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Program

GUEST OF HONOR

THE HONORABLE TIMOTHY F. GEITHNER

President and Chief Executive Officer

Federal Reserve Bank of New York

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R. GLENN HUBBARD

Chairman of the Club

QUESTIONERS

Martin Feldstein

Professor of Economics, Harvard University

Henry Kaufman

Treasurer, The Economic Club of New York

President, Henry Kaufman & Company, Inc.

Introductions

Remarks at The Economic Club of New York, New York City

GLEN HUBBARD: Good afternoon everyone. I'm Glen Hubbard, the Chairman of the Economic Club of New York. It's a pleasure to welcome you to the 397th meeting of this club in its 101st year. Over those 101 years the members and guests of this club have heard very enriching exchanges from a whole host of world leaders, national leaders and great business people, more than a thousand guest speakers have appeared before the club over the past century establishing a tradition of stature and excellence that we will continue today. I would also like to recognize members of our Centennial Society. Last year, several dedicated club members sparked the formation of this society in order to ensure the stability of the club as the nation's premier speaking platform. Thus far, 85 club members have made a personal contribution of $10,000 to the Centennial Fund and as being honored in your program as founders of the Centennial Society. I can tell you, of course, as a business school dean in my day job, it's never too late to give money, and so if any of you would like to become Centennial members, that can be accommodated.

Today, of course, we are especially honored to hear from Timothy Geithner…9th President and Chief Executive Officer of the Federal Reserve Bank of New York. He is, of course, Vice Chairman and permanent member of the Federal Open Market Committee, the group that is responsible for conducting the nation's monetary policy. Before joining the Fed, Tim served five Secretaries of the Treasury and worked for Kissinger Associates, and I am pleased to say he is presently a Trustee of this organization. He, of course, graced the pages of the Financial Times this morning, perhaps previewing his remarks today. The Wall Street Journal has reported recently that he has been the Federal Reserve's fireman on Wall Street. Along with Chairman Bernanke and Treasury Secretary Paulson, he, of course, participated and led the activity in the Feds of Bear Stearns decision. As some of you know, former Fed Chairman Paul Volcker recently spoke to the Economic Club of New York in April teeing up these issues. This is a time of significant disagreement in the economics profession both on the shape of financial regulation of banks and other financial institutions, and indeed about the conduct of monetary policy itself. In that environment, we're particularly eager to hear Tim's thoughts and observations. After his remarks, as is our custom, we will hear from two designated club members some questions. Tim, the floor is yours.

TIM GEITHNER: Thank you Glen. It's a pleasure to be here. I just want to begin first by acknowledging the exceptionally talented public servants I have the privilege of working with at the Federal Reserve Bank of New York. A bunch of them are here sitting in tables in front of us, but there are many who are not here. Those of you who have not had the chance, and I know many of you here have to work in public service, I would commend it to you. It has its burdens, it has its moments, but it's consequential work and our country would be well served if more people like you, talented people across the country spent part of your lives in public policy.

I'm, of course, exceptionally fortunate in my predecessors at the New York Fed. Most recently Bill McDonough, Gerry Corrigan, the late Tony Solomon, and Paul Volcker, and I want to just start by saying that I agree with Paul Volcker when he said at this podium eight weeks ago that the system "failed" the test of the market. I very much share his concern that we were put in a position where we had to take some exceptional actions to protect the economy from systemic risks, and I share his belief and the belief of many that we need to consider some very fundamental changes to our system.

This has been a very severe, very complex financial crisis. The fabric confidence that is essential to the viability of individual financial institutions and to market functioning, both in the U.S. and in Europe has proved exceptionally fragile. Money in funding markets became severely impaired impeding the effective transmission of the monetary policy to the economy, and central banks here and around the world, governments as well have taken some dramatic actions to contain the risks in this to the broader economy. Why was the system so fragile? This is the central question.

