CENTRAL BANKING AT A CROSSROAD
REMARKS BY PAUL A. VOLCKER
UPON RECEIVING
THE ECONOMIC CLUB OF NEW YORK
AWARD FOR LEADERSHIP EXCELLENCE
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This is a very special occasion for me. The New York Economic Club has, in its 100 plus years, given its Award for Leadership Excellence only once before today. I also realize one is entitled to such an award only in the light of a long life, carrying with it the implication that my remaining time may be limited.

In light of those circumstances, I set out to write a treatise on monetary policy and the purposes and functions of the Federal Reserve. After all, I've been around the System, the Treasury and banking for some 60 years. But then, Jan Hopkins called, explaining quite clearly that 20 minutes or so would be quite adequate for my remarks. She is right. So you will not get my treatise this afternoon. Rather, I have what is known in the academic world as an abstract.

In thinking about it, I have been struck by parallels between the challenges facing the Fed today and those when I first entered the System as a neophyte economist in 1949.

Most striking then, as now, the Federal Reserve was committed to maintaining a pattern of very low interest rates, ranging from close to zero at the short end to 2½ percent or less for Treasury bonds. If you feel a bit impatient about the situation now, quite understandably so, recall that the earlier episode lasted 15 years.

The initial steps taken in the midst of the 1930's continuing depression were at the Fed's initiative. The pattern was held through World War II in explicit agreement with the Treasury. Then it persisted right in the face of double digit inflation after the War, increasingly under the duress imposed by Treasury and Presidential pressure.

The growing restiveness of the Federal Reserve was reflected in testimony by Mariner Eccles in 1948: "under the circumstances that now exist, the Federal Reserve System is the greatest potential agent of inflation that man could contrive", pretty strong language by a sitting Fed governor and a long serving Board Chairman. But it was then a fact that there were many doubts about whether the formal legal status of the central bank could or should be sustained against Treasury and Presidential importuning. At the time, the influential Hoover Commission

on government reorganization itself expressed strong doubts. At any rate, over time calls for freeing the market met strong resistance.

Treasury debt had ballooned in the War, exceeding 100 percent of the GDP, so there was concern about an intolerable impact on the budget if interest rates rose strongly.

Ending Federal Reserve support might lead to panicky and speculative reactions, and declines in bond prices would drain bank capital.

Main line economists, and the Fed itself, worried that a sudden rise in interest rates could put the economy back in recession.

All of that resonates today, some 60 years later, even if few now take the extreme view of the first report of the then new Council of Economic advisors: "low interest rates at all time and under all conditions, even during inflation" would be desirable to promote investment and economic progress. Not exactly a robust defense of the Federal Reserve and independent monetary policy.

Eventually, the Federal Reserve did get restless, and finally in 1951 rejected overt Presidential pressure to continue the ceiling on long-term Treasury rates. In the event, the ending of the "peg" was not dramatic. Interest rates did rise over time, but long bonds, with markets habituated for years to a low interest rate, remained at moderate levels. Monetary policy, free to act against incipient inflationary tendencies, contributed to 15 years of stability in prices, accompanied by strong economic growth and high employment. The recessions were short and mild.

No doubt, the challenge of orderly withdrawal from today's broader regime of "quantitative easing" is far more complicated. The still growing size and composition of the Fed's balance sheet implies the need for, at the least, an extended period of "disengagement". Moreover, the extraordinary commitment of Federal Reserve resources, alongside other instruments of government intervention, is now dominating the largest sector of our capital markets, that for residential mortgages. Indeed, it is not an exaggeration to note that the Federal Reserve, with assets

of three and a half trillion dollars and growing, is, in effect, acting as the world's largest financial intermediator, acquiring long-term obligations and financing short-term, aided and abetted by its unique privilege to create its own liabilities.

Beneficial effects of the actual and potential monetization of public and private debt, the essence of the QE program, appear limited and diminishing over time. The old "pushing on a string" analogy is relevant. The risks of encouraging speculative distortions and the inflationary potential of the current approach plainly deserve attention. All of this has given rise to debate within the Federal Reserve itself. In that debate, I trust sight is not lost of the merits - economically and politically - of an ultimate return to a more orthodox central banking approach.

I do not doubt the ability and understanding of Chairman Bernanke and his colleagues. They have a considerable range of tools and instruments available to them to manage the transition, including the novel approach of paying interest on excess reserves, potentially sterilizing their monetary impact. What is at issue - what is always at issue - is a matter of good judgment, leadership, and institutional backbone. A willingness to act with conviction in the face of predictable political opposition and substantive debate is, as always, a requisite part of a central bank's DNA.

Those are not qualities that can be learned from text books. Abstract economic modeling and the endless regressions of econometricians will be of little help. The new approach of "behavioral" economics itself is recognition of the limitations of mathematical approaches, but that new "science" is in its infancy.

A reading of history may be more relevant. Here and elsewhere, the temptation has been strong to wait and see before acting to remove stimulus and then moving toward restraint. Too often, the result is to be too late, to fail to appreciate growing imbalances and inflationary pressures before they are well ingrained.

There is something else beyond the necessary mechanics and timely action that is at stake. The credibility of the Federal Reserve, its commitment to maintain price stability

and its ability to stand up against pressing and partisan political pressures is critical. Independence can't just be a slogan. Nor does the language of the Federal Reserve Act itself assure protection, as was demonstrated in the period after World War II. Then, the law and its protections seemed clear, but it was the Treasury that for a long time called the tune.

In the last analysis, independence rests on perceptions of high competence, of unquestioned integrity, of broad experience, of non-conflicted judgment and the will to act. Clear lines of accountability to the Congress and the public will need to be honored.

Moreover, maintenance of independence in a democratic society ultimately depends on something beyond those institutional qualities. The Federal Reserve - any central bank - should not be asked to do too much, to undertake responsibilities that it cannot reasonably meet with the appropriately limited powers provided.

I know that it is fashionable to talk about a "dual mandate" - that policy should be directed toward the two objectives of price stability and full employment. Fashionable or not, I find that mandate both operationally confusing and ultimately illusory: operationally confusing in breeding incessant debate in the Fed and the markets about which way should policy lean month-to-month or quarter-to-quarter with minute inspection of every passing statistic; illusory in the sense it implies a trade-off between economic growth and price stability, a concept that I thought had long ago been refuted not just by Nobel prize winners but by experience.

The Federal Reserve, after all, has only one basic instrument so far as economic management is concerned - managing the supply of money and liquidity. Asked to do too much - for instance to accommodate misguided fiscal policies, to deal with structural imbalances, or to square continuously the hypothetical circles of stability, growth and full employment - it will inevitably fall short. If in the process of trying it loses sight of its basic responsibility for price stability, a matter which <u>is</u> within its range of influence, then those other goals will be beyond reach.

Back in the 1950's, after the Federal Reserve finally regained its operational independence, it also decided to confine its open market operations almost entirely to the short-term money markets - the so-called "Bills Only Doctrine". A period of remarkable economic success ensued, with fiscal and monetary policies reasonably in sync contributing to a combination of relatively low interest rates, strong growth, and price stability. That success faded as the Viet Nam war intensified, and when monetary and fiscal restraints were too late and too little. The absence of enough monetary discipline in the face of overt inflationary pressures left us with a distasteful combination of both price and economic instability right through the 1970's - not inconsequentially complicated further by recurrent weakness in the dollar.

We cannot "go home again", not to the simpler days of the 1950's and 60's. Markets and institutions are much larger, far more complex. They have also proved to be more fragile, potentially subject to large destabilizing swings in behavior. The rise of shadow banking, the relative decline of regulated commercial banks, and the rapid innovation of new instruments have all challenged both central banks and other regulatory authorities around the developed world. But the simple logic remains: it is, in fact, reinforced by these developments. The basic responsibility of a central bank is to maintain reasonable price stability - and by extension to concern itself with the stability of financial markets generally.

In my judgment, those functions are complementary and should be doable.

I happen to believe it is neither necessary nor desirable to try to pin down the price stability objective by setting out a single highly specific target or target zone for a particular measure of prices. After all, some fluctuations in prices, even as reflected in broad indices, are part of a well functioning market economy. The point is no single index can fully capture reality, and the natural process of recurrent growth and slow-downs in the economy will usually be reflected in price movements.

With or without a numerical target, broad responsibility for price stability over time does not imply an inability to conduct ordinary counter-cyclical policies. Indeed, in my judgment confidence in the ability and

commitment of the Federal Reserve (or any central bank) to maintain price stability over time is precisely what makes it possible to act aggressively in supplying liquidity in recession or when the economy is in a prolonged period of growth well below potential.

Credibility is an enormous asset. Once earned, it must not be fritted away by yielding to the notion that a "little inflation right now" is a good thing to release annual spirits and to pep up investment. The implicit assumption behind that Siren call must be that the inflation rate can be manipulated to reach economic objectives - up today, maybe a little more tomorrow, and then pulled back on command. But all experience amply demonstrates that inflation, when fairly and deliberately started, is hard to control and reverse. Credibility is lost.

I have long argued that central bank concern for "stability" must range beyond prices for goods and services to the stability and strength of financial markets and institutions generally. I am afraid we collectively lost sight of the importance of banks and markets robustly able to maintain efficient and orderly functioning in time of stress. Nor has market discipline alone restrained episodes of unsustainable exuberance before the point of crisis. Too often, we were victims of theorizing that markets and institutions could and would take care of themselves.

My concerns in that respect and their relevance to central banking and the organization of regulatory authority, were more fully expressed in a speech to this Club several years ago. Congress was then beginning to consider reform legislation. It was recognized that regulatory agencies, perhaps most specifically the Federal Reserve, had exhibited a certain laxity and ineffectiveness in the period leading up to the financial breakdown, particularly with respect to the mortgage market.

Nevertheless, the provisions of the Dodd/Frank Act implicitly recognized and even reinforced the range of Federal Reserve regulatory and supervisory authority. To that end, it provided for a new Vice Chairman of the Board specifically charged with responsibility for supervision. (Apparently one Governor has in practice undertaken that substantial role, but for some reason after almost three years the specific position remains unfilled. That lapse

unfortunately leaves open the question of whether the Administration and the Federal Reserve really appreciate the significance of maintaining the Fed's supervisory responsibilities over time.)

The Act does establish a new Financial Stability Oversight Council, a coordinating mechanism chaired by the Treasury. However, the regulatory landscape has been little changed. The result is that we are left with a half dozen distinct regulatory agencies involved in banking and finance, each with their own mandate, their own institutional loyalties and support networks in the Congress, along with an ever growing cadre of lobbyists equipped with the capacity to provide for campaign financing.

I will not take the time to elaborate on all of the evident frictions and overlapping responsibilities. But here we are, almost three years after the passage of Dodd/Frank with important regulatory and supervisory issues arising from the Act unresolved. That includes the prohibition on proprietary trading by banks (especially close to my heart) and certain aspects of trading of derivatives.

Beyond Dodd/Frank, a seeming consensus among the agencies and the Treasury on reform of money market mutual funds still has not resulted in action even though no new legislation is required. Similarly, progress toward international accounting standards is stalled and any meaningful reform of the credit rating agencies is absent.

I know these issues raise old questions of regulatory organization, some apparent 50 years ago. I also know some of the current issues are complex and call for highly technical judgments. But none of that mitigates the fact that lack of agreement on key regulations and their enforcement is simply unacceptable to the financial industry as well as in terms of effective governance. We also know that the present overlaps and loopholes provide a wonderful obstacle course that plays into the hands of lobbyists resisting change. The end result is to undercut the market need for clarity and the broader interest of citizens and taxpayers.

The simple fact is the United States doesn't need six financial regulatory agencies. It is a recipe for

indecision, neglect and stalemate, adding up to ineffectiveness. The time has come for change.

As things stand today, I am told that can't happen and it won't happen. However powerful the arguments for action, the vested interests - within the agencies, in the Congress and outside - are just too strong.

I ask you, can we let that view stand unchallenged?

Permit me to look back once more, a half a century ago, for inspiration. Then, faced with similar issues about financial markets, monetary policy and regulation, with unanswered questions and political pressures from left and right, two special inquiries were launched. The first was by the Congress itself. A few years later an extensive review entirely sponsored by the private sector was undertaken. Both were well financed and staffed, with highly responsible leadership. In the Senate, there was Senator Paul Douglas, a well known economist, who provided leadership and chaired the inquiry by the Joint Economic Committee. Frazer Wilde, a public spirited, highly respected insurance company executive chaired the private Commission on Money and Credit.

I recall from my then limited perch that the Federal Reserve was, true to its name, reserved, fearing that its independence and authorities might be questioned. Moreover, it's easy to look back and find that most of the specific and detailed recommendations - including proposals to consolidate the regulatory agencies - never were acted upon.

However, something crucially important was achieved. The result was to reinforce the rationale for Fed independence at a time when that was not taken for granted. Both extreme "populist" and "liberal" views about the monetary policy and the organization of the Federal Reserve were rejected. The need for adequate resources and able staff for all the regulatory agencies was strongly supported. More broadly, a growing role for active counter-cyclical fiscal policy was advocated when that was not yet commonly accepted.

Can we replicate that process today? Can the strong ideological and political divisiveness, along with the baleful influence of the constant search for campaign

financing, in the present Congress be overcome? I don't know. I do sense a risk of a quite different kind of inquiry emerging, one with a preconceived mission of limiting Federal Reserve independence, restraining needed financial regulation, and conducting radical surgery on the financial system.

Let's reject a meat axe approach. Much better that the President, Congressional leaders, interested and responsible business and academic experts together support something constructive, a well coordinated, adequately financed inquiry bringing together the legitimate public and private interests.

The erosion of confidence and trust in the financial world, in the financial authorities that oversee it, and in Government generally is palpable. That can't be healthy for markets or for the regulatory community. It surely can't be healthy for the world's greatest democracy, now challenged in its role of political and economic leadership.

Instead of complaining, let's do something about it - something that can in its own way help restore a sense of trust and confidence which is so lacking today.