The Economic Club of New York

101st Year

395th Meeting

Tuesday, April 8, 2008

Grand Hyatt

New York City

Program

GUEST OF HONOR

THE HONORABLE PAUL A. VOLCKER

Former Chairman, Federal Reserve System

PRESIDING OFFICER

R. GLENN HUBBARD

Chairman of the Club

QUESTIONERS

Peter G. Peterson

Former Chairman, The Economic Club of New York

Senior Chairman, The Blackstone Group

Edward S. Hyman

Chairman, ISI Group, Inc.

Introductions

R. Glenn Hubbard

Paul A. Volcker: Mr. Chairman, members of the Economic Club, Fellow New Yorkers,

Fellow New Yorkers: That was the salutation of my last speech to the Economic Club of New York, delivered more than 30 years ago. For me, the timing was auspicious. As the newly minted President of the Federal Reserve Bank of New York, I naturally shared the intense concern that this great city was unable to finance itself. Beyond the parochial concern was the risk that default by New York might spread a sense of financial crisis through an already recession-weakened economy.

There were calls for the Federal Reserve to step in, to resort to a long dormant emergency lending authority enacted in the depths of the Great Depression. Those calls were resisted. Discipline would be enforced and any precedent to "bail out" a large but irresponsible borrower would be avoided. The city had to declare a moratorium on its short-term debt. Eventually the Federal Government, after contentious political debate, did provide limited liquidity support, but highly conditioned.

In time, the city, with new management and the installation of strict oversight and budgetary controls, regained its financial footing. It came to flourish as the world financial center, attracting talent and a capacity for innovation that has been at least partly replicated and implemented throughout the world.

Well, that may sound like ancient history to most of you, more evidence of my age than of current relevance. However, some of the differences -- and some of the parallels -- to today's financial turmoil strike me as relevant.

Until the New York crisis, the country had been free from any sense of financial crisis for more than 40 years. In contrast, today's financial crisis is the culmination, as I count them, of at least five serious breakdowns of systemic significance in the past 25 years – on the average one every five years. Warning enough that something rather basic is amiss.

Over that time, we have moved from a commercial bank centered, highly regulated financial system, to an enormously more complicated and highly engineered system. Today, much of the financial intermediation takes place in markets beyond effective official oversight and supervision, all enveloped in unknown trillions of derivative instruments. It has been a highly profitable business, with finance accounting recently for 35 to 40 percent of all corporate profits.

It is hard to argue that the new system has brought exceptional benefits to the economy generally. Economic growth and productivity in the last 25 years has been comparable to that of the 1950's and 60's, but in the earlier years the prosperity was more widely shared.

The sheer complexity, opaqueness, and systemic risks embedded in the new markets – complexities and risks little understood even by most of those with management responsibilities – has enormously complicated both official and private responses to this current mother of all crises. Even previously normal trading relationships among long-established institutions are questioned. What has plainly been at risk is a disorderly unraveling of the mutual trust among respected market participants upon which any strong and efficient financial system must rest.

Simply stated, the bright new financial system - for all its talented participants, for all its rich rewards – has failed the test of the market place. To meet the challenge, the Federal Reserve judged it necessary to take actions that extend to the very edge of its lawful and implied powers, transcending certain long embedded central banking principles and practices. The extension of lending directly to non-banking financial institutions – while under the authority of nominally "temporary" emergency powers – will surely be interpreted as an implied promise of similar action in times of future turmoil. What appears to be in substance a direct transfer of mortgage and mortgage-backed securities of questionable pedigree from an investment bank to the Federal Reserve seems to test the time honored central bank mantra in time of crisis -- "lend freely at high rates against good collateral" -- to the point of no return.

The implications of these decisions, and the lessons from the unfolding crisis itself, surely deserve full debate and legislative review in the period ahead. It is certainly right that in this instance, the Federal Reserve acted with full support of the Secretary of the Treasury. In their technical details, the issues are terribly complicated. That is true in large part because of the mind-bending complexity of the world of derivatives and securitization. There are also cross-cutting bureaucratic and political concerns – political concerns at the high level of the proper use and allocation of government power and at the low level of embedded economic interests.

In sum, it all adds up to a clarion call for an effective response.

Before turning to the specifics of the needed debate, I want to emphasize that we are not dealing simply with problems of financial structure and regulation, of repairing or papering over weak links in markets, or of realigning supervisory responsibilities. Financial crises typically emerge after a self-reinforcing process of market exuberance marked by too much lending and too much borrowing, which in turn develop in response to underlying economic imbalances.

The New York case was illustrative. The city had spent beyond its means for years. Aided and abetted by the local banks, a seemingly profitable but rickety financial structure was built. It was dependent on the rollover of short-term financing and rested on the unspoken presumption that major cities don't go broke.

That was child's play relative to recent years. It is the United States as a whole that became addicted to spending and consuming beyond its capacity to produce. The result has been a practical disappearance of personal savings, rapidly rising imports, and a huge deficit in trade. The process has been extended by the willingness of other countries – foreign investors, businesses, and governments – to close the gap by buying our Treasury securities, by directly indirectly financing our home buyers as well as our banks, and increasingly by buying into our businesses.

It all seemed so comfortable. There was no pressure for change, not in Washington which was spending money and keeping taxes low, not on Wall Street which was wallowing in money, not on Main Street with individuals enjoying easy credit and rising house prices, not in China or elsewhere dependent on booming exports and content to build huge financial reserves.

But in the end, just as in the case of New York, no financial legerdemain could long sustain the unsustainable. A breaking point, usually not anticipated, appears - in this case triggered by some softening of the housing market. The excesses of the sub-prime mortgage were exposed, doubts about financial values spread and adjustments – painful but necessary adjustments – are forced on the economy.

A second generic point is worth emphasizing. Financial crises have been a recurrent feature of free and open capital markets, not least in the United States. Those 40 years of relative tranquility were the exception, not the norm. Any return to heavily regulated, bank dominated, nationally insulated markets is pure nostalgia, not possible in this world of sophisticated financial techniques made possible by the wonders of electronic technology. Markets are international, and so are businesses and individuals. We cannot regulate and supervise without taking account of, and even learning from, practices elsewhere.

But it is equally compelling that a demonstrably fragile financial system that has produced unimaginable wealth for some, while repeatedly risking a cascading breakdown of the system as a whole, needs repair and reform.

The nub of the problem is the inherent risks involved in financial intermediation, a process vital to the success of any free economy. On the one hand, there are those who need funds – reliable long-term funds – to build businesses, to buy homes, to finance education. On the other hand, many of those with available funds insist upon safe, highly liquid outlets for their money. Reconciling those different requirements inherently involves uncertainty, and risk -- credit risk and maturity risk.

Absorbing those risks was once largely the role of commercial banks, saving institutions, and insurance companies. Typically, those institutions were subject to rather comprehensive regulation. The banks also have had access to an “official safety net” in times of stress, and in recent years built substantial capital. The business model of those institutions also rested on the continuity of customer relationships implying some cushioning of the impact of market volatility.

In the new paradigm, the intermediation process has increasingly become the domain of the open market. The general idea is the inherent risks can be minimized by unpackaging the institutional relationships, separating maturity and credit risks, “slicing and dicing” so that those risks can be shifted to those most willing and capable of absorbing them. Trading would be encouraged by sophisticated packaging of obligations, and by developing “derivatives” replicating one characteristic or another of the financing relationship, derivatives that have taken on a trading life of their own. The liquidity of active open markets also encouraged thin capital positions and high leverage.

The intellectual rationale was to encourage arbitrage to close inconsistencies in pricing and to enhance market efficiency. Efficient in theory, but in practice lacking two practical imperatives in the lending process. One is the clear responsibility of a lender for judging the credit worthiness of a loan. The second is the ability of a purchaser in the secondary market to itself appraise the nature and value of the credits it is acquiring.

The first of those requirements has clearly been undercut by the tendency to package and sell a loan promptly after its origination. To the extent those originations are by a commercial or investment bank, the practice can at least be reviewed and disciplined by a relevant supervisory authority. For instance, one possibility, by market practice or official requirement, would be to insist on the retention by the originator of a significant part of the loan or loan packages.

In the domain of the secondary market, the principal "gate keepers" have been the few credit rating agencies, each of which has a certain status by means of SEC recognition as well as years of experience. Those proud agencies have a strong reputation to protect. However, it appears that their approach toward rating complex packages of mortgages and loans has suffered not only from the appearance of conflicts of interest, but also from the common difficulty of much financial engineering.

Mathematical modeling, drawing strong inferences from the past, has demonstrably failed to anticipate unexpected events of potentially seismic importance. The commonly cited "two sigma" or "once in a 50 years" event has materialized too frequently to validate that approach. Part of the problem, as I understand it, is that mathematical modeling simply cannot deal with markets where it is not random or physically determined events but human instincts that cause self-perpetuating waves of unwarranted optimism or pessimism.

The combination of herd behavior, opaque loan characteristics, and breakdowns of market function at times of crisis has also raised important questions about the characteristics and usefulness of "mark-to-market" accounting, particularly its extension in uncertain and illiquid markets to what is euphemistically known as "fair value" accounting. That is too complicated a subject for me to linger on today. Suffice it to say there cannot be much doubt that "mark-to-market" is an essential discipline for trading operations, hedge funds and other thinly capitalized financial firms. What is at issue is the extent to which it is suitable for regulated, more highly capitalized intermediaries, including commercial banks. Their ongoing customer relationships, the value of which is not automatically correlated with reversible swings in market interest rates, cannot be easily reduced to a market price or a mathematical model.

I know very well that the seemingly simple approach of "fair value" accounting is a highly complex matter extending beyond financial markets. As it should be, resolution of these questions is in the hands of independent standard setters. I am encouraged that the issues are under review, and I trust minds are not closed as to the appropriateness of "mark-to-market" under particular circumstances.

Another highly significant area of concern has been the practice of important commercial and investment banks to move certain sponsored and related operations "off balance sheet". That has been surprising in light of the well publicized problems of Enron and other industrial companies. Experience has again demonstrated that "off balance sheet" cannot be the same as "out of mind" or out of responsibility. Too much is at risk both financially and reputationally.

The recitation of particular market vulnerabilities, of supervisory lapses, of failure to close gaps or end disagreements among regulators is not surprising. In the United States, informed observers, market participants, officials themselves have long been aware of fragmented responsibilities, competing and overlapping institutional objectives, and ingrained resistance to change. Established agencies haven't been able to keep up with all the complexities. The drumbeat of lobbying pressure has not been for more effective supervision; to the contrary, it's been fear of allegedly heavy handed and intrusive official intervention damaging to the competitive position of institutions operating in international markets.

Perhaps most insidious of all in discouraging discipline has been pervasive compensation practices. In the name of properly aligning incentives, there are enormous rewards for successful trades and deals and for loan originators. The mantra of aligning incentives seems to be lost in the failure to impose symmetrical losses – or frequently any loss at all - when failures ensue. The point has been made time and again, yet, with rare exceptions, compensation committees and their consultant acolytes seem unable to break the pattern. That may not be an area that law or regulation can, or should, deal with effectively. Surely it is a matter for the leadership of large institutions, particularly those sheltered by official support.

While far from complete, I've said enough to confirm that reform, intelligent reform, will be a lengthy and arduous process. I particularly welcome Secretary Paulson's leadership in setting out a broad vision of one logical direction for change. Congressional leaders and others are preparing legislative proposals. All that is useful, but will take time to debate and mature.

Meanwhile, for the time being we are dependent on ad hoc approaches, making do with – hopefully making better – what we have. In the process, we need to take care that immediate decisions don't inadvertently prejudice more considered approaches.

The immediate response to the crisis has been to resort to untested emergency powers of the Federal Reserve. Out of perceived necessity, sweeping powers have been exercised in a manner that is neither natural nor comfortable for a central bank. As custodian of the nation's money, The Federal Reserve has the basic responsibility to protect its value and resist chronic pressures toward inflation. Granted a high degree of independence in pursuing that responsibility, the Federal Reserve should be removed from, and be seen to be removed from, decisions that seem biased to favor particular institutions or politically sensitive constituencies.

Housing is certainly a sector politically sensitive as well as economically important. So, I ask myself why, in the present circumstances, is so much of the burden of restoring liquidity in the mortgage market placed on the Federal Reserve? There are very large long-standing institutions, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, created by law explicitly to nurture and support the mortgage market they have come to dominate. They have long enjoyed direct and indirect government support. Until now, Fannie and Freddie stockholders and executives have been generously rewarded. Existing law provides for direct government financial support which could include fresh capital in time of need. Yet, given the illiquidity of mortgages, including their own mortgage-backed securities, they have been remarkably passive until very recently.

I well understand their managements feel a fiduciary duty to their stockholders. But if that duty in face of a national crisis in the mortgage market and their own statutory purposes is the overriding criterion, we can ask what is the rationale for their existence as a government sponsored (and subsidized) agency? If instead it is a matter of the budgetary consequences of overt government support, those consequences are only hidden by Federal Reserve mortgage acquisitions, not avoided. Somehow, the proper structure and role for those organizations in the face of a crisis playing out in their own front yard need to be reconsidered as part of financial reform.

In the here and now, if the illiquidity of the mortgage market is the crux of the problem, use of the existing institutions would be quicker and more effective now than building a new channel for government assistance. At any rate, the crisis is simply too threatening to rule out the possibility of government support.

There is, quite understandably, a great deal of attention being paid to the future role of the Federal Reserve as lender of last resort, regulator and supervisor. That is an area in which I hold some strong views. The Fed, by reason of its mandate, its prestige, its perceived competence, and most importantly because it is called upon to lend to troubled banks, is advantageously placed to exercise strong and effective oversight of the financial system.

That was a simple and straight-forward proposition when commercial banks, over which the Federal Reserve had direct authority, were the systemic heart of the system. Recent developments have affirmed that those institutions with relatively strong capital positions are still critical in absorbing risk when the system is under pressure. Now, we are faced with further extending and clarifying the Fed's regulatory and oversight responsibilities to investment banks and beyond or, conversely, changing direction toward a new, presumably consolidated, regulatory authority.

I have neither the time nor competence to consider this afternoon all the ramifications of the two broad alternatives, or of less sweeping possibilities. The Treasury outline published last week sets out a comprehensive vision (which, however, does not deal with the government sponsored enterprises).

The answers won't come easily, but they must come. Recent developments certainly justify a sense of urgency, permitting the Congress and the new President to cut through entrenched political and institutional resistance to change.

In dealing with the challenge, a number of points seem to be of fundamental importance:
.

- The role of the Federal Reserve as lender of last resort and as regulator does need clarification. Those functions are inextricably linked to the extent particular institutions are protected by borrowing privileges. The plain implication of recent actions is that in time of stress investment banks deemed of systemic importance are to be so privileged. Unless the Fed's initiative can somehow be contained to a single aberrant incident – which seems quite unlikely - a direct responsibility for oversight and regulation follows. I do not see how that responsibility can be turned on only at times of turmoil – in effect when the horse has left the barn.

- If the Federal Reserve is also to range further, to have clear authority to carry effective "umbrella" oversight of the financial system, internal reorganization will be essential. Fostering the safety and stability of the financial system would be a heavy responsibility paralleling that of monetary policy itself. Providing direction and continuity will require clear lines of accountability (running, for instance, to the Vice Chairman of the Board and to relevant Reserve Bank Presidents), all backed by a stronger, larger, highly experienced and reasonably compensated professional staff.

- A case can be made for consolidating all supervisory and regulatory responsibilities for "safety and soundness" into a single "super agency". While starkly contrary to the American tradition of more specialized agencies, it is the path taken by the U.K. and a number of other countries to assure consistent effective coverage. However, as recent U.K. experience emphasizes, close liaison and cooperation with the central bank would be absolutely essential for anticipating and managing crises.

- No one will benefit from regulation and supervision which is unduly intrusive and arbitrary. Venture capital and equity funds have been two successful, creative and valuable parts of American capital markets. By their nature, they are dependent on strong and sophisticated investors, so systemic implications of failure of particular funds is unlikely. Consequently the case for either official liquidity support or direct regulatory intrusion is weak.

Hedge funds, when managed carefully, may add to the efficiency of markets. However, the potential for trouble has been amply demonstrated particularly when those funds are sponsored by banks. Consideration needs to be given to ways and means of damping excessive leverage, possibly through the influence of their prime brokers. Similarly, banks in their lending need to resist the dangerous and excessive leveraging of businesses acquired by equity funds.

The potential for conflicts of interest strongly suggests the most careful consideration of the governance structure of equity and hedge funds, including independence from bank sponsorship.

- In a globalized world, regulation and supervision cannot usefully proceed in isolation. Today, that has been broadly recognized in work toward common capital requirements for banks, toward international accounting standards, toward more disciplined auditing, and perhaps most critically toward the development of more effective settlement and clearing arrangements for derivatives. The work already underway in these areas under the auspices of the G-7 or otherwise is encouraging.

For financial regulation in general, competition in regulatory laxity cannot be a tolerable approach.

I am constitutionally unable to end these remarks without re-emphasizing the point with which I began. Financial crises are most damaging when underlying economic forces are out of kilter, and when the bursts of self-reinforcing enthusiasm or fears take hold. It is the basic responsibility of a central bank – most decidedly of the Federal Reserve, the influence of which spreads worldwide - to balance and moderate those forces.

That is a tough job, especially when the markets are in turmoil and concerns about recession are rife. Then the temptation is to subordinate the fundamental need to maintain a reliable currency worthy of trust and confidence at home and abroad.

The dollar, after all, is a fiat currency, backed only by the word and policies of our government, exemplified by an independent central bank committed to maintaining a price stability. The apparent pressure of the Federal Reserve to take many billions of uncertain assets onto its own balance sheet raises questions that must be decisively answered by demonstrating the commitment to deal with emerging inflationary pressures – that is all the more important in the midst of the weakness of the dollar internationally and our dependence on foreign capital.

Let's not lose sight of the silver lining – what can be the positive outcome of all the turbulence. The excesses of the market are surely being penalized in terms of huge losses of money and prestige. The transient pleasures of extreme leveraging have been exposed. By force of circumstances, the nation's spending and consumption are being brought in line with our capacity to produce. The need for regulatory reform is broadly recognized.

We have the opportunity to lay the foundation for a new period of sustained growth and stability. I trust we will seize that opportunity – to the benefit of this city, the country, and, indeed, to global finance which is still so dependent upon American example and leadership.

(Q&A)

GLEN HUBBARD: Thank you very much for those remarks. As is our tradition, we do have two distinguished club members as questioners. Pete Peterson, who is the co-founder of Blackstone, a former Commerce Secretary and former Chairman of this club, and Ed Hyman, an eminent Wall Street economist and Chairman of ISI Group. Pete the first question is yours.

PETE PETERSON: Thank you. Mr. Chairman, I've known you for over 35 years, and during all of those years, I've known you to be a man of high principle, and as a founding director of the Concord Coalition I know you have a principled view of the critical importance of long term fiscal responsibility. Yet at a recent meeting that I understand was public, my wife, a card carrying Democrat, heard you make a strong statement in support of Barack Obama's presidential candidacy. Now I don't know the truth of it, but some say he has the most liberal voting record in the senate. The obvious question is this, do you feel that the senator has some special attributes, like his presumed ability to unifying the country, that might transcend the principle of long term fiscal responsibility? Or is there a relationship between your support of Senator Obama and your commitment to long term fiscal responsibility?

PAUL VOLCKER: Well I will make a great confession in this small group that I did, I thought we weren't supposed to talk about political matters here…

PETE PETERSON: You and I have never done what we should have done.

PAUL VOLCKER: …this is non-political. Some time ago I did indicate my support for Barack Obama. My confession is I had not long studied his economic program and his voting record in the Illinois legislature, let me make that clear. Nor did I long examine his oppositions voting record on these matters or their economic program, and neither of which were very clear at the time. What I do have is some fairly strong feelings, and I don't like the direction that this country has been going in for some time, in many directions. Economic may be part of it, but it is only a small part of the problem in this country. Let me give you one little symptom of a lot that's wrong.

People have taken surveys of American opinion every year for years. One of these things where they ask the same question. Do you trust your government to do the right thing most of the time? Not a very tough examination. That used to be, 20 or 30 years ago, when we first met, the positive response was 70%. Now the positive response is 25 to 30%. I think that tells you something. The quarreling in Washington, the inability to get things done, the amount of money being spent to affect political outcomes or to create political roadblocks is, I think, damaging the ability of this country to meet the very huge problems before it. Whatever it is. Foreign policy, global warming, Medicare, medical expenses, medical programs, even something as simple, straightforward as social security, that you've been talking about for five years and nobody does anything. That's got to change.

It seems to me the kind of comments that Barack Obama was making, and if you read his books it's consistent, and they go back for some period of time, there's a recognition of those problems and a recognition that that takes a change in the political climate in this country and the mutual commitment and confidence of citizens in all directions, and when I look at the various candidates it seems to me that he is best able to achieve that purpose of reaching out with some hope of restoring confidence in the American public. I would just make other comment, which has struck me, when you look at those early election returns in Iowa or elsewhere, to exaggerate a bit, everybody under 30 was voting for Barack Obama, everybody over 60 was voting for Hillary Clinton. If you ask yourself, where does the future of the country lie, I think the answer is obvious.

GLEN HUBBARD: That's a good argument.

ED HYMAN Mr. Chairman, even if it's poetic, let me wish you a happy 80th birthday.

PAUL VOLCKER: I've got a hope for the Economic Club, if I may say, I had forgotten that this is supposed to be a birthday party. My birthday was eight months ago. But I wonder if you could arrange another dinner for me next year, and maybe we can celebrate my 79th birthday and we'll go backwards.

ED HYMAN: So thank you for meeting with us and thank you for delivering such a thought provoking and substantive speech. Thank you very much. My question is what are your views on the inflation outlook?

PAUL VOLCKER: Well my views of inflation is that it's a bad thing.

ED HYMAN: We're well aware of that.

PAUL VOLCKER: I think we have to keep making that clear, but what concerns me about the present situation, of course, it's very difficult, but I have reached a certain age where I can remember quite a few things, and there are some resemblances between the present situation, I'm afraid, and the early 1970's. Not in the late 1970's when inflation really got started. But you know, there was some fear of a recession, the oil price went skyrocketing up, the dollar was very weak, commodity prices went up, and there was some understandable, I was there, I was in the government, I wasn't in the Federal Reserve, thank God, but I was in the government and the answer you got was well, you know, the oil price had come down, it's temporary, it's a special circumstance. Soy beans, remember soy beans skyrocketed. We prohibited export of soy beans for a while. It sounds like rice today. But you found out that once that process got started and the extremes of those prices did come down, but the sense of some continuing inflation began to get built in. And you know, we had great hopes of having killed that a while ago, and I don't know what to say of inflationary expectations now. I don't think they're radical the way they were in the late 1970's, but I think we're at a point where we have to worry about it, and that cannot be excluded from policy consideration.

GLEN HUBBARD: Pete, the last non-partisan question goes to you.

PETE PETERSON: Mr. Chairman, in times past you have said that there is a 75% chance of a dollar crisis within five years. What are the likely scenarios that might lead to such a crisis? What would such a crisis look like and what would its implications be, and what might we do to prevent one? Or do you believe we're already in a dollar crisis?

PAUL VOLCKER: I think that's a very simple answer Pete. I think I said crisis time, not dollar crisis, and I said it about four years ago, and we're in it. You don't have to predict it, you're in it.

GLEN HUBBARD: There we have it. It falls to me to take the punch bowl away just as this party was getting going, but thank you so much Chairman Paul Volcker for those outstanding remarks and to our questioners. We do have, as lunch is being served, a birthday cake I believe somewhere being brought out to honor you on your 80th birthday, and we're happy to do 79, 78, 77 and just roll backward with you. (Happy Birthday to You).

END OF MEETING