Part of the explanation lies in the size of the global boom that preceded this crisis. The larger the boom, the greater the potential risk of damage when it deflates. This boom, both fed and was fed by a wave of financial innovation as the magnitude of financial resources seeking higher returns increased around the world, products recruited to meet that demand. Financial innovation made it easier for this money to flow around the constraints of regulation and to take advantage of more favorable tax and accounting regimes. The U.S. financial system created a lot of lower quality mortgage securities over this period, many of which were packaged together with other securities into complex financial products and sold to institutions around the world. Many of these securities and products were held in leveraged vehicles and financed with substantial equity risk.

The structure of the U.S. financial system, in particular, changed fundamentally during the boom with very dramatic growth in the share of assets outside the traditional banking system. This parallel system financed a large quantity of assets on a short term basis in repo markets. Assets financed in these markets expanded beyond the most highly liquid securities to include less liquid securities. These assets were assumed to be readily tradable, readily saleable, in part because assets with similar credit ratings had generally been tradable even during past periods of acute financial stress. The liquidity supporting these vehicles was assumed to be continuous, assumed to be essentially frictionless because it had been so for such a long time.

The scale of relatively risky, relatively illiquid, relatively long term assets financed with short term liabilities made many of the vehicles in the institutions in this parallel financial system vulnerable to what you might call a class type of run, but importantly, without the protections that exist in the banking system to reduce such risks. Once investors in these financing arrangements, including conservatively managed money funds withdrew or threatened to withdraw their funds from these markets, the system became vulnerable to a self-reinforcing cycle of forced liquidation of assets with further increased volatility putting downward pressure on assets across a broad range of markets.

In response, of course, margin requirements went up, financing was withdrawn from customers forcing more deleveraging, capital cushions eroded as assets were sold into distressed markets. The force of this dynamic, this is a classic dynamic in financial systems, was exacerbated, of course, by the poor quality of assets, particularly mortgage assets that had been spread across the system. This helps explain why and how a relatively small quantity of risky assets was able to undermine confidence across a much broader range of assets and markets, in a sense, contamination amplified contagion.

Banks, of course, were not able to fully absorb the effects of this run on the non-bank system. They had written very large contingent commitments to provide liquidity support to many of the funding vehicles that were under pressure, and they had retained on their balance sheets substantial exposure to the risk of the deterioration of house prices and to an economic downturn. The combined effect of these factors was a financial system that appeared to be more stable across a broader range of circumstances, but had become vulnerable, in a sense, to extreme events, and the change in the structure of the financial system, the relative decline in the share of banks in the system made the crisis more difficult to manage with the traditional mix of instruments available to central banks and governments.

What should be done to reduce these vulnerabilities, our first, our most immediate priority, our continuing priority is to help the economy and the financial system get through this adjustment process. First repair, first stabilize and only then reform. The actions by financial institutions to reduce risk, raise capital, build liquidity and actions by the official sector have, I believe, helped reduce the risk of a deeper downtown in economic activity and helped reduce the risks of a systemic financial crisis. But the U.S. economy and economies around the world are still in the process of adjusting to the aftermath of this long period of relatively rapid asset price growth and unsustainably low risk premium, and this process is going to take time.

As we continue to work with other central banks to ease the adjustment process underway, we're working to make the financial system more resilient to improve its capacity to deal with future crises. We're working closely with the SEC, with banking supervisors in the United States and around the world, with the U.S. Treasury, to encourage broad improvement and quality of financial disclosure, to support efforts that have already brought a substantial amount of new equity into the financial institution, which will help mitigate the affects or the amplitude of the potential credit crunch. And even as the Federal Reserve has worked to mitigate liquidity pressures in markets with this new set of lending facilities, we've with the SEC and other supervisors to strengthen the liquidity positions funding base of the major institutions.

We're also initiating some important steps to strengthen the financial infrastructure. We're in the early stage of the process, but in the process of encouraging a significant increase in the resources held against the risk of default by a major market participant across the set of private sector and cooperative arrangements for clearing and settlement of financial transactions that we call the centralized infrastructure of this system. We have begun to review how to reduce vulnerability of secured lending markets, including in tri-party repo, in part by reducing the scale of potentially liquid assets that are financed at very short maturities.

This afternoon, 17 of the largest financial institutions of the world that represent about 90% of activity and credit derivative markets meet at the Federal Reserve Bank of New York with their primary supervisors to launch a comprehensive set of changes to the derivative infrastructure. This agenda includes the establishment of a central clearing house for credit default swaps, a program to reduce the level of outstanding contracts through bilateral and multilateral netting, the incorporation of a cash settlement protocol for managing defaults into existing and future credit derivatives contracts and concrete targets for achieving substantially greater automation of trading and settlement.

These changes in the derivative infrastructure, in the centralized infrastructure and in repo markets will help improve the system's ability to manage the consequence of failure by major institution, and we expect to make meaningful progress over the next six months. These initiatives though are the beginning and they should be considered a bridge to a broader set of necessary changes to the regulatory framework in the United States and globally. I think the severity and complexity of this crisis makes a very compelling case for a broad, comprehensive reassessment of how we use regulation to strike an appropriate balance between efficiency and stability.

This is exceptionally complicated, both in terms of the tradeoffs involved, but also in terms of building the necessary consensus here in the United States and around the world. It's going to require significant changes to the way we regulate and supervise financial institutions, changes that, in my view, need to go well beyond modest adjustments to some of the specific capital charges in the existing capital regime that applies to banks. We have to recognize, however, that poorly designed regulation has the potential to make things worse. Former official to the New York Fed, Steve…wrote recently that crises beget regulation, but as everyone knows, regulation can beget crises. We have to carefully distinguish between problems markets will solve on their own and problems markets cannot solve. We have to understand that regulation can distort incentives that may make this system less safe and we have to focus on ways regulation can help mitigate the moral hazard risk created by actions central banks and governments have taken and may take in the future to avert systemic financial crises.

I'm going to outline some broad proposals for reform, but these proposals focus on aspects of our system that are most important to dealing with systemic risk. I'm not going to talk about the myriad of other very consequential important aspects of regulatory policy that affect the mortgage origination process or the future role of government sponsored enterprises in the housing business and a range of other things. Any agenda for reform has to deal with three important dimensions of the regulatory system. First, regulatory policy. These are the incentives and constraints that affect the level and incidence of risk taking. You can think of these as the financial analog to speed limits or anti-lock breaks or airbags or to building codes in earthquake zones. You have to address regulatory structure. This is about who's responsible, who's accountable for setting and enforcing those rules, and they have to address crisis management. This, of course, is about when and how we intervene and about the expectations we create for intervention and crisis. Let me just make a few broad points in each of these areas.

First on regulatory policy or on the incentives we set. The key objectives of regulatory policy have to be to improve the capacity of the system to withstand the effects of failure and to reduce the overall vulnerability of the system to the type of funding runs, margins, spirals we've seen in this crisis. This means first looking beyond prudential supervision of the critical institutions to broader oversight of market practices and market infrastructure. Two obvious examples that are hard to capture with the classic institution based prudential supervision. We need to make it much more difficult for institutions with little capital, little supervision to underwrite mortgages, we need to look more comprehensively about how to improve the incentives for institutions that structure and sell asset backed securities and CDOs of ABS, and supervision has to pay more attention to the extent of maturity transformation that takes place outside the banking system.

A second aspect of the incentive structure in regulatory policy. Risk management practices and supervision have to focus more attention on strengthening shock absorbers within institutions and across the infrastructure against very bad outcomes, very bad economic and financial outcomes however implausible they may seem. After we get through this crisis and after the process of stabilization and repair is complete, we will put in place a carefully designed set of more exacting requirements on capital and liquidity and expectations for risk management for the largest institutions that play a central role in intermediation and market functioning.

This is important for reasons that go beyond the implications of excess leverage for the fate of any particular institution. As we have seen, the process of deleveraging by large, but even relatively strong institutions can cause significant and collateral damage for market functioning and for other institutions. Inducing institutions to hold stronger cushions of capital and liquidity in periods of calm may be the best way we have to reduce the amplitude of financial shocks on the way up and contain the damage on the way down. Stronger initial cushions against stress reduces the need for institutions to hedge dynamically into falling markets and reduces the broader risk of a self-reinforcing procyclical margin spiral such as we’ve seen in this crisis.

Now how should we decide where to set these constraints on leverage or risk taking? This is exceedingly difficult and complicated work, but the objective should be to frame it simply, to offset the benefits and moral hazard risk that come with access to central bank liquidity in crisis without setting the constraint at a level that will only result in pushing more capital to the unregulated parts of the financial system. Risk management and supervision now focuses too much on the idiosyncratic risk that affects an individual firm and too little on the systemic issues that could affect market liquidity as a whole. To put it somewhat differently, the conventional risk management framework today focuses too much on the threat to a firm of its own mistakes, too little on the potential for mistakes to be correlated across firms. It's too confident that a firm can adjust to protect itself from its own mistakes without adding to downward pressure on markets, and takes too little account of the risk of a broad flight to safety, a broad based market wide rush for the exists as the financial system as a whole deleverages and tries to collectively move into the more liquid and lower risk assets of government obligations.

A third set of things about supervision. Supervision has to focus first on the stability of the core institutions, but it can't be indifferent to the scale of leverage and risk outside the regulated center. I don't believe, this is my personal view, but I don't believe it would be desirable or feasible to extend capital requirements to institutions such hedge funds or private equity firms, but supervision of the regulated core has to insure that counter party credit risk management in those institutions contains the overall exposure of the regulated to the unregulated. Counter party credit risk management can help limit the risk of an overall rise in leverage outside the regulated institutions that could threaten the stability of the system. Supervision, I believe, has to pay particular attention to focus on inducing higher levels of margin and collateral in normal times against derivatives and secured borrowing to better cover the risk of market illiquidity. Greater product standardization and improved disclosure can help as well as will changes to the accounting rules that govern what risks reside on and off balance sheet. And finally, last thought on this, central banks and governments and supervisors have to look much more carefully at the interaction between accounting, tax disclosure and capital requirements and their effects on overall leverage and risk across the system. The President's Working Group on Financial Markets and the Financial Stability Forum have laid out a very detailed list of reforms to begin this process, and we're fortunate that Gerry Corrigan is engaged in leading another private sector effort to help us get the balance better.

A few quick points on regulatory structure. Apart from the broad mix of incentives and constraints we set through policy, I believe the structure of the regulatory framework in the U.S. needs substantial reform. Our current system has evolved into a, it has many strengths, let me say, it has many strengths, but it's evolved into a very confusing mix of diffused accountability, regulatory competition, an enormously complex web of rules that create perverse incentives and leave huge opportunities for arbitrage and evasion. This crisis gives us the opportunity to bring about fundamental change in the direction of a more streamlined and consolidated system with more clarity around responsibility for the prudential safeguards in the system.

In this regard, Secretary Paulson's blueprint outlines a sweeping consolidation, sweeping realignment of responsibilities with a very clear set of broad objectives designed to achieve a better balance between efficiency and stability, between market discipline and regulation, and this proposal has done what it should do, which is to simulate a very constructive debate set of discussions which will help lay the foundation for action when the dust settles. I think the most fundamental reform that's necessary is for all institutions to play a central role in money and funding markets, including the globally active banks and investment banks. We need to operate under a more unified framework with a stronger form of consolidated supervision with appropriate requirements for capital and liquidity.

To complement this, I think we need a framework of oversight authority over the critical parts of the payment system, not just the centralized infrastructure, but the infrastructure that underpins the decentralized over the counter markets. I believe the Federal Reserve should play a central role in this framework, working closely, of course, with supervisors here and in other countries. At present the Federal Reserve has broad responsibility for financial stability, but that responsibility is not matched by direct authority, and the consequence of the actions we've taken in this crisis make it more important today that we move to close that gap.

