

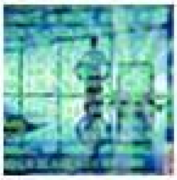

March 2010

INTERVIEW WITH PAUL VOLCKER, BY ECR'S EDIN MUJAGIC

Paul Volcker

A few months ago our monetary economist Edin Mujagic sat down and had a long chat with Paul Volcker, former chairman of the Federal Reserve and currently the head of the Economic Recovery Advisory Board in the administration of the American President Barack Obama. A short version of this interview was published in December 2009 in the Dutch business and economics weekly magazine FEM Business & Finance. Below you can read the entire interview that took place in the Rockefeller Center in New York.

Q: You said we live in a difficult world. More difficult than in the eighties, when you were the Chairman of the Federal Reserve?

A: Yes, I think so.

Q: Why is that?

A: The problem back then was fairly straightforward. We had an inflation problem, in the sense that high inflation was pretty engraved in the system. Moreover, there was abundant lending to Latin American nations and there was a great feeling of confidence on the financial markets, that one could lend freely and nobody would ever go bankrupt and everything would be fine forever. Back in those days there was also a total breakdown of commercial banking. That, in some respects, resembles the current crisis. But this crisis is much more complicated.

Q: In what sense?

A (laughing): Well, I blame it partly on financial engineers. They succeeded in greatly increasing the complexity of financial markets and the interdependence of different institutions in ways that disguised the real risks. That is much more the case now than it was in the eighties. Financial engineering had not been invented then. The difference is, banks were much more dominant in the financial system in those times than they are now. When the Latin American debt crisis broke out, regulators and central banks were able to get all of the lenders in one room and strike a deal. You cannot do that anymore. That reflects in part a relative decline of commercial banking and increase of the role of a large variety of other financial institutions, which are operating for a substantial part outside of the regulatory systems. Back in the eighties, regulators knew what was going on, because important players on the financial markets were inside the system.

Would you like to comment on this interview, then please send an email to: e.mujagic@ecrresearch.com

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Q: Would you like to re-introduce the Glass–Steagall Act, which separated commercial and investment banking?

A: I do not want to do that, because the Glass-Steagall Act was very simple. It said commercial banks were not allowed to underwrite or deal in corporate securities. I would actually let them underwrite corporate securities, I think that is an extension of their credit business. Banks directly servicing businesses, individuals and governments are the heart of financial system. Activities on capital markets entail a lot of added risk and are inappropriate for commercial banks, which ought to be protected and regulated. But I do not propose to regulate everybody on the capital markets beyond some basic registration and reporting requirements and for a few large institutions capital and leverage restrictions. I want as few institutions as possible to be regulated and protected.

My philosophy is: let those capital markets activities take place in the capital markets and let the customers-related activities take place in the banking system. Protect those basic banking activities by regulation and deposit insurance but try not to extend that protection to the capital markets institutions generally. During this crisis that has happened, protection has been extended to non-banking institutions. Some of them own some kind of a little bank and have gotten named bank holding companies basically in the midst of the crisis to bring them in the protection-camp, while they have not been bank holding companies before the crisis. I want to get them out of that camp. It seems anomalous for the government to be seen as supporting financial activities of companies like General Electric or indeed of Goldman Sachs and other institutions that are primarily trading companies.

Q: What new regulations would you like to see for banks?

A: The primary thing I would like to see is prohibiting commercial banks from proprietary trading and investing in or owning equity funds and hedge funds. I do not think we need any change of the law to impose capital and other prudential standards. Regulatory authorities, certainly those in the United States, have all the authority they need. A key component of my proposals is the so-called resolution procedure. I think some agency should have the role of a funeral parlor so to speak. When a non-bank institution get in trouble and it is so large it requires some kind of official handling, the official handle should be to see it to a merger or to the grave, not to provide new capital for that company.

Q: What lessons has the world financial community learned in the last year or so?

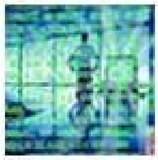
A: I think the current problems date back longer than one year ago. What made the crisis so complex is not just financial excesses, it is also economic imbalances. US and some other countries, but primarily the US, have consumed too much for too long. They financed that consumption with money from other countries, such as China and other Asian countries and also the oil-producing countries. The money came very easily. The combination of lots of money and financial engineering together has led to a great boom in consumption and in housing markets. When the housing market got too far out of the line, the confidence of consumers fell and mortgage financing evaporated. This mortgage financing had been extreme in the US. When things unraveled in those sectors, it exposed weaknesses in other sectors of the economy as well.

Q: Do you feel a more monetarist-like monetary policy, meaning if more attention was paid to money supply growth by central banks, would have helped to prevent or cushion the crisis?

A: My impression is that during the build-up to the current crisis, the money supply was not really exceptionally high. All the financing took place in alleys of the financial markets that did not require expansion in money as defined traditionally.

Q: Let me rephrase that question. Should the monetary authorities in the US and elsewhere have been more alert to growing economic imbalances and bubbles in financial markets?





A: (laughing) It became out of fashion to worry about those kinds of things. I think it is back in fashion now.

Q: The money supply has increased recently as governments and central banks around the world have taken far-reaching measures to prevent a meltdown of their financial systems. Does that worry you?

A: Down the road, if nothing is done, yes, that worries me. There is however still sufficient time to deal with that, but it has to be done in a disciplined way as the economy recovers. That is however very difficult to do, because it means central banks have to begin to roll back their emergency measures while there is still a lot of unemployment and excess capacity and their actions therefore are not very popular politically. It has never been popular and it will not be popular this time.

Q: You have been able to do that when you were chairman of the Federal Reserve.

A: It requires a lot of discipline of monetary authorities. On top of those problems the US also has this great budget deficit.

Q: How would you like to see that deficit reined in?

A: Ordinarily, I am not a fan of creating some commission to deal with these problems. But depending on how it is structured, I would not exclude that as a method this time to get some consensus on what should be done. There must be broad consensus and some degree of bipartisanship about what kind expenditures are appropriate and to face up to the need for some new taxes. That is impossible at the moment.

There must be enough sense of urgency to get that consensus and I do not feel enough concern is mustered at this moment. Some people say you have to have a big crisis before people act. Well, I think we have a very big crisis now, you cannot get much bigger crisis in financial markets than this one. But despite all that and despite the big deficits we have not a budget crisis in the US. We are having one at the state and local level of government however. State and local authorities in the US are much more constrained in their ability to borrow. Most of them have constitutions prohibiting them from running deficits.

However, many have yarning deficits now due to the crisis. Those deficