, the price of gold was fixed.

MR. SMALL. Did that play a big role in monetary policy or discipline?

⁴ Editor's note: Winfield Riefler was an assistant to the Chairman of the Board of Governors from 1948 to 1959.

MR. MAISEL. No, because you had semiofficial or official controls over the amount of exports and imports and credit, and you were always aware of them. In my book I said that, all the time I was there, I think that only eight decisions (five to tighten, three to loosen) of the FOMC were really based on gold and capital flows.⁵ Gold flows were primarily being handled through the controls, not monetary policies.

MR. SMALL. And that was largely through the Treasury.

MR. MAISEL. Well, the Fed had some involvement. Dewey Daane handled it, and then Andrew “Andy” Brimmer. Those two would know more about that control situation, but looking at it from my point of view, as I say, I went over it in my book and decided there were only eight times that the foreign situation was really significant for an FOMC decision. Now, quite a few times, when it was a question of changing the interest rate, some would argue that it would affect the foreign exchange situation—not the exchange rate, but the pressure against the controls. And Dewey made that argument almost every meeting, but he was almost alone.

Nomination to the Board

MR. SMALL. How did you find out about your nomination to the Board?

MR. MAISEL. Sometime in 1964, I had dinner with C. Canby Balderston [Governor of the Federal Reserve from August 1954 to February 1966]. His son Fred was one of my best friends, and Fred invited me to dinner with him. I told him my reaction to the fact that the Board was not keeping up with what was happening in the field. The Federal Reserve clearly was very good at what it did, but it wasn’t keeping up. When I left the Board, I found the same thing was true—the Board was way behind. It knew nothing about Sharpe and Lintner and modern finance theory, even though, I think, the Sharpe-Lintner stuff is 1965, so it existed all the time I was on

⁵ Sherman J. Maisel (1973), *Managing the Dollar* (New York: W.W. Norton).

the Board. The staff, as far as I know, never brought up anything about modern finance theory. Anyway, I'd had this dinner with Canby, and apparently he took my view back to Martin.

But how I got appointed was a very different thing. A friend asked me whether I would talk to the [Federal] Home Loan Bank Board. It badly needed somebody with my background. I talked to the head. He asked whether I would take an appointment on the [Federal] Home Loan Bank Board. I couldn't make up my mind. I came back and talked to my family and finally said, "Yes." At that point, the FBI did a full field search, and so on. But it turned out that the industry didn't want somebody who knew anything, so industry representatives opposed my appointment to the [Federal] Home Loan Bank Board. President Johnson, I think, decided it wasn't worth having a fight with the industry. Those in the industry went broke, because they always insisted that nobody on the [Federal] Home Loan Bank Board knew anything about what their problems were.

Anyway, I had thought I was going to Washington, and suddenly there was a notice in the paper that the appointment had gone to somebody else, a guy named Michael Greenebaum who'd been Senator Paul Douglas's finance chairman. All of the time we were together in Washington, he would always apologize to me, saying, "You should have had this job, not me"—because it was actually true!

Anyway, that ended, and then I got a call from Gardner Ackley saying he wanted to talk to me. He said, "Would you be interested in an appointment on the Federal Reserve?" I said, "Well, who's kidding whom? I just didn't get the other appointment." A vacancy existed on the Board. England was in trouble. Ackley, who was head of the Council of Economic Advisers (CEA), and Kermit Gordon, who was head of the Bureau of the Budget, were worried that if England did something, the Fed would tighten. They would feel very embarrassed if they lost

the tightening vote by one vote, so they decided they wanted to get the vacancy filled as soon as possible. They found I had an FBI clearance for the [F]HLBB job. Gardner said to me, “Will you come talk to the President?” I said, “Yes. How about in two days?” And he said, “Oh, no, come overnight. I will set up an appointment for you with President Johnson for tomorrow.” So I went in and talked to him. I am told—and I don’t know if it’s true—that C. Douglas Dillon, who was Secretary of the Treasury, and Chairman Martin wanted a banker on the Board, and Gordon and Ackley wanted me. Supposedly, Johnson took the two files to bed with him and read them and then told Ackley to call me.

Later, Martin said he could have stopped me, but Johnson didn’t give him a chance. I was there in the White House after Dillon had resigned and Henry H. Fowler was going to be sworn in. Johnson said to me, “I’ll have Martin come over a little early and talk to you to see what he thinks.” So Martin came over, and we talked for about an hour and a half. Then we went into the swearing-in ceremony, and Martin said, “Don’t come with me, because people know there’s a vacancy, and if they see you with me, they may think it’s related to the vacancy.” So we went in, and I was in the back with the press. Martin was up with Dillon and Fowler. Fowler got sworn in, and Johnson said, “I have a surprise,” which he frequently did. He had somebody bring him a press release announcing my appointment to the Board. So he didn’t ask Martin or anything, although, as I say, Martin told me that he thought he could have stopped it, but he didn’t see the President between my meeting and the President’s announcement. It was funny, because I had—for personal reasons related to Berkeley politics—asked him to delay the appointment for a couple days, but he didn’t.

MR. SMALL. Do you remember your conversation with LBJ?

MR. MAISEL. Yes. He was primarily interested in the fact [that] I had defeated a recall attempt at Berkeley. I was on the Berkeley School Board. The fact that I had run for office, even though it was a school board office, and had been elected was always important to him. He didn't ask me any economic questions. Ackley and Gordon had asked me questions, but he basically didn't.

MR. SMALL. What did Ackley ask you?

MR. MAISEL. Well, just that I was a modern Keynesian.

MR. SMALL. So when you took office at the Board, that was a tense situation with the Patman hearings either ongoing or about to begin, and that was six, seven, or eight months before the famous increase in the discount rate in December of 1965.

MR. MAISEL. Right.

Raising the Discount Rate

MR. SMALL. You have said that part of Martin's desire to raise the discount rate had to do with the banks setting the prime interest rate, and how [Lyndon] Johnson had controlled or held down the prime rate.

MR. MAISEL. Yes, I guess so. I thought there would be a major study from the Board about what effect the changes in the interest rate would have and so on, and nothing of that sort appeared. In fact, the call to the meeting was a surprise. There was an annual meeting with the directors of the 12 regional Reserve Banks. It was in process, and I think the Board meeting concerning the discount rate increase took place in the afternoon after all of that.

Basically, Martin had decided that the discount rate ought to go up, and the Board had to act. He must have known that Dewey [Governor Dewey Daane] was going to vote with him. Martin had an appointment with President Johnson on Monday. Johnson was recovering at his

ranch from an operation, and Martin was to fly down there. Martin simply decided he wanted a fait accompli, that he didn't want to discuss it with Johnson, and he was certain he was right.

Our argument—the minority—was that there was a month before the President's budget had to be finalized. We thought fiscal policy would be a better way of controlling demand through a tax increase and that, with the threat of the interest rate increase, there was a fair chance that Johnson would go for a tax increase rather than an interest rate increase. We thought Johnson ought to have that three-week period to make up his mind. Okun and Ackley thought they could get him to go for a tax increase rather than an interest rate increase, but Martin didn't think so. He wanted to give them a fait accompli and didn't worry about what the budget was going to be.

MR. SMALL. Do you remember how you looked at the economy, inflation pressures, and full employment at the time, and how good your data were?

MR. MAISEL. Well, yes, because we knew the war was starting. We tried to get information. Charles J. "Charlie" Hitch had been comptroller of the Pentagon. He was resigning as comptroller. I sold my house in Berkeley to him. And at some point during that period I tried to get his view about what was happening. The Pentagon didn't have much. Both Johnson's advisers and I recognized that there was a threat of too much demand, and this is why, at least at that point, it was put as a question of taxes or interest rates. They all wanted higher taxes rather than a higher interest rate, whereas Martin was clear that there wouldn't be a tax increase. So everybody agreed that there was too much demand, that Vietnam was creating too much demand.

I forget now the whole question of voluntary price and wage controls. I don't remember what the timing of all that was. This took place in December. By June 1966, the amount of credit was going up at a tremendous rate. The increase in the discount rate had had exactly the

opposite effect of what it was supposed to have. This is why Andy [Governor Andrew Brimmer] and I wanted an “open mouth policy,” feeling that the change in the discount rate hadn’t influenced the amount of credit. In fact, it had gone the other way: The banks had more money and were increasing their loans way too much. Therefore, we argued for the open mouth policy, which we finally got in September 1966. That policy took the form of a letter to the banks saying, in essence, “If you keep lending the way you’re lending, increasing the amount of credit, don’t expect the discount window to be open to you if you need it.”

MR. SMALL. What was the mechanism or economics behind an increase in the discount rate increasing credit growth rather than decreasing it? How did that work?

MR. MAISEL. Well, there wasn’t any control over total reserves or similar measures. I guess people weren’t thinking in those terms. They were thinking that the amount of free reserves would control credit. All I know is that the amount of loans kept going up rapidly. In fact, they went up faster, and by June this development was clear. Whether it was clear to everybody I don’t know, but Andy Brimmer and I both suggested the letter to banks in June. I forget why it didn’t go out earlier, but I think in September is when the letter was finally sent, and that stopped the increase in credit.⁶ In fact, it came down, I think, after that.

Regulation Q

MR. SMALL. You mentioned earlier that that was the time when Regulation Q ceilings were hit and disintermediation started?

MR. MAISEL. Yes. The savings and loans were the first ones hit, but I don’t remember the exact timing. California savings and loans in particular had advertised all over the country that they were paying more on accounts. Each of them set up a boiler room to bring in money,

⁶ Editor’s note: The letter was published in the *Federal Reserve Bulletin*, September 1966, pp. 1338–39.

so their money was growing very fast. It wasn't local deposits. It was money brought in from the money market. Then, when Regulation Q ceilings increased in December 1965, they got hit hard. Because they were invested largely in fixed-rate mortgages, they couldn't meet the higher ceiling rates offered by banks. The money that they had brought in from all over the country began to leak out. But, as I say, I'm not sure month-by-month what the timing was.

MR. SMALL. Nowadays we don't have Regulation Q ceilings. People just talk about moving interest rates up and down and maybe focusing especially on the real interest rate. But back during that period, how much did Regulation Q ceilings factor into how monetary policy was thought to affect the economy—if you tighten too much, those ceilings would kick in.

MR. MAISEL. Right. That was the first realization that it was the amount of deposits and the credit channel, and not interest rates, which had the largest impact on housing credit and construction.

Shifting Fannie Mae out of the Government Budget

MR. MAISEL. That realization led to what I felt was my most important contribution. It was the shifting of Fannie Mae out of the government budget—the founding of Fannie Mae as a government-sponsored agency. Fannie Mae existed, but it was in the government. Its loans counted as part of the deficit. Therefore, it had a cyclical problem, because when the government was doing well and the deficit was not so much of a problem, it could make loans. But when Fannie Mae was needed to make loans, such as in a recession, it couldn't make them because that would increase the deficit. So Fannie Mae was working exactly the opposite [from the] way it should have.

I met with Jim Duesenberry from the Council of Economic Advisers and Charlie Zwick, who was Associate Head of the Budget Bureau. The President appointed us as a committee to

look into this question. Our recommendation was, in effect, that Fannie Mae be made an off-budget agency so it could make mortgage loans countercyclically. And that happened.

Then Raymond H. "Ray" Lapin came in as president of Fannie Mae. He was trying to decide what to do. He set up a committee of brokers and bond dealers, and the idea of asset-backed bonds came in. The whole asset-backed thing started with Fannie Mae. When the savings and loans lost their deposits, Fannie Mae could issue bonds based on its mortgages and, later, guarantee the bonds that the banks could issue. This turned out to be very successful. They could make the loans when nobody else could, so you got a much smoother flow of housing credit than you had had previously.

When Nixon came in, there was a fight. They fired Lapin because he felt Fannie Mae ought to be run as a government institution, like the Fed. The Nixon people felt it ought to be run as a private corporation, which is how it got in all its trouble. When he was fired, Lapin filed a lawsuit. The issue was whether the President had the right to fire him or not. He lost, but that was a complete change in Fannie Mae policy from what the original idea was.

I knew Lapin well. I helped get him appointed. The mortgage bankers didn't like him because he had successfully upset their business, and they had been opposing him. The Secretary of Housing was afraid to appoint Lapin because of this opposition from the mortgage bankers. But I was one of those who helped convince the Secretary of Housing he was wrong, and that Lapin would do a good job, which he did. Lapin believed that Fannie Mae's public concerns ought to be the important thing rather than its stock price, and Nixon fired him because of that.

Communications with the Administration

MR. SMALL. That would have been in 1968, I guess. Going back a bit, you mentioned Zwick. And in your writings, you talk about back in 1965, what you called a “junior Quadriad” memo written by Zwick, Volcker, Okun, and Dan Brill on the economy and price pressures. There was some tension there about how Martin handled that memo.⁷

MR. MAISEL. Yes, because Martin didn’t give it to the Board. For some reason or other, I think Martin felt that his membership on the Quadriad was personal, and he didn’t want it to be as a representative of the Board. I was annoyed at that concept. I felt he was there because he was Chairman of the Federal Reserve, not because he was Bill Martin, but I think he felt the other way.

MR. SMALL. At that time, what was the communication like between Governors, CEA members, and Treasury? Was it pretty free flowing?

MR. MAISEL. No. As a result of the decision on the discount rate in December 1965 and the Patman hearings on it, Martin got mad at me, and we didn’t talk outside of meetings for a month or two. Rep. Wright Patman [D-TX] was going to bring in legislation requiring that the Board meet with the Treasury and the Council, and Martin thought it would be a mistake to have that in the law, that it would be much better to be unofficial. So Martin came around and asked me if it would be all right if he could set up the meetings with the Council and the Treasury as a weekly luncheon and tell this to the Congress so that the bill wouldn’t be passed, and he did, and we were friends after that again. Sometime in the spring or summer after that, Board members met weekly with the CEA and about once a month with the Treasury.

⁷ Paul A. Volcker, Daniel H. Brill, Charles J. Zwick, and Arthur M. Okun (1965), “Quadriad Analysis, Memorandum for Honorable Henry J. Fowler, Honorable Charles L. Schultze, Honorable William McC. Martin, Jr., and Honorable Gardner Ackley,” memorandum, November 6, Administrative Histories of the Council of Economic Advisers, Lyndon B. Johnson Presidential Library, University of Texas at Austin.

MR. SMALL. In reading some of your work, you mention that, before the December 1965 rate increase, Martin read to the Board a memo he had sent to the President. Were memos between the Fed Chairman and the Administration common?

MR. MAISEL. I don't remember that. I would think that Martin gradually got to where he talked to the Administration, and that he probably didn't earlier. I just don't know.

MR. SMALL. There's a criticism nowadays that Martin, through the Quadriad or whatever, got too entangled in political pressures—that, with hindsight, he would have been better off not to get so involved.

MR. MAISEL. I don't think so, because it's always been my feeling that the Federal Reserve is part of the government. It has to cooperate with the other parts of the government.

Committee on the Directive

MR. MAISEL. Let's go on to one more thing related to this. When Burns's appointment was announced as the incoming Chairman, I went to Martin and said, "Look, it took me over a year to find out how the Federal Reserve worked. Burns has to be told in some form or other what the thing is about, because otherwise he will be as misinformed as I was." So I suggested that he reestablish the Committee on the Directive, which Martin did. And he appointed me as chairman of the Committee on the Directive. I'm not sure what form the output of that committee took. It must have taken the form of a memo so that I could take it to Burns and say, "This is how the Board works," so that Burns could come in with some knowledge.

MR. SMALL. You were trying not only to convey how it worked, but also to advance the directive [Domestic Policy Directive].

MR. MAISEL. Right, yes. We wanted the directive [Domestic Policy Directive] to be quantitative—the System should add or subtract reserves if money and credit were not growing

at the rate desired by the FOMC. I've always admired Martin for his action on our report. My memory is that the new-type directive was passed during Martin's last FOMC meeting, but he need not have had a major policy change occur when he was about to leave. He could have pushed it off to Burns, but he didn't. He went out of his way to get the FOMC to adopt whatever we were advocating. I was surprised by that. This was just Martin's feeling that he ought to do the right thing. He was a very honest guy in that sense. So, in his last meeting, he got the FOMC to adopt the fact that we would use a new policy. Then in Burns's first meeting, we adopted a policy under the new techniques.

MR. SMALL. My understanding is that this new technique was the first time—

MR. MAISEL. A quantitative measure was used.⁸ It was a question of whether to focus on reserves and total credit or both. There was always some balance there with some believing it was both, and some—

MR. SMALL. Prior to that it had just been credit by itself?

MR. MAISEL. No, it had never been credit, it had been the “feel of the market” and the amount of free reserves plus or minus, which was a very small amount. The directives were in terms of free reserves.

MR. SMALL. During Martin's time, was there was a lot of tension between him and Alfred Hayes, the New York Fed president, or between the Board and the New York Desk about discretion and how closely the Desk was following the directive?

⁸ “To implement this policy, while taking account of the forthcoming Treasury refunding, possible bank regulatory changes and the Committee's desire to see a modest growth in *money and bank credit*, System open market operations until the next meeting of the Committee shall be conducted with a view to maintaining firm conditions in the money market; provided, however, that operations shall be modified if *money and bank credit* appear to be deviating significantly from current projections.” (Emphasis added; see Board of Governors of the Federal Reserve System (1970), “Memorandum of Discussion” (January 15), p. 110, available at the Board's webpage “Federal Open Market Committee: Transcripts and Other Historical Material.” This quote from the transcript is from the final FOMC meeting attended by Chairman Martin.

MR. MAISEL. There always was tension with Charles A. Coombs, but never with Alan R. Holmes.

MR. SMALL. What about Martin and Hayes?

MR. MAISEL. I don't know. I didn't ever feel any particular tension there. There may have been. The only tension I knew was with Coombs, because he wanted to run by himself. He went to Europe, and nobody else went there most of the time.

The Rise in Inflation

MR. SMALL. We've crept up to early 1970. In your book, you talk about successes and failures, and the failure you note is that inflation got unhinged. One explanation, which you've referred to a little bit here, is aggregate demand took off.

MR. MAISEL. Well, what happened there—I'm not clear on the exact dates—is that the tax bill was passed. And I felt—and eventually the whole Board felt—that we had made a promise to the Congress that we would loosen money if the Congress passed the tax bill. So in the first meeting or so after the tax bill was passed, we loosened money according to whatever measure of money we were operating with then. Now, I think that turned out to be a mistake. The tax bill didn't have as much negative impact on aggregate demand as was projected.

MR. SMALL. In your book, you mention two areas where Martin got a little grumpy with things. We talked about the Patman hearings, but also exactly this point, the forecasting in 1968, the use of formal models—that Martin kind of bought into it, with Dan Brill developing this new stuff, and with you backing the models, and—

MR. MAISEL. The model was wrong.

MR. SMALL. One of the critiques was Milton Freeman's distinction of temporary versus permanent tax cuts, which the model presumably did not incorporate. But the modeling effort took a hit at that point. That set Martin back to his ways of—

MR. MAISEL. No, as I say, because in his last meeting he put through the report, my committee's report. Poole has written something about this at the conference memorializing Frank Morris of the Boston Bank.⁹ Poole was engaged in the Committee on the Directive. Whether he was on the Board staff or whether he was consulting with Frank Morris, I'm not sure. And I don't remember what Poole said in that paper, but there's something about that Committee of the Directive and the adoption of that policy in the thing that Poole wrote 5, 10 years ago. The point was that Martin at his final meeting prepared the FOMC to adopt a quantitative directive.

MR. SMALL. So by 1970, when Burns came in, inflation was certainly higher. I can imagine newly minted Ph.D.'s nowadays looking back over the postwar period and saying, "In 1979, Paul Volcker came in when inflation was out of control. He slew high inflation, and inflation has been low since then. It's really not that hard to control inflation if you move interest rates enough. Those guys before Paul Volcker didn't get it. It's just not that difficult."

MR. MAISEL. The feeling, I would say, was that to really get interest rates to work, you had to hit the economy very hard, and the country didn't particularly want to make that choice. People weren't that afraid of inflation yet, and therefore the unemployment rate was a more significant concern. For example, Okun often said that the unemployment rate should be under

⁹ See William Poole (2000), "Monetary Aggregates and Monetary Policy in the Twenty-First Century," in Richard W. Kopcke and Lynn Elaine Browne, eds., *The Evolution of Monetary Policy and the Federal Reserve System over the Past Thirty Years: A Conference in Honor of Frank E. Morris* (Boston: Federal Reserve Bank of Boston), pp. 13–24.

4 percent. Now, it wasn't until Volcker that people were agreeing on a higher value of the perceived "full employment" level of unemployment—suddenly it went from 4 to 6 percent.

During the 1970s, there was this constant question of, how much unemployment is the country willing to take? Volcker agreed that it should take a lot to bring inflation down. But during the 1970s, the price–wage controls under Nixon were thought of as a way of keeping unemployment and inflation down. In other words, the tradeoff was there in the price–wage controls.

MR. SMALL. Volcker has said that what he did in 1979, the Board could not have done two or three years earlier. There wasn't the public support.

MR. MAISEL. Yes. My feeling is that the level of unemployment was given a lot more weight. The maximum or the optimum rate of unemployment was questionable, just as it is questionable now and has been for the last couple of years. For a long time people talked about 6 percent, and then it gradually dropped down to 5 or 5.5. I remember Okun very distinctly using 4 percent as what the unemployment rate ought to be under. It took a long time for the policy objective to be primarily inflation.

Chairman Martin

MR. SMALL. How did the approaches of Martin and Burns differ in running the Federal Reserve?

MR. MAISEL. Let's talk about Martin first. Martin was a guy who felt he had a certain number of chips and he would only use them in critical times, which meant that, most of the time, whatever the rest of the Board wanted, he would go along. He never wanted to be in the minority, so he would vote last. And if it was 3–3, then he could make the decision. If there

were four votes already, he would always go with the majority. He never was willing to fight about anything except what he felt were the critical decisions on monetary policy.

He didn't pay much attention to how the Board ran and stuff like that. He let the Board do it. That meant, for example, that Vice Chair Robertson and the Legal Division had much too much say. There was a point when the Comptroller of the Currency was liberalizing banks, I think properly. And the Board wasn't going along, because Robertson opposed it. I fought him for a long time and finally won one, because there was a Supreme Court decision that said this was something that the Federal Reserve Board had to decide, and I said, "Look, it says the Board, it doesn't say the Legal Division of the Board. It says the Board has to decide! So to heck with what the Legal Division says, the Board should decide." And we did. Martin came up and thanked me afterward, because he didn't like what was happening but was never willing to use his power.

MR. SMALL. He's given a lot of credit for bringing the Reserve Bank presidents into policy discussions, for building this system.

Arthur Burns

MR. MAISEL. Yes, but he was willing to, as I say, let it go, whereas Burns was the opposite. I only served with Burns a little while. He couldn't stand having any opposition, and he would spend a lot of time with a Bank president who opposed him. He'd call him in and talk to him for hours to get him to change his mind and to convince him that Burns's policy was right. Andy Brimmer never understood this, so Burns would get mad as hell at Andy, and Andy couldn't understand. He was just expressing his own opinions, but the fact that they disagreed with Burns was, to Burns, a terrible situation.

MR. SMALL. Burns came under some criticism on the thought that he was more beholden to political pressure than Martin. Do you agree?

MR. MAISEL. Yes. In fact, when I wrote my book I had a couple things in there that Burns asked me to take out, and he never really was friends with me anymore because I had those in my first draft of the book. There were two things. I quoted James B. Reston that Martin opposed Burns, and Burns claimed Reston was wrong, but I was quoting Martin, really—not directly, but through Reston. But since Burns felt so strongly, I took it out.

The second thing occurred before the 1972 election at a meeting of the directors of the Reserve Banks, which was held once a year. Burns, inadvertently I'm sure, made some remark about how important it was to reelect Nixon.

MR. SMALL. You were on the Board until the spring [of] 1972.

MR. MAISEL. Yes, officially until the end of January 1972, but there wasn't another appointment until June, so I stayed on, although I was in California most of the time. I would come back for meetings.

MR. SMALL. There's a famous story, and there's testimony on both sides. Maybe this was after your time on the Board, but the story concerns an FOMC meeting: Burns gets up, leaves, goes into his office, takes a phone call from Nixon, comes back and says something.

MR. MAISEL. I know nothing about that. But, as I say, I did hear Burns say it's very important, telling all the directors of the local branches of the regional Banks, to reelect Nixon.

MR. SMALL. Did you have a sense of the political pressure that Burns was under from Nixon and Halderman?

MR. MAISEL. Yes, but from the other guy, the guy who went to jail. Burns was limp from the attack from the White House on him. Charles W. Colson made a bitter and incorrect

attack that he gave to the press without being quoted, but it was obvious that it was Colson, and Burns just was completely lost. He didn't understand how Nixon could let this happen, but I'm sure it was at the instigation of Nixon.

MR. SMALL. Was there a sense any time during your tenure that a Chairman might have to balance short-run policy versus the independence of the Fed—that the Administration would rein in the Fed through legislation or something?

MR. MAISEL. Yes, with Patman particularly, since he always had a bill to do away with the powers of the Fed. There was a general recognition that you had to handle the Congress in such a way that Patman wouldn't get his way.

The Bank Holding Company Act

MR. MAISEL. The Bank Holding Company Act, for example, is interesting. Under the previous law, you could have a one-bank holding company.

MR. SMALL. Because the law was written plural, right—"banks"?

MR. MAISEL. Yes.

MR. SMALL. If a holding company held banks, plural, it came under the supervision of the Federal Reserve. And they said, "Well, we'll hold only one! Therefore we're not subject—"

MR. MAISEL. Right. So, at some point, the big banks thought, "Oh, boy, we'll become bank holding companies under the one-bank thing."¹⁰ I asked Martin to set up a committee, which I headed, on what the Fed should do about this and how it should handle the whole bank holding company thing. After one bank spent a lot of money on lobbying to keep it the way it

¹⁰ Editor's note: "The 1970 amendments [to the Bank Holding Company Act of 1956] changed the definition of bank holding companies to encompass companies that control only one bank but restricted the definition of a 'bank' to those institutions that accept demand deposits and make commercial loans. The 1970 amendments also modified the standards under which bank holding companies may engage in nonbanking activities." See Congressional Research Service (2001), *A Reference Guide to Banking and Finance* (New York: Books for Business), p. 57.

was, one of the big speculators took a computer company where, say, your price to earnings ratio was 100 to 1 at that time. He found he could buy another large bank cheaply with the stock of his computer company. Under the one-bank holding company act, there was nothing they could do about it, so the acquiring bank turned 180 degrees. Suddenly, every bank was scared—not that they were going to buy out everybody, but that everybody was going to be able to buy them out, because the stock prices of computer firms and others were so much better! So there was a 180-degree turn, and that led to the new Bank Holding Company Act.

Under Patman's draft, he wasn't going to let banks do anything. The Holding Company Act had to be expanded. The legislation had to be changed to include the one-bank holding companies, and Patman said the list of what banks could do should be as narrow as possible. My committee had come up with what we thought was a logical policy. There were some things that banks ought to be able to do and others that they couldn't do under the Bank Holding Company Act.

Anyway, as a result of this, I went to Henry Reuss, who was the second man on the House banking committee, and got him to agree on the wording that finally appeared in the act, which said that the Federal Reserve in effect could, with proper study and thought, increase the things that bank holding companies could do. He replaced Patman's "no rights" with whatever the eventual clause was, and the clause in effect said that, with hearings and reports, the Fed could expand what banks could do within limits.

MR. SMALL. This is basically to expand on the asset side of the balance sheet?

MR. MAISEL. On what the other companies in the holding company could do, it was really both, but it was mainly that you could set up an insurance company, something you couldn't under the original act, as well as other things. Glass-Steagall still applied. You

couldn't do investment banking, but things like insurance and mortgages, maybe stuff like that, the Board could allow you to do in the holding company. I don't think they were automatically allowed in the banks. I think these functions had to be in separate companies.

Eurodollars and Liability Management

MR. SMALL. The banks expanded through the bank holding companies on what activities they could go into. On the liabilities side, you had Regulation Q. That spurred Eurodollars and a lot of innovation to get around Regulation Q. So the banking sector was changing quite rapidly?

MR. MAISEL. Right, yes. One of the fights I had with Martin was on Eurodollars. That was the only time I felt he misused his chairmanship. The big banks were bringing in lots of Eurodollars, which didn't require reserves. So, in effect, the Fed had lost control of that part of the bank liabilities.

In his monthly meetings with the banks—there were only five or six involved—Martin thought he had gotten them all to agree that they would limit the amount of Eurodollars they brought in, and therefore he didn't want to put reserve requirements on Eurodollars. Some people agree a better theory is that you're better off with an informal agreement rather than a regulation.

Even though I had a majority, Martin would never put it on the agenda. That was the one time that he controlled the agenda—to stop reserves against Eurodollars. For what I would say was four or five months, we both knew that the majority of the Board wanted reserve requirements against Eurodollars, but he had this agreement with the major banks to restrict their funding through Eurodollars, so Martin wouldn't allow the regulation to be passed. Then he called me in one day, and he said that he got a call from David Rockefeller at Chase Manhattan

Bank that Walter Wriston at Citibank had broken our agreement, and as long as Citibank was doing it, he [David Rockefeller] would have to do it. So our agreement no longer held. Martin came in and said, “Now that the agreement doesn’t hold, we’ll put the issue of reserve requirements on Eurodollars on the agenda and pass the reserve requirement thing that you’ve been trying to get for five or six months.” But that was the only time in my experience that he controlled the agenda.

MR. SMALL. Under the law, the Chairman does not have many special powers. He’s just a member of the Board. He votes along with everyone else. But one of the few explicit special powers he has is that he controls the agenda?

MR. MAISEL. I’m not sure. But that was the only time that happened, and it was simply a difference in philosophy. He felt he was better off with his informal agreement than with a regulation. Yet when Rockefeller told him the agreement was busted, then he felt the regulation was necessary.

MR. SMALL. That Citibank under Wriston went out more to the edge and broke the agreement and Chase didn’t—was that a general difference in the culture of the banks?

MR. MAISEL. Right, I thought so. I didn’t like Wriston’s culture, ever. I thought it was wrong, particularly in his lending in South America and stuff like that. I thought he had gotten the American banking system in problems several times.

Handling Financial Crises

MR. SMALL. In your book, one thing you say about the successes of the Federal Reserve was the lack of any serious financial meltdown.

MR. MAISEL. Yes, and particularly in the Penn Central case, which everybody realized at that time was a critical thing. I have a good story there that I tell frequently. In about the third

day of that crisis—Penn Central—the commercial paper market was going to hell, and the main company that was under tremendous pressure was Commercial Credit, I think. Morgan, which was the chief lender to Commercial Credit, called a meeting of the lenders—there were 40 or 50 or something like that in the line of credit. Normally, at that time, in commercial paper you had to have a bank backup. I don't know if it's still true. You only called in the backup in critical times, so Commercial Credit was calling on its backup, and the question was whether the situation was changed so the bank has the right to not—

MR. SMALL. Sort of a “material adverse change” type of issue?

MR. MAISEL. Right, like the Merrill Lynch thing now. Anyway, so that was the meeting that Morgan called, and Morgan said, “We're going ahead. We feel this is what the backup is for. We're going to do it. How about the rest of you?” A couple of little bankers got up and said, “It would be unfair to our stockholders. The risk is too great. We're not going to allow them to draw funds from the backup agreement.” The president of JP Morgan got up and said, “Okay, that's fine. We'll take your share, but never come near Morgan again. We'll never do business with you again if that's the way you do business.” And both of those little guys said, “Oh, no, no. We'll lend. We won't withdraw our commitment.” The president of Morgan was one of the admirable guys, and that's a story I frequently tell. It seems to me it is what a good banker can do, as opposed to a “nongood” banker.

MR. SMALL. Let's set that up. The commercial paper market had grown [to be] significant.

MR. MAISEL. Yes, that may be, and Penn Central was the first major failure in the market, so the people who had lent on commercial paper to Penn Central lost their money.

MR. SMALL. The credibility of the commercial paper market was in question.

MR. MAISEL. Yes. And the finance companies were the largest users by far, because that was their business. They borrowed on commercial paper and made loans to individuals.

MR. SMALL. This was all credit flowing outside the banking system except for the backup lines.

MR. MAISEL. Right.

MR. SMALL. Was that seen as something that reduced the leverage of the Federal Reserve?

MR. MAISEL. No, it wasn't that important. We followed the amount of commercial paper—how much there was and stuff. But it goes way back, because in England, that's the way the Bank of England does it—through bills, in effect, that are really commercial credit.

MR. SMALL. Financial crises up through that time include Penn Central, Franklin National—

MR. MAISEL. Yes. The other big one would've been the whole question of Regulation Q and the savings and loans. A couple of the big savings and loans went broke in 1966 or 1967 because—

MR. SMALL. How was the Regulation Q ceiling changed? It wasn't that the Board could unilaterally raise—

MR. MAISEL. Well, again, it was and wasn't. As part of the deal where we didn't have to meet officially with the Treasury and the Council of Economic Advisers, we still had to meet if we wanted to change Regulation Q with the [Federal] Home Loan Bank [Board] and the FDIC. That had to be a joint meeting. The Board could change Regulation Q, but the others could comment. For example, at one of those meetings, there was an agreement that we had to move the ceilings. Preston Martin, who then was head of the [Federal] Home Loan Bank [Board],

knew the savings and loans didn't want the ceilings raised. He agreed in the meeting and then said he opposed it publicly purely for political reasons—because he wanted to appear to go along with the savings and loans.

At that point, big savings and loans had boiler room operations. Later on, I was brought in by the [Federal] Savings and Loan Insurance Corporation to help run a failed S&L.

Something like 80 percent of their money came from their boiler room. They knew how much money they needed every day, and they had 20 people at phones. They knew where to call, and they would offer a different rate if they needed to, to get the money they needed that day.

MR. SMALL. It might've been after you left the Board, but at some point you studied the effect of FDIC deposit insurance. At that time, the savings and loans could bring in money: It was insured. How aware were policymakers of the moral hazard problem during that time?

MR. MAISEL. Bill [William F.] Sharpe, in accepting the Nobel Prize in Economics, indicated that one of his great disappointments was that the government didn't act on our memos to them about the risk.¹¹

MR. SMALL. But early on, weren't you thinking hard about adjustable-rate mortgages to give the S&Ls more flexibility?

MR. MAISEL. Yes, because I realized the risk they were taking by borrowing short and lending long. I realized that before I went on the Board. And all of the time I was on the Board, I urged them to change, because the interest rate risk was too great. They had to get a more

¹¹ "I spent the 1976–1977 academic year at the National Bureau of Economic Research as a member of a team studying issues of bank capital adequacy under the direction of Sherman Maisel. . . . The NBER project strongly advocated greater concern with the risk of financial institutions and warned that a system of fixed insurance rates and de facto unlimited coverage with imperfect monitoring and enforcement procedures provides dangerous incentives for those running such institutions to take excessive risk. Would that our results had been heeded by those concerned with savings and loan institutions in the United States in the subsequent decade!" See William F. Sharpe (1990), "Autobiography," *Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel*, in Tore Frängsmyr, ed., *Les Prix Nobel/The Nobel Prizes 1990* (Stockholm: Nobel Foundation).

flexible mortgage rate to limit that risk. I gave quite a few speeches while I was on the Board about this risk.

MR. SMALL. But, at the time, adjustable-rate mortgages would've been the only way that S&Ls could have gotten more flexibility on their balance sheet, because they couldn't go outside of mortgages and get it that way.

MR. MAISEL. Right, yes. They could go to consumer loans and stuff, and they tried, but it never got very important. Before I went on the Board, I did a book on real estate finance. This was the thing that struck me right from the start—what a tremendous risk they were taking by borrowing short and lending long.¹² And then we did this study.

MR. SMALL. After you left the Board?

MR. MAISEL. After I left the Board. And, as I said, in his Nobel Prize speech, Sharpe said this was a great disappointment, that the government paid so little attention to our pointing this out to them.

MR. SMALL. Just pointing out the interest rate risk or the FDIC insurance or both?

MR. MAISEL. The fact that they were allowing the banks and the savings and loans to game against them. This was a losing situation, as far as the government was concerned, by allowing that much gaming.

MR. SMALL. The commercial banks also had FDIC insurance.

MR. MAISEL. Yes, but they had a little more capital. At that point, the S&Ls were down to zero capital. I noticed yesterday the FDIC closed two that had negative capital. But these were commercial banks—theoretically, that shouldn't happen. But in S&Ls, I guess

¹² Sherman J. Maisel (1965), *Financing Real Estate: Principles and Practices* (New York: McGraw-Hill).

Reagan's Administration let them go to negative capital, which was a pure game against the government.

MR. SMALL. During your time at the Board, do you remember concerns about or efforts on capital ratios, [the] amount of capital, and the banks taking it too low?

MR. MAISEL. No, I don't. The number of regulatory things we had was very small. One or two [times] a year was all that ever came. Of course, we only had the state member banks. We didn't have any say about either the nonmember banks or the national banks. Any power that the Fed has come through the bank holding companies, not directly. I don't know how many state member banks there are any more.

MR. SMALL. As interest rates rose with inflation, the cost of holding reserves rose. Was the Fed concerned about losing control because of declines in membership?

MR. MAISEL. It was a little concerned, but not very much.

MR. SMALL. By 1980 and the Monetary Control Act, it might've gone—

MR. MAISEL. Not while I was there. I think Chase shifted from being a state member bank to a national bank, but that was because [of] this fight over regulation, that the Comptroller was properly liberal in most of his cases and Robertson wouldn't let the state member banks do what the Comptroller was letting the national banks do. I think it was Chase. Wells Fargo may also have been involved. I don't remember which they were, but two or three of the largest banks were state member banks, and they shifted to national because of this fight.

MR. SMALL. Later on, a term that came into play a lot was "regulatory arbitrage."

MR. MAISEL. Yes, that was what it was, but I have no feeling for what the situation is now with respect to state member banks. But at that point, 2 or 3 of the 10 largest were state member banks, and the others would have been national banks. You didn't have any large

nonmember banks, because at that point the only way you could fund a bank was with deposits. Few large depositors were going to put money in a nonmember bank. But just as I was leaving, Maryland suburban banks were nonmember banks, and they were about the largest nonmember banks at that time.

MR. SMALL. So they had to be members.

MR. MAISEL. To get the discount window access—and any large depositor, noninsured depositor, wanted the guaranteed liquidity of the discount window. So they wouldn't put their money in a nonmember bank.

[Lunch recess]

Reserve Banks

MR. MAISEL. I would say that all the time I was at the Board, the directors of the regional Reserve Banks were thought of as a way of getting the public to know what the Federal Reserve did. They were a conduit for information. Whether you want to call it public relations or not, the theory was that you want prominent citizens all over the country understanding how the Federal Reserve works, and that was their function.

MR. SMALL. With the recent crisis going on—in particular, with the role that Timothy Geithner played at the Federal Reserve Bank of New York—there's going to be questions about whether Reserve Bank presidents should be confirmed by the Senate.

MR. MAISEL. I thought they shouldn't be on the [Federal] Open Market Committee. I don't think the [Federal] Open Market Committee ought to exist.

MR. SMALL. Just have the Board?

MR. MAISEL. Yes. The Reserve Bank presidents were a useful source of local information, but they shouldn't particularly have a vote on monetary policy. On the other hand,

how you would get decent people to be Reserve Bank presidents if you didn't give them some say is the opposite question, but it never seemed to me that that was a logical way to get people. I followed the rule, which we did once or twice, that the voting Reserve Bank presidents could never outvote the Board members. Once or twice, when we changed the discount rate, we convinced a District [Reserve] Bank to act. I can't recall each one, but I know at the time I felt very strongly that, if necessary, the Board could act. It has never used the power, but it does have the right to set the discount rate without the vote of the Reserve Bank presidents. And once or twice we threatened to do it.

MR. SMALL. What about the structure of the Federal Reserve being heavily involved in bank supervision and regulation? In some countries, supervision and regulation is set separately from the central bank.

MR. MAISEL. My feeling was that it was useful for the Board to be there, because it was more independent. With any type of decision that you wanted to keep politics mainly out of, it was good to have the Board to do it, and in regulation that was important at times. For example, I think the claim that the [Federal] Savings and Loan Insurance Corporation or the Federal Home Loan Bank Board always was dominated completely by the industry was somewhat true. And, in effect, the Board was keeping the other two regulatory agencies honest. That was the main reason for keeping some regulatory functions in the Board. It improved the regulation by the non-Board regulators.

Bank Regulation and Supervision

MR. SMALL. How do you draw the line where the Board supervisory powers should end and where people on the other side should be able to go out and play and take risk and make money in open and competitive markets?

MR. MAISEL. I'll have to say, I never thought too much about that one way or the other. One thing: I wasn't in favor of the repeal of Glass-Steagall. I was in favor of a semi-limited banking system. I always felt that it was important to keep competition in local markets, that the main priority of competition was really for local businessmen, and that you wanted at least six or seven banks or something that they could go to. During the Depression, my father was a businessman. The banks tightened, and there was nothing you could do about it. It turned out not to be critical, but it almost was. It seemed to me that the average local businessman is in a situation where he would like enough competition among banks so that he wouldn't be squeezed.

MR. SMALL. Another way banks can expand is to move from commercial into investment banking.

MR. MAISEL. I thought that they ought to remain commercial and mortgage banks, for consumer loans and stuff, too. But even if you got down to a town of a couple hundred thousand people, you would want seven or eight banks. You wouldn't like just two or three.

MR. SMALL. On the expansion of the financial sector, what processes led to our current—

MR. MAISEL. When I was there, it was shrinking. Commercial banking was becoming a smaller part of the whole financial section. Insurance companies were becoming more important. Savings and loans were growing. Savings banks held about even at that point but later lost. But I saw no reason for banks to go into investment banking. Now, it turns out, that was very right. Banks should not have gone into securitization so heavily. From the little experience I had with mortgages, I would never want a situation where a bank didn't have some

of its own money in the loans it made. The idea of being able to have no claim against you at all doesn't make for a sound banking system.

MR. SMALL. With Penn Central and the commercial paper market, you experienced this idea that markets can freeze up. Now we don't think about only institutions or banks going bad, but whole markets—it's the LIBOR market, it's the commercial paper market. I don't know if you want to call this mission creep, but the scope seems to be ever expanding, and then wherever we stop our regulation, the markets set up outside that.

MR. MAISEL. Yes, well, my feeling simply was that good commercial banks ought to run as a commercial banking system and not other things. That would stop a lot of the problems we're having, in a way. In our book on bank problems, we primarily warned against interest rate risk, that this always ought to be a critical regulatory thing.¹³ Secondly, regulators ought to be cautious anytime there is a big expansion in a bank of any type of loan. Those two were the only real risks we could find. If you went along lending as you had been lending, and so on, you didn't make mistakes. But the risks were always that you would suddenly go from 5 percent of your assets to 25 percent of your assets, and that expansion would kill you. Those were the two main points we came up with, as well as gaming against the government.

Being a Board Member

MR. SMALL. When you were leaving the Board and you were summarizing some of the lessons learned, one of your criticisms was that the Board's allocation of effort and time was—

MR. MAISEL. Wrong.

MR. SMALL. Let's review that.

¹³ Sherman J. Maisel, ed. (1981), *Risk and Capital Adequacy in Commercial Banks* (Chicago: University of Chicago Press).

MR. MAISEL. Let me start in a slightly related way. I felt that being on the Board was a great job, because you could really do the job. You had half your time to think of other things. I gave a lot of speeches, but of those speeches, 5 or 10 a year would be semi-major research jobs that weren't officially part of my job. Being on the Board gave me both the time to do the research and the way of getting them public. So it didn't seem to me it was a question of lack of time to do the things.

The Board should have been—but it wasn't—organized for the staff to optimize its efforts. As I said, that first shock in December 1965 was that I thought I had asked quite a few times that there be a study of what would be expected to happen if the discount [rate] were raised, there was no such thing. I gather that could still be the case—or at least when I left, it was still the case. It was the failure of staff use to which I was objecting.

MR. SMALL. I think you said some place that the amount of time and effort that the Board put into looking forward and to designing monetary policy was surprisingly little.

MR. MAISEL. Right.

MR. SMALL. It was mainly reading where the economy is now. What freedoms did you feel you had in directly using the staff?

MR. MAISEL. I was the first one to ask for a personal assistant. I had a personal assistant within the first year, I guess. They were very good. One became the top American at the IMF [International Monetary Fund]. One became chief of staff for the Council of Economic Advisers. And another became president of the San Francisco Reserve Bank. Those were my three special assistants, so I obviously had good aides.

When we started with the formal models of the economy, the assumption was that you could say, "I would like to see what happens if this assumption is changed." I think I did that a

few times. Otherwise in doing this research, I'd do it with my assistant, and then we would send it out to one, two, or three people in the parts of the Board that were handling whatever that question was. A lot of the effort was still related to housing and mortgage finance.

MR. SMALL. How directly did you interact with Dan Brill about setting the research agenda?