Finally, a few things on crisis management. No system, of course, will be free from crisis. Whatever the design of the regulatory framework or the rules of the game and the framework of lender of last resort policies that central banks maintain and the regime we have for facilitating orderly resolution of major institutions, these are critical to our ability to contain crisis. In response to this crisis, of course, the Federal Reserve has designed and implemented a number of new facilities for injecting liquidity into markets. These facilities have played a very significant role in easing liquidity strains in markets and we plan to leave them in place until conditions in money and credit markets have improved very substantially.

We're also examining, of course, what complement of facilities will be appropriate in the future with what conditions for access and what conditions in terms of oversight requirements to mitigate the moral hazard risk. Some of the mechanisms we employ during this crisis may become permanent parts of our arsenal tool kits, some might be best reserved for the type of acute market liquidity problems experienced in this crisis. It would be very helpful for the Federal Reserve to have the flexibility, to have greater flexibility than we do today to respond to acute liquidity pressures and markets without interfering with or undermining our capacity to manage the Federal Funds Rate and the committee’s objective. That Congress is now considering accelerating authority it gave us to pay interest on reserves that would very much help in that regard. The major central banks, should I believe, put in place, keep in place a standing network of swap facilities with appropriate collateral policies, account arrangements that would make it easier to mobilize liquidity across borders in crisis.

The Federal Reserve Act gives us very broad authority to lending crises and we use that authority in very new and consequential ways, but in the classic tradition of centrals banks and lenders of last resort. As we broaden the range of collateral, we were willing to finance, as we extended the terms of our lending and as we provided liquidity insurance to primary dealers our actions were clearly calibrated to improve overall market functioning by providing a backstop to markets. But we tried very carefully to avoid supplanting either the unsecured inter-bank market or the secured funding market.

Now, of course, in addition to these facilities, the Fed made the judgment, after very careful consideration, that it was necessary to use its emergency powers to protect the system and the economy from a systemic crisis by committing to facilitate the merger between JP Morgan and Bear Stearns. We did this with great reluctance and only because it was the only feasible option available to avert default and because we did not believe we had the ability through other means to contain the damage that would have been caused by default.

Our actions were guided by the same general principles that have governed Fed actions in crises over the years. It was an acute risk to the stability of the financial system. We were not confident the damage could be contained through other means. We act only to the extent necessary to help facilitate an orderly resolution, not to preserve the institution itself, and the management of the firm and the equity holders of the institution involved suffered very substantial consequences. Although we assume some risk in this transaction, that risk is modest in comparison to the risk of very substantial damage to the financial system and the economy as a whole that would have accompanied default.

Finally, in conclusion, one of the central objectives in reforming our framework has to mitigate the fragility of the system and reduce the need for this type of official intervention in the future. I know that many hope and many believe that we could design our systems so that central banks and supervisors would have the ability to act preemptively, to contain dimensions of credit booms or to preemptively come in in diffused pockets of risk and leverage. I don't believe though that that's a desirable or realistic ambition for policy. It would inevitably be ineffective and the attempt, the attempt at achieving that would entail a level of regulation and an uncertainty about official intervention about the rules of the game that I think would offset any practical likely benefit. I do believe, however, and this is the essential imperative, I do believe that we have the ability to make the system better able to withstand failure by making the shock absorbers and the system stronger.

This crisis exposed very significant problems in the financial systems of the United States and in some of the other major financial centers, major economies. Innovation, as it always does, got too far out in front of knowledge and of risk, and I think it's very important we move very quickly to adapt the regulatory system to address the vulnerabilities we exposed by this crisis, and with the leadership of Secretary Paulson and the Chairman of the Fed, we're beginning the process now of building the necessary consensus here and with other major central banks and supervisors.

But I just want to finish by saying that confidence in any financial system depends in part on confidence in the individuals running the largest institutions. Regulation cannot produce the desirable level of integrity, foresight or judgment in those responsible for managing those institutions. That's up to their boards and that's up to their shareholders. One of the great strengths of our system though is the speed with which we adapt to challenge, and I think we can do better and I'm reasonably confident we will. Thank you very much.

