

REMARKS BY PAUL A. VOLCKER
BEFORE THE
STATUTORY CONGRESS OF THE
EUROPEAN PEOPLE'S PARTIES
IN BONN, GERMANY
DECEMBER 9, 2009

As an American long involved with economic policy and the world of finance, I welcome this opportunity to review with European leaders matters of common concern.

For some time, the world economy has been faced with large and growing imbalances in trade and international payments. American deficits and Chinese surpluses have been the largest of those imbalances, but they have not been the only examples. One result has been a massive increase in foreign holdings of the United States dollar, which happens to serve the world as an international currency.

Then last year, the breakdown in the financial system plunged the developed world into sharp declines in production - a "Great Recession" from which signs of recovery are still weak.

Taken altogether, this combination of underlying economic imbalances, the mutual dependence on the dollar and the disruption of financial markets poses challenges for policy as complex and as intractable as any I have experienced in my many years. These are certainly matters of concern on both sides of the Atlantic, and equally as much across the Pacific.

As noted in the Report of your Working Group, recent months have brought signs of economic recovery and there has been some stabilization in financial markets. But do not be misled. The recovery is still weak and vulnerable, still dependent on forceful monetary and fiscal support. In the United States as elsewhere, the commercial banking system still requires attentive care, and financial markets are still dominated by official intervention.

In other words, this is no time for a return to "business as usual". The rally in world stock markets from recession lows, has brought renewed hopes on Wall Street and the City of London for a return to outlandish bonuses

for financial operators and a vigorous defense of established vested interests. Those hopes and positions must not distract us from what needs to be done to achieve needed reform.

We simply cannot afford further breakdowns in financial markets. A prolonged economic slump with sustained high unemployment would undermine public confidence in the value of free and open economic systems in support of the growth and vitality of the world economy.

As emphasized in your Working Group Report, reform - lasting and effective reform - of the financial system is dependent on achieving international consensus, not necessarily in every detail, but certainly in broad approach. Both the United States and Europe will necessarily be the center of that effort - after all, it is our markets and our institutions that are still predominant in the financial world.

There can be no doubt prospects for success in achieving wide international agreement will be dependent on Europe and the United States providing leadership.

In that respect, there is a lot of common ground. I can point for example, to many consistent elements in the G-30 Report that I chaired a year ago and the characteristically lucid analyses of Lord Turner and Governor King in the U.K. Perhaps most relevant is the careful detailed work of the Financial Services Board in Basle under the leadership of Governor Draghi of the Bank of Italy, with his colleagues from around the world.

Important elements of this work can proceed without the need for national legislation. Specifically, the need for better risk management within commercial banks and other important financial institutions is evident and can and should be pressed by existing regulatory agencies.

If institutional risk management was inadequate, then what about the official regulators? Clearly, there are lessons to be learned, and more effective supervisory practices developed. An important part of that work must be common approaches toward capital and liquidity, building upon the substantial, but now inadequate efforts of past years.

Another area calling out for a common approach is better surveillance of the grossly swollen shadow world of derivatives, critically including the relatively new and not fully tested instrument of credit default swaps. The fact is that so-called CDS' within a few years expanded to amounts far exceeding the credits for which they nominally provided protection against default. That in itself raises interesting questions about the degree of speculation and an erosion of credit standards in the market place. Specifically, legislation may be needed to assure proper "fail-safe" clearing and settlement practices for these derivatives.

Registration, reporting and surveillance of hedge funds, private equity funds, and credit rating agencies are also parts of the detailed reform agenda that will require legislative and regulatory attention in most countries.

The main point I want to emphasize is a broader, more fundamental issue at the heart of financial reform.

Banking, as well as finance generally, entails large risks. That has been true throughout history. As financial institutions have become larger, more complex, and more mutually interdependent, the adverse economic consequences of default and failure of these institutions have become greater. Recent events amply demonstrate the points.

In recognition of that reality, governments and central banks have both rescued particular financial firms and flooded markets with liquidity to deal with the market repercussions. However necessary in the circumstances, adverse consequences of that intervention are apparent. There are competitive inequities and distortions inherent in official large scale intervention in particular sectors of financial markets. Potentially much more important is the creation of expectations of future rescues. The insidious result is to encourage further risk-taking - the essence of "moral hazard".

A particularly notable characteristic of recent developments is that the official intervention has been extended beyond past practice of protecting commercial banks to non-bank money and capital markets.

The challenge before us all is not only to reduce highly aggressive, excessively risk-prone banking but to make the financial system "safe against failure".

That has been a challenge since Adam Smith and before, without a totally satisfactory answer. One consistent response has been to protect and support national commercial banking systems with a combination of regulation and a so-called "safety net", including deposit insurance and a central bank able and willing to serve as a "lender of last resort". The central idea is to provide liquidity to troubled but solvent institutions while protecting individual depositors.

The need for that approach seems to me clear and still valid. It is commercial banks that lie at the heart of any financial system. It is those banks that provide efficient facilities for making payments nationally and internationally. They provide a safe depository for liquid funds. They are a basic source of credit for individuals and businesses large and small. They provide investment advice, and these days both underwrite corporate debt and securitize credits.

Those are basic, really indispensable functions for any economy. They typically involve direct customer relationships and dependencies. And that is why they have through the years been regulated and protected.

We have in more recent years seen proliferation of non-bank financial institutions - hedge funds, equity funds, investment banks heavily engaged in trading activity, even sometimes, as once in Germany, a substantial mixture of banking with ownership of commercial firms. These capital market institutions, despite some overlap, serve different functions than commercial banks. They trade and speculate in open markets on the basis of price and spread rather than primarily for customers. They provide liquidity to markets and may raise capital, but they do so without implied responsibility for meeting customers' continuing needs. Indeed, much of their activity is trading with each other, and they are typically dependent on commercial banks for payment, credit and custodial services.

The distinction between commercial banking and capital market institutions provides a clear rationale for a

practical approach toward more effective regulation and supervision of financial organizations and markets. The object is to greatly reduce moral hazard by limiting the need to rescue even large failing institutions. At the same time, the tendency for a failure of one institution to set off an infectious panic would be contained.

Specifically, the logic would be to reduce the risk and vulnerability of commercial banks by:

- Prohibiting their ownership or sponsorship of hedge funds, private equity funds, and purely proprietary trading in securities, derivatives or commodity markets, and
- Strictly enforcing a functional separation of banking organizations from commercial and industrial activities.

These measures, in addition to directly eliminating potential areas of risk, would help focus management attention on the core functions of banking organizations. Pervasive conflicts of interest would be reduced. If one result would be to limit the size of the largest mega-banking organizations, that too would be useful.

There may well be a few (I think very few) non-banking financial firms so large and so interconnected that their sudden failure would present a systemic risk. There are, in fact, only three free-standing investment banks of great size and international stature still operating independently. For those institutions and others, authority for an appropriate regulator to place restrictions on capital and leverage will be appropriate.

There also appears to be a growing consensus among national regulatory officials that a standby "resolution authority" be established for a failing or failed institution, bank or non-bank. In concept, the appropriate agency would step in to manage in an orderly and expeditious manner the liquidation or merger of that institution, rather than assist in its survival. The plain implication would be to eliminate residual value for stockholders. Depending upon the ultimate liquidation value and respecting the established contractual priorities, creditors would be placed at risk.

I am well aware that any national approach along these lines will raise cries by organizations facing new restrictions of unfair competitive disadvantage. I hear those complaints in New York, in London, and elsewhere.

The answer couldn't be more clear: this is, indeed, an example of why a common international approach is essential, in concept if not in every detail. I feel confident that such a common approach between the European Union and the United States would attract a following elsewhere and could be broadly enforced.

Important questions of appropriate administrative arrangements arise in all national and regional jurisdictions. They will not need to be uniform, and in the light of different political, cultural and regulatory traditions, they will not be.

Issues of appropriate administrative agencies and their jurisdiction are being actively debated in the United States Congress as I speak.

In our particular context, the main question is the extent to which our central bank, the Federal Reserve, should retain extensive, if any, regulatory and supervisory authority over banks and the financial system generally. The Administration and many experienced commentators propose that "the Fed" take on additional explicit responsibilities as "systemic regulator" or "systemic overseer" (as I would like). That view is, however, strongly contested.

At first impression, it seems to be a purely domestic matter for the United States to resolve. Permit me, however, in this particular place and before a European audience to make clear my own conviction: the Federal Reserve must retain "hands on" regulatory and supervisory powers to effectively discharge what I and many have always considered one of its principal responsibilities - that is to contribute to and maintain financial stability. Given the economic importance of the United States and the international role of the dollar, the uniquely important role of a strong American central bank cannot be overstated.

My point is that the Federal Reserve should not become an enclave for theoretically trained macro-economists

rather insulated from direct contact with markets and important financial institutions. If, as Chairman Bernanke has acknowledged, the Federal Reserve, like other agencies, failed to foresee and forestall the financial crisis, then the lesson is clear, its responsibilities should be clarified and its organization strengthened. But all my experience suggests that separation of monetary policy from supervisory oversight would serve neither responsibility well.

At the start of these remarks, I referred to the underlying and unsustainable imbalances in international payments. Both the recent G-20 meeting and your own Working Group have emphasized the importance of dealing with those imbalances, which, further prolonged, carry the clear risk of further monetary disturbances. Those concerns are entirely understandable and properly international, amplified by the current weakness in economic activity.

If the concerns are international, the need for action is national. As you are well aware, the American addiction to consumption over many years, supported in part by the successive stock market and housing bubbles, led to spending beyond our capacity to produce. The result was a large and growing trade deficit. China, and some other emerging and raw material-rich economies were in the opposite position, looking toward export markets to absorb rapid growth in production. With large current account surpluses, they were willing to hold rapidly increasing amounts of U.S. dollars in their reserves. Those same dollars, available at remarkably low interest rates, lubricated our financial markets and our spending.

To put the issue bluntly, we in the United States cannot persist in consuming as much as 70 percent of our GDP, while at the other extreme China, still a much poorer country, consumes at home but 35 percent of its output. Nor can we in the United States comfortably continue to finance our current account and budgetary deficits by the willingness of others to hold dollars.

Classical economists have argued with some reason that recessions are a curative process, restraining excesses and inducing a corrective process. Indeed, American consumption is now being forcibly restrained. Savings by households have finally turned positive. Most of the emerging world has happily escaped the worst of the recession. China in particular has embarked on a strong stimulus program. In

time, if sustained, those developments should achieve better balanced economies, nationally and internationally.

Those adjustments will, by their nature, take time. There is no quick fix, and we certainly can't afford to sit back, satisfied with a long period of slack performance.

Just how that challenge can be approached is a matter for a different speech on a further day. I rather want to conclude with two related points.

How did we, the United States, China, elsewhere in Asia, within Europe permit those economic imbalances to grow so large and persist so long?

To me there has been a lack of effective discipline. Fiscal and monetary policies have simply not responded in a timely way to developing and chronic financial and economic disequilibria. That marks a failure of the international monetary system - or should I say the absence of anything that can rightly be thought of as an intellectually coherent and widely acceptable international system. Instead the imbalances built up and holdings of dollars around the world have reached amounts that are increasingly uncomfortable for both those holding the dollar and those responsible for its stability.

Fundamental monetary reform has not been on the international agenda for decades. Somehow, it has seemed more comfortable to permit nations to go their own way, no matter the persistent imbalances and the volatility of exchange rates.

To its credit, Europe faced the issue head on in creating the Euro as a common currency. Individual countries in the region have been shielded from some of the uncertainties of exchange rate instability.

Broader, multi-lateral reform, I suspect is still a long ways off. Nonetheless, we can nurture thinking and encourage debate. Your Working Group has proposed precisely that in urging "a strategic discussion of as to whether and how to reform our global currency systems".

For the time being, fiscal and financial policies in the United States, as in a number of other countries are held hostage to the need to support economic recovery and

functioning financial markets. The time will come when those policies will need to change, restoring a sustainable budgetary position and heading off monetary excesses.

As both President Obama and the Federal Reserve have acknowledged and emphasized the challenge is real, and action cannot be put off indefinitely.

In the meantime, nothing in monetary affairs is more important amid the ups and downs in the market than to maintain confidence in the basic stability and purchasing power of the United States dollar. After all, it is not just our currency, it is in crucial respects the world's currency as well.