MR. MAISEL. I would talk with Dan a lot. I think he would want to be there when I was talking with a staff member, except for when I was sending out my speeches for comments. I would send them to whoever I thought ought to have something to contribute.

Transparency

MR. MAISEL. I've got two other things I'd like to discuss. One is transparency. I kept pushing for transparency. Later I was quoted at length on transparency by the minority of the Supreme Court rather than the majority. Now the Board would say "yes" to what I wanted.

MR. SMALL. This is the lawsuit by David Merrill against the FOMC? Could you discuss this a bit?

MR. MAISEL. The issue was, at what point should the decisions of the Board be made public? I was always in favor of them being made public sooner. It's changed now—it has gone 180 degrees.

I was arguing two things. First, we were giving investment bankers a big break by not publicizing our decisions, because they could figure them out before the public could and make a lot of money. That's what was quoted in the court decision, I think.

Secondly, the public wasn't as sure what the FOMC's decisions meant. One of the only times I called my own press interview was when I thought the press was misunderstanding the Board's policies. I can't remember why I had to do it myself, but I guess because the other

people didn't believe in transparency. I felt that we were in a situation where the misunderstanding was causing us lots of trouble. I got the press department of the Board to set up a public interview with the press because of this transparency point.

MR. SMALL. Nowadays in the profession, widely—and especially in academics—expectations are seen as important. One place they come into play is in modeling the setting of wages and prices. At some point, perhaps in the 1960s, the expectations of stable inflation got unhinged, and that led to big problems. The other is the expectation of the Fed following systematic behavior and getting that behavior put into market interest rates so that markets understand and work with us.

MR. MAISEL. Right, and that was what I was arguing from the start. But the whole philosophy then was exactly the opposite, and I just felt it was wrong. At quite a few meetings, I said, “We ought to make this clearer right away.” And, as I say, two things: In the Merrill case, I would've gone the other way—I was off the Board when it was decided—but, secondly, I did call this press conference, because I felt that the transparency was important. Transparency was a constant battle.

MR. SMALL. People are used to thinking of Keynesians versus monetarists. Your move to transparency and quantitative objectives on policy can look very monetarist, while some of your other statements can look quite Keynesian, so you partake of both.

MR. MAISEL. Yes, but they were two different things. In the monetarist [camp], I had lots of arguments with Herbert Stein and George Schultz and others that I was always concerned about velocity changes. It seemed to me that the velocity changes are as important as the quantitative change, and yet they simply gave no weight to the change in velocity, so I simply thought they were wrong. They were right in the idea that quantities were important, but you

had to weight them by the velocities. You couldn't use them by themselves, and they never mentioned velocity.

MR. SMALL. Velocity, if anything, became more volatile after—

MR. MAISEL. Yes, and also when you think of the narrowest money supply, half of it's held abroad. It has nothing to do with domestic policy.

MR. SMALL. Yes, and then the high interest rates caused a lot of financial innovation, and you had lists of different definitions of money: M1, M2, and M3.

MR. MAISEL. Right. I've got several speeches in which I make that point quite often.

Supply Side

MR. SMALL. One important development in the academic literature was the natural rate of unemployment and the vertical long-run Phillips curve that came along in the late 1960s. Do you remember the debate within the Board and the modeling effort about the short-run and long-run slopes of the Phillips curve tradeoffs?

MR. MAISEL. I wrote my first macroeconomics book because it seemed to me the whole question of the supply of output was neglected in the price curve. Around 1955 to 1956, I wrote it because the supply side of the curve wasn't in the models, and it never really got there, I felt, until much later. But again, that was the problem of the monetarists, that they didn't pay enough attention to output. And my feeling with the Keynesians is that the supply curve can be shifted by monetary policy. A good monetary policy gives you maximum productivity and maximum investment. The supply curve is not fixed. The price level is not primarily or completely a function of money. It's also a function of what's happened to the supply curve, and this is completely outside of the monetarists' literature.

MR. SMALL. From reading some statements you made like that, you sounded almost like Alan Greenspan when he talks about how low inflation lets business people plan better, and it helps investment productivity.

MR. MAISEL. But I was talking about the amount of money doing that.

MR. SMALL. Do you think the Board generally, and the modeling staff in particular, was slow to catch on to the shifting—the expectations-augmented Phillips curve?

MR. MAISEL. Maybe. But Meltzer, it seems to me, is wrong in what he writes. I certainly never had a feeling—and I don't think Okun or anyone like that had a feeling—of a true Phillips curve in the short run. I never heard it argued that you had a tradeoff between prices and output. That just didn't exist. It may have existed a little in the academic literature at that time, but nowhere in Washington did I ever hear a discussion of a short-run tradeoff, that you could trade inflation for output.

MR. SMALL. One view I have read about—I forget where—was that when John F. Kennedy became President in the early 1960s, there was the “new economics,” and economic things generally went well for a while. But somewhere in 1965 to 1968, some of the traditional Keynesians—Okun, Solow, or Tobin—were getting the feeling that we needed to worry about deficits, because if inflation ramps up, that will destroy the legacy of everything they've accomplished. Were Okun and other Keynesians concerned? Did they switch to wanting tighter monetary policy?

MR. MAISEL. No, I don't think there was that concern. I think another way of looking at it is that our knowledge of what was the optimum output level is very different now. The facts are different. The question of government statistics and how often they get revised changes history. So it's simply wrong now to go back and look at the revised figures and say they did

this or that because of the revised figures. Policy was made on the original figures, and the revisions have gone the other way to make policies look more inflationary than they did then.

MR. SMALL. Right. So there were a lot of statements that back in the middle of the 1960s, when unemployment was at 4 percent, the economy could be pretty well balanced at that point. Do you think that was a view generally held or generally reflected by the FOMC?

MR. MAISEL. Yes, I think so.

MR. SMALL. You could use monetary policy to get the unemployment rate down?

MR. MAISEL. Yes, or at least to let it stay there, but you might have to use fiscal policy. For example, after the December 1965 discount rate increase, Keynesians were very much concerned about the level of demand, and that was particularly true in the spring when credit kept going up even though the discount rate had been raised. The Keynesians, but not others, were concerned about the level of demand.

MR. SMALL. There was a fair amount of analysis of wage and price pressures to validate or reject whether the 4 percent was right?

MR. MAISEL. I don't remember a lot of discussion of it.

MR. SMALL. That number came out of the Council of Economic Advisers and was pretty well accepted.

MR. MAISEL. I don't know, but there was never a feeling that you ought to run at a level that caused prices to go up. I think that is completely wrong. There was never a consideration that there was a tradeoff, that you ought to choose higher prices for higher output. I'm positive that didn't exist. I think this is the sort of thing that Meltzer says was common, and it simply wasn't so.

The Great Inflation

MR. SMALL. If you were teaching about the general macroeconomic contours—that we got to a lot higher rates of inflation after 1965—what would you point out now for your undergraduates as the big milestone? Was it the OPEC price increases? Was it the Vietnam War?

MR. MAISEL. I think it was the interaction—during the 1970s—of periods of probably too high demand and letting prices go up too high, but that was considerably later. Then there was the attempt to do something about it in 1972, the Nixon price and wage controls, which I thought were right. Theoretically, the Board had been working on that, and so on—I'm thinking in terms of the going off gold completely. But at that meeting when the decision by Nixon to go off gold was made, there were no studies on the table. Nobody asked what's going to happen as a result of this. I guess Volcker represented the Treasury. I forget who represented the Board, or if we were even represented, but I know there were no studies at the meeting. Nobody looked at the question of what will happen as a result of this.

MR. SMALL. Burns was at that famous Camp David meeting, and he had been in favor of incomes policies.

MR. MAISEL. Yes, but I forget what the relation was to the going off gold. That was a separate meeting on a Sunday, and the Board wasn't involved. Burns may have been, but my feeling at that time was that nobody had looked at this carefully, although theoretically the Board staff had been working on it, but certainly none of it was at the meeting.

Guaranteed Insurance Contracts

MR. SMALL. Do you have another point or two you want to discuss?

MR. MAISEL. Yes. Inadvertently, we invented something called guaranteed insurance contracts, GICs, which became very important in the insurance industry. I was trustee of the Federal Reserve's pension system. I was amazed that the pension system was run by Harris Trust, and they would meet with the Reserve Bank presidents and not the Board. I was the only member of the Board to discuss the economy several times a year. I said, "This is a horrible conflict of interest. We can't allow this to happen. The money in the pension fund is basically the Treasury's money. The System is responsible for it, but there is no reason we should be trying to make money on the stock market, bringing in a private bank, and conferring with them on what's going to happen in the stock market. The pension ought to be put simply in government bonds. It may not be the most profitable, but it doesn't make any sense to put it in any other investments."

MR. SMALL. Until that point, Harris would invest it in the stock market?

MR. MAISEL. Yes. I said, "That simply doesn't make sense. We've got to go to government bonds." Then the question was, what should we do for the employees to guarantee the risk? I'm trying to think—there are two different questions involved here, and I guess the risk estimates and stuff were based on the way they invest.