GLEN HUBBARD: Thank you Tim. We will have two questioners from the club. The first, on my left, is Marty Feldstein, who is Baker Professor of Economics at Harvard, outgoing President of the National Bureau of Economic Research and a former Chairman of the Council of Economic Advisors under President Reagan. On my right, Henry Kaufman, who is the President of Henry Kaufman & Company, an extremely distinguished monetary economist. First question goes to you Marty.

MARTY FELDSTEIN: Well thank you very much. Although I was very interested in what Tim had to say to us today and what we read in the Financial Times this morning, my question is on a different subject. I want to ask about the dollar. Until recently, the Federal Reserve has deferred to the Treasury on all questions about the dollar, but Ben Bernanke recently broke with that tradition and spoke about the dollar, and so I'd like to ask Tim a question about it. As we all know, Treasury Secretaries for at least two decades have said that a strong dollar is good for America. We also know that the dollar has to come down in order to avoid an increase in the current account deficit. So my question is this, is it possible to have a strong dollar at home, that is a low inflation rate that protects the purchasing power of the dollar in the United States, while at the same time having a more competitive dollar internationally. In other words, a lower dollar relative to foreign currencies, and if that is possible, how is it to be done?

TIM GEITHNER: That's a more thoughtful question than will be my answer. Let me just say on the tradition, Marty, that, you know, I've spent a large part of my professional life at the Treasury, and one of my colleagues at the Fed at that point explained to me early in my day there at the Treasury that responsibility on exchange rate policy was a delicate balance between the Treasury and the Fed and this person from Fed said it was basically 60/40. So a presumptive lead, but it's a lead. And that tradition I think across generations of central banks of the United States, I think, reflects that basic balance. Again, I said, Marty, I'm going to give you a less interesting answer than your question deserves, but I just want to say the following. No government, no central bank can be indifferent to changes in value of its currency. The dollar is important to us not just because of the affect it has on growth and inflation here and around the world, but it's important because of the very important role the dollars plays in the international financial system, and as a result, as you would expect, we pay very close attention to what happens in exchange markets.

HENRY KAUFMAN: To what extent did the counter party risks contribute to the Fed's decision to help facilitate the sale of Bear Stearns, and was JP Morgan Chase a large participant in these risks?

TIM GEITHNER: The dynamics in markets that would accompany default by a major financial institution, that create such a great risk of amplifying fragility of systemic crisis were partly related to the affects that would accompany default on derivative contracts. But not only those. We were also very worried about the capacity of the centralized infrastructure withstand a major default, and we were worried about what was happening in secured funding markets at that time more generally. So I would say what the potential risk that would come with the disorderly unwinding of an institution with I think in the range of three-quarters of a million derivative contracts, thousands of counter parties was one of the risks that we were worried about, but really only one of those risks. That's why, as I said, I think it's very important that we move to improve the capacity of that decentralized derivative infrastructure today to handle default and we are doing, and have been doing, two sets of really important things working with other major supervisors to achieve that.

One is to improve the measurement and management of the risk in those positions. There's a lot of attention on the operational infrastructure, which I said something about, and I'll just come back to in a sec, but the most important thing is that those exposures to risk of major default…are managed carefully, and that's partly managing your derivative exposure carefully, but there's a bunch of other exposures people have to the risk of a very bad adverse outcome that have to be managed carefully and it has to start with that. Managing those financial and counter party credit risks. But it's also important to make the operational infrastructure a bit more mature, and you know, robust to a level appropriate to the risk in the system as a whole. As I said, I believe we have a reasonable prospect of a consensus across the major financial centers to get the standardized part of the credit default swap market on to a clearinghouse to use bilateral, multilateral netting to collapse, compress a substantial fraction of the outstanding trades, to improve clarity and confidence around how a default would be managed by an underlying corporate and to substantially automate and standardize the existing derivative infrastructure, not just in credit derivatives, but across equity derivatives and others, and we helped lead a very important effort in that beginning three years ago, but now we're at the point where we can take the next step, and I hope, and I expect the meeting today will be able to lay out an agenda with a bit more detail.

MARTY FELDSTEIN: Now that I see that I have a microphone here, I want to ask a question about monetary policy. I think it's clear that the U.S. economy is experiencing a significant slowdown. Almost all of the indicators of economic activity are lower now than they were in December or January, and yet, of course, inflation expectations and inflation are both rising. The Fed's fund rate is very low, less than the rate of inflation. So my question is, why is a negative real Fed Funds Rate appropriate in the context of rising inflation and inflation expectations?

TIM GEITHNER: Very important to start with the world. The world is going through a very complicated transition. Although demand is slowing here, and it's likely to be running below potential in the major economies as a whole, growth is very strong in many parts of the world, many of the most populous parts of the world, and the fact that the structure of those economies are changing to increase their use of energy and the consumption happens to be changing in the ways that you've seen is creating a very large sustained rise in relative prices. You've seen it in energy, commodity prices in a range of types. Containing the risks in what is globally a less benign inflation environment is going to probably require tighter monetary policy on average around the world. But the mix of policies that are going to be appropriate to contain that is going to vary considerably across countries. In the United States, of course, we face a very, fine, delicate, complicated balance. We've tried to get policy, the Fed Funds Rate, to the point where we've provided enough insurance against the risk of a very bad economic outcome, a very bad financial outcome without taking too risk that underlying inflation is going to accelerate over time. So far we do not see evidence yet of a significant acceleration of underlying inflation in goods and services or in wages or a substantial erosion in long term inflation expectations, but we are going to be very attentive to those risks, and I hope that was more responsive, Marty, than I was to your first question.

HENRY KAUFMAN: Tim, in your remarks you spoke about the expanded supervisory authority perhaps for the Federal Reserve. Could you perhaps put a little bit of more detail around that? Should that supervisory authority be expanded to investment banks, to major insurance companies and how should that be structured within the Federal Reserve in how monetary policy is to conducted?

TIM GEITHNER: We're at the very early stages in thinking through that in cooperation with everybody who is going to matter to the ultimate decision, but I would just say, again, that I think that what you really want to try to achieve is that for that limited set of institutions, who by the nature of their size and their role in markets are so important to market functioning that they're likely to be the beneficiaries of liquidity and insurance and extremis. I think you want to have a framework of oversight with a set of well designed rules for leverage and liquidity that are appropriate to their systemic role in the system. We, of course, will play a central role in designing that, but we're going to have to play an important role in running it too, but we can do that in cooperation with the complement of other functional supervisors that exist today. Very hard to know where to draw that line, and harder still to design the appropriate set of constraints, and it's going to take a lot of care and thought for how we do it. So beyond that, Henry, I don't have any more flesh to add to that skeleton. I think there's just a simple, pragmatic, compelling reality that if institutions who want to or made need to have access to central bank and liquidity and extremis, they need to operate in normal times under a framework that the central bank has some role in designing/approving.

MARTY FELDSTEIN: The tax rebates that are now beginning may give a temporary boost to consumer spending, but that's likely to end by the end of the year, by November or December. So there's talk in Washington about another fiscal stimulus package later this year or in early 2009. My question is this, if the Congress passes another such substantial stimulus, would it be appropriate for the Fed to have a higher interest rate, a higher Fed Funds interest rate than would otherwise prevail?

TIM GEITHNER: Very hard to know. I think it depends, of course, on what's happening to the outlook for growth relative to trend in the United States around the world. What's the risk to that path? How much of the downside risk has been attenuated to that path? What's happening to financial conditions generally? Of course, because the overall stance of…and his force is importantly determined by what's happening to a constellation of other types of interest rates that reflect credit risk, and it would depend, of course, on the magnitude and timing and likely affect of the stimulus. Hard to know whether they're going to get to that point whether that's going to be necessary or desirable, but we'll do the sensible thing in reaction.