When we decided to change to government bonds, the whole pension system had been set up with actuarial estimates for individuals and so on. Under my plan, the individual policies were done away with. We went to the insurance companies and said, "We have these 20,000 individual policies. We want you to take them over, and we'll cover them from the Board." They said, "Okay," and provided a bid. I said, "That makes no sense. You've calculated the risk on 20,000 people, and obviously the risk of insuring 20,000 in one policy is very different than that." They recalculated and bought the assets at a price that guaranteed everything. Our policy

with them covered all that had been insured up to that point—I guess is what it was—but it was for the policy they quoted then a single rate of return on the policy, having nothing to do with the individual's risk. It was simply that they were charging so much for the whole thing, and we said, "Fine." Then they found that this was a good business, just writing a single policy. I guess they still do it. It became a fairly sizable part of their business, selling these guaranteed insurance policies.

The other thing we did was to set up individual investment plans—the equivalent of 401(k)'s, which hadn't existed. We set them up so that the people could invest in them, and the Reserve Banks matched their savings. It was agreed that there'd be, I think, three managers, and they would only change for a two- or three-year period, so there wouldn't be any individual consultations between the Banks and the investment managers. That was set up to get out of having to consult with Harris Trust, which apparently bothered no one until I got extremely bothered by it.

More on Fannie Mae

MR. MAISEL. I didn't go very much into the Fannie Mae thing when, earlier in this interview, we discussed transferring it to a government-sponsored agency. The whole idea of lending on assets came out of that. We had to get a meeting with a lot of bond people. The question was whether we could sell securities backed by government-guaranteed mortgages, and what sort of rate would there be on mortgage-backed securities. That started the derivatives business.

MR. SMALL. Sorry, I've lost the thread here a little bit. How did you get involved with Fannie Mae?

MR. MAISEL. There was an advisory committee to the Secretary of HUD (Department of Housing and Urban Development), who was brand new. HUD was made a cabinet position just about that time. The advisory committee had people concerned with finance from the whole government. I represented the Fed on that. Jim Duesenberry was on the Council of Economic Advisers. They were worried that the money was disappearing from the mortgage market. Fannie Mae couldn't make loans because each mortgage they made would increase the government's deficit. FNMA (the Federal National Mortgage Association, "Fannie Mae") was part of the budget. Also, the loans that they were making were poor. They were rationing loans because they weren't made at market. So Duesenberry and I decided that we ought to get that changed. He asked the President to set up a committee, which consisted of Duesenberry, Zwick, and me. Our recommendation was that Fannie Mae be taken out of the budget and made a government-sponsored agency rather than a government agency. That was the first thing. Then, after Lapin came in to FNMA and there was a question of what they should do, I sat with him and a few of the others—probably Duesenberry and Zwick—on the question of how should Fannie Mae operate. The best bet seemed to guarantee pools of mortgages. If the pools were of sufficient size, they could be sold like bonds on the national bond markets, so housing wouldn't be dependent upon the savings and loan industry.

MR. SMALL. Fannie would buy the mortgages and sell the pass-through certificates?

MR. MAISEL. Right. That was when mortgage-backed securities were invented. Part of the discussion was what size would they have to be, and what about the fact that you would be getting payments depending upon whether the mortgages were sold off or not. It turned out, that caused a little worry, but not much.

MR. SMALL. During this period, by setting this up, did Fannie Mae have much of an influence on how mortgages were written. For example, no prepayment penalty?

MR. MAISEL. No. They bought regular mortgages. The real question was, should they hold all the mortgages in their portfolio—that would be limited by the amount of capital they had—or should they raise money by selling the mortgage-backed securities with their guarantee? Later they simply gave their guarantee, for which they got paid. They didn't even buy the mortgages or look at the mortgages—or, at least, not much.

I was on a loan committee at a mortgage company once. We did a couple billion dollars of Fannie Mae-guaranteed loans. We had the right to make the loans—these were apartment house loans—under an agreed-upon system. Then Fannie Mae had the right—after we had sold their guarantee—to audit them and come back to us and say, “We don't think you should've made this loan,” or “We would like you to change your lending in this way,” but the guarantees were there already. Fannie Mae was paid for the guarantee, but they had no administrative function.

Small: Then Fannie Mae was privatized, and that led to problems, because Fannie Mae had obligations to its stock holders, but they had this public—

MR. MAISEL. Yes, well, Fannie Mae felt it had to be competitive and make nonprime loans. The part I was with was the exact opposite—there were very strict controls. I think we made two or three billion dollars' worth of loans. I don't think there was a foreclosure on any—well, maybe one or two.

I've covered the topics on my list.

How the Board Operated

MR. SMALL. Let's switch topics to how the Board worked.

MR. MAISEL. Under Martin, it was a very collegial Board. We had lunch together every day. Not everybody was there every day, but, I would say, in the Board dining room, there were four or five people every day, and we would discuss everything. Now, I'm told that, partly for legal reasons, no three members of the Board could eat together.

MR. SMALL. It might be three and not four, but there is a limit.

MR. MAISEL. I have been told, so I don't know personally, that under Greenspan, the collegial thing collapsed completely, whereas all the time I was there we were very close. If that is the case, the whole manner of the Board changed completely.

MR. SMALL. What about the Federal Reserve staff and the role of minorities?

MR. MAISEL. One member of the Board—and I guess I had it most of the time I was there—was in charge of the Reserve Banks' budgets, so the Banks had to submit their budgets. I must have had a staff [member] looking at that. We had to approve all the Reserve Bank budgets. I suppose they still do.

In terms of the staff, when I came on, and even maybe when I left, the whole question of staffing was for the Board as a whole. But at some point, the Chairman was given that responsibility. I'm not sure that he had that responsibility when I came. We had quite a few three-man committees of the Board. And the presidents of the Reserve Banks always had their own committees. Lots of things were done by those committees, like the pension thing. A Board member would be part of a committee.

MR. SMALL. Do you remember efforts on hiring minorities or advancing minorities?

MR. MAISEL. No. That one never came up while I was there.

MR. SMALL. What about the Vietnam War? Did that make you feel more sensitive about changing interest rates because of effects on the social fabric, or that you didn't want to

finance the war through money, and that it would be better for the government to do it through taxes?

MR. MAISEL. Yes, there was some feeling—which Patman was obviously the ultimate expression of, but Johnson felt the same way—that interest rates did cause a change in distribution of income. And there was—at least in my mind—always a question of the fact that when you moved interest rates, you were changing income distribution.

MR. SMALL. What reflections or advice would you have to a new Chairman about the importance of the composition of the Board or the management of team work?

MR. MAISEL. Well, I thought it was very important that we were good friends and had lunch every day, where maybe we would discuss the Vietnam War, for example. We didn't discuss monetary policy or anything at those lunches, but we got to know each other very well.

MR. SMALL. In your book, you have a listing of which groups are powerful. You put the Chairman first, then the staff members. Are the staff members powerful—and rightly so—because they are modern researchers, or because they, in effect, define the conversation by having the paper that everyone reads off of?

MR. MAISEL. I would say both, because of their knowledge. But also the way that they brought the knowledge to the Board was important.

MR. SMALL. Do you think the relationship between Board members and staff members has changed, in that, now, for example, we have Chairman Bernanke, who is a very successful academic researcher. He's not the first by any means, but he can clearly handle his own, and we have a lot of Ph.D. economists at the Board level. Those Board members can hold their own on the professional economics level, whereas before, in your day—

MR. MAISEL. When I came to the Board, the economists were just starting to take over. It was different before. When I was on the staff, just out of college, I didn't even know who the Board members were. Eccles was the Chairman. You can see his house from here, where he lived, but I don't think I had any idea then who the other members of the Board were. They were almost nonentities and did little. One of the famous cases—James K. Vardaman, I guess it was—took his messenger, and they went off for a month at a time.

MR. SMALL. Was there a problem in communication between the Board staff, with their mathematical approach to economics, and the Board members, with their more intuitive and less formal approaches to economics?

MR. MAISEL. When I came, there were three known economists, plus C. Canby Balderston. I would guess he had a Ph.D. in economics, but he was a marketing man, and his whole field was marketing, not economics. Charles N. "Chas" Shepardson's specialty may have been agricultural economics, or just agriculture. He never had much to say one way or the other. James L. Robertson had been in the Office of the Comptroller of the Currency. He was a lawyer, but he did a lot of reading in economics, though not technical. And there were George W. Mitchell and J. Dewey Daane. One had been at the Chicago Reserve Bank, and one had been at the Richmond Reserve Bank, so they had a background in the Federal Reserve System. I don't know how technical either of them was in economics. I was the first academic economist after the first Board. The first Board had an academic economist on it, and I think I was the next one.

MR. SMALL. Do you think that the Shepardsons, the Robertsons would have a difficult time using the staff appropriately or communicating, because—

MR. MAISEL. Yes, I would think so. Robertson ran the legal staff, so we had no problem there. He had more of a law background in regulation that nobody else had.

MR. SMALL. You mentioned that, at the time of the discussion of your appointment, Martin may have preferred a banker.

MR. MAISEL. He did. I know he did.

MR. SMALL. Not in that particular situation, but more generally, do you think, for the Board's composition, there should be—

MR. MAISEL. In my book I said—and I guess I'd still feel that way—a non-economist would have a difficult time understanding what's going on.

MR. SMALL. Now, the academic economist might have a hard time understanding all the financial instruments that are being invented in the market.