HENRY KAUFMAN: Tim, in view of the very rapid rise in the price of oil, has the Fed evaluated the magnitude of the speculation in this market, and what actions, if any, could be taken to limit that speculation?

TIM GEITHNER: People much smarter than me spend a lot of time crawling over that basic question, and I've listened to a lot of people talk about it, I read a lot of the analysis about it, and I think as far as we can judge today most of what is happening in energy and commodity markets reflect this very substantial increase in demand and expected demand relative to supply around the world. Now those prices are also affected by policy, by subsidies and a bunch of other distortions introduced by policy here and other parts of the world. At the margin, those policies may be amplifying that imbalance. It's very hard to explain the level of volatility you see in markets, much less the…by those fundamental factors, but as far as we can tell, they seem largely due to fundamental factors in anticipation of how those are going to evolve in the future, and we don't see in stocks or inventories yet, evidence that would justify the conclusion that this is substantially largely about what some people call speculation. To be honest with you, Henry, I don't know, even if you knew with certainty that this was something that we would call a speculation, it's very hard to know what you can do that's responsible and sensible to intervene in that set of judgments about prices as a whole. But it is complicating monetary policy around the world, and it does, it is part of what is overall a less benign inflation environment than we've faced the last decade or more.

MARTY FELDSTEIN: Your remarks today called, as I understand them, for permanently extending Federal Reserve supervision and liquidity facilities at least to the key investment banks, and in turn requiring them to increase the level of capital and of liquidity that they maintained. So I wonder whether your concerned that doing that will simply cause the highly leveraged ex-ante profitable transactions to migrate from these investment banks to other financial institutions like the large hedge funds? Isn't, in the end, the market discipline of a fear of failure the only way to avoid excessive risk taking?

TIM GEITHNER: Well let me just begin by saying just by what you inferred from my remarks, we have not decided yet whether we would permanently extend, and if so, how, access to liquidity bank type, liquidity support to investment banks. We're thinking through it carefully, but haven't reached a judgment on that yet. There's a series of strong, practical, pragmatic reasons for thinking about doing so, but there's a pretty compelling set of other reasons to think through it kind of carefully. I think your point though is absolutely right. If you set the constraints on leverage in the regulated core too high, all you will do over time is diminish their relative role and you will simply feed further the shift in capital outside those institutions. So you need to get that leveraged capital regime set carefully so that what you're doing is mitigating to the extent you can the moral hazard risk, but not setting it so high you're going to make activity there adjusted for the liquidity benefits of access to central bank insurance. Not so that you're making that so high that you're going to make it un-economic to take risk in that. So it's an exceptionally difficult balance. We've been playing with that balance for decades, and you're never going to get it right ex-ante, and it's going to have to change over time because things change, markets evolve, and of course, the measurement of risk is a process fraught with terrible complexity, uncertainty and vulnerable to failures of imagination.

HENRY KAUFMAN: Well if this is the last question, I'm going to ask you the same question that I asked Chairman Bernanke last fall, and that is this. Of all the information you receive and evaluate at the Federal Reserve, what information would you like to have that is not available to you presently?

TIM GEITHNER: We'd like the unattainable, you know, we'd like the confident capacity to come to work in the morning and look at our screens and see finely defined probabilities of the future of the world. But I suspect that would be beyond our reach, and so in central banking, both in monetary policy or in how you think about financial stability, the central dilemma is how you deal with the inevitable uncertainty you face in making decisions about an uncertain future and weighing carefully the range of possible scenarios out, there are relative consequences for the things we're here to address. But we're on it, Henry, I want you to know we're on it.

GLEN HUBBARD: Thank you very much, Tim, and also Marty and Henry for those fine questions. I hope there will be an instructor's manual available afterward with the answers to all of these questions for everyone. Please enjoy your lunch as it's served. Just an update, Chairman Bernanke has committed to an October date at the club. We have a number of other events that are on the dock for September, October, November, but the Chairman will be with us in October. Please enjoy your lunch.

(END)