MR. MAISEL. I don't see why they would. They would have to read up on them, but there's nothing that exotic or anything that I see.

MR. SMALL. The reason I say that is that one of the stories of how we got in the current financial crisis is that the instruments, and where the risk lies, are so nontransparent that, even to the traders and managers of banks, it's hard to follow.

MR. MAISEL. Maybe there's more there than I see.

The Current Financial Structure

MR. SMALL. So if you were a student and had 10 minutes to write your answer, how would you revise the financial architecture going forward?

MR. MAISEL. I don't think the big banks should be allowed to merge with smaller banks. I see no good reason for them to grow bigger by merger.

MR. SMALL. What about this "too big to fail" issue? How do you address that?

MR. MAISEL. I would address it by making sure that if you failed, you would at least wipe out the stockholders. I think it's wrong that the government puts in the money that they put

into Citibank and only takes 40 percent or what have you of the equity. Maybe they're taking big enough warrants. I could compromise by letting the stockholders hold something as long as you had large enough warrants to mean the government got most of the change in the value of the firm going from that point forward.

MR. SMALL. I wonder if at some point the banks get so big they hold the government hostage. Banks won't accept a certain deal, and if the banks go under, they bring everyone down.

MR. MAISEL. Well, then I think they can fail. You might've said a year ago that you couldn't let General Motors be in this situation it is in, but it's been done.

MR. SMALL. Part of the problem with some of these large institutions recently is that the Fed couldn't go in and grab hold of them to make sure that it was handled in an orderly, systematic manner—AIG, for example, which is mainly an insurance company.

MR. MAISEL. It seems to me that the counterparty should have been made to take a loss. They should not have been wiped out. It wouldn't hurt Goldman Sachs to lose a couple of billion dollars too if they got that involved with AIG. I guess, when the Fed went in originally, nobody knew how bad the assets were, the commitments. At least the way I interpret it was that you were getting calls from the counterparties. Originally, they didn't require any bank capital at all, but when the market got a certain way, then AIG was supposed to put up capital that it didn't have. That's where the feds came in and put up the capital. I would have let those making the margin calls take some losses, because they made the loans.

Only about four big banks got almost all the money from the Fed. I don't think it was necessary for the Fed to pay off Goldman Sachs. Or, at least if they got paid off, it should have been, like, at 50 cents on the dollar or something like that.

As I said about the Penn Central thing, we thought the limit was the fact that even though the Fed had the right to make the loan, we didn't have the right to make a bad loan. The New York Reserve Bank went over their books and said there was very little possibility that they could pay off the whole loan, so we'll take a loss, and we don't have a right to make a loan that we'll take a loss on.

MR. SMALL. Yes, and we talked about this, I think, earlier in the interview, that part of the Federal Reserve Act stipulates that the loans have to be "secured to the satisfaction"—¹⁴

MR. MAISEL. As I say, the New York Reserve Bank did go over Penn Central's books and simply said that it's not there: The loan won't be covered by the capital they have.

Fed Independence

MR. SMALL. You said earlier that one reason to have bank regulation in the Fed is because it's more independent than the government.

MR. MAISEL. My feeling has always been that the Fed is independent to make decisions that the government doesn't particularly want. But if the government is sure it wants the Fed to follow a certain course and is willing to go public and say, "We insist that the Fed do this," that they have the right to do that. But the Fed has the right to insist that the government do it publicly. In Canada, the president of the Bank of Canada once resigned, I think, on this basis. It has always seemed to me that there is a certain point where the Chairman of the Fed has to go public and say, "I don't think we should do this, I'm going to resign." But he has to resign. He can't do something that the government thinks is wrong.

MR. SMALL. On all the individual banking matters that you participated in, did you ever get a call from someone at a bank saying, "Look at my issues"?

¹⁴ Section 10B, Federal Reserve Act.

MR. MAISEL. No, the only call of that type that I know of was by one of the major savings and loans that was going broke. He had an appointment to see Martin. Martin talked to him, and then Martin called me in to talk to him, too. We said, "It's your business. It's tough." I think he tried to get a congressman to call Martin on that. I'm sure the Chairman always got congressional calls. I had friends in the Congress like Henry Reuss, but he never raised any question of an individual—

MR. SMALL. The Fed has been given delegated rulemaking authority over time, and the Fed has exercised that.

MR. MAISEL. Right.

MR. SMALL. Would you ever get calls on a general ruling—not on a particular ruling on a particular bank? Did you get calls from individual banks or from lobbying groups or pressure groups? Was it always this formal process: You make the rule, you put it out for comment, and only then do you hear back?

MR. MAISEL. Socially, I had relationships with some of the S&L lobbyists for peculiar reasons, because I had been active in stuff. The Fed had a policy—and I supposed it still does—that every state banking association would send a delegation to Washington. One member of the Fed would meet with them at lunch. I remembered discussing, in some of those lunches, Regulation Q and its effect on the markets. Bankers would express their views, but never in a specific lobbying sense. One member of the Board met with a lobbying group from virtually every state banking association in the country. I don't know if they still do or not, or we may have had two or three states at the same time—I don't remember. But I do remember having lunches with the people who were there in Washington to lobby.

MR. SMALL. There probably have been instances over time, whether general rulemakings or specific cases, where one or more big—let's just say New York, Citibank—had potentially millions or billions of dollars at stake. How would they get their views known? What avenues?

MR. MAISEL. Well, as I said, I knew who the bank lobbyists were, but I don't remember ever having them call and come into the office. I'm just not sure. I know I heard from them in some ways.

In some rulemaking, I sat a few times as head of the rulemaking committee, and we had hearings. The banks obviously appeared at those hearings. In other words, on a proposed regulation under the Bank Holding Company Act, we had quite a few hearings. The lobbyists and so on would appear, but I can't recall any of them calling. I talked to reporters occasionally. They would call, and I'd talk to them. We were very clear not to talk about what we were going to do.

MR. SMALL. You mentioned that you were head of the rulemaking committee. Could you discuss the structure and the scope of authority?

MR. MAISEL. Well, I forget. It might've been something like the right of bank holding companies to own insurance companies—that type of question.

The Board's Responsibility for Regulating Consumer Financial Services

MR. SMALL. Did you get into consumer credit issues somewhere along the way?

MR. MAISEL. Yes, we drew the original regulations on consumer credit [the Truth in Lending Act]. You had to publish all these regulations for public comment. The staff would have held hearings, and they would summarize the hearings when they brought a proposed

regulation to the Board for consideration. That's my memory of it, and the fact that you had to have the right interest rates shown on a loan.

On the bank holding companies, it may have been different. I just don't remember. I know I sat as the chair in a couple [of] hearings.

MR. SMALL. The Fed got involved in consumer credit because the Congress mandated it?

MR. MAISEL. The Congress had passed the law and gave the Fed rulewriting authority. I don't know if it is still that way, but the enforcement authority under the law was split. The Fed had to draw the regulations for all financial institutions but enforce the law only for state member banks, and the FTC drew them for nonfinancial institutions. It seems to me that was the case. That's the criticism, that it didn't take action on the nonprime mortgages, because it had authority. We drew up the regulations for all the other consumer loans, credit cards, and all that kind of stuff.

MR. SMALL. Was there the normal battle between lack of government interference in markets and people who take that position—

MR. MAISEL. Yes, but we had to draw up some regulations, so it was a question of how far the regulations went. When you quote an interest [rate] on deposits, we drew up, I guess, what form it had to be—whether it was compound or simple and how you expressed it, those types of things. Those we drew up a lot. We always had regulations of those types coming up.

MR. SMALL. Sounds simple. You can say, "You can charge this much," but then you get into, just like you mentioned, simple and compound interest rates.

MR. MAISEL. Daily, quarterly compounded, when you compound it. The Fed has regulations, or at least had regulations, on all those things.

Closing Comments on the Fed

MR. SMALL. What was your role on the modeling and on the directive? Those were initiatives that have lived.

MR. MAISEL. Well, as I say, the Brunner-Meltzer criticism was right. The Fed didn't have any theory.

MR. SMALL. Do you think the Fed is, at times, too insular and too thin skinned?

MR. MAISEL. I don't know.

MR. SMALL. Or it turned inward?

MR. MAISEL. There was always the worry. The Congress had rights and had the ability to change the laws and the powers of the Fed. That was always a concept that was there, particularly with Patman, who was always fighting to reduce the power of the Fed. So you were well aware that what you did had to be acceptable to a majority of members of the Congress.

MR. SMALL. Do you think the Fed model is a good model? Does it generally work well—the Fed straddling between the Administration and Congress, and—

MR. MAISEL. Yes. I think better than the English model, for example, which for a long time was simply that the one member of the Board was the assistant secretary of the Treasury, and he could make the decisions if necessary. The original Federal Reserve Board included the Treasury and the Comptroller of the Currency. I think it's a much better model not to have them. On the other hand, I think the Quadriad was a good concept. In making policy, the Fed should know what everybody else is doing and thinking.

MR. SMALL. Do you think the criticism is valid that the Congress is too focused on the short term and would be too easy with money, and the Fed takes a longer view, and—

MR. MAISEL. Yes, I think that's probably true, because members of the House of Representatives have to be reelected every two years, and that's what they have their sights on.

MR. SMALL. Thank you very much for this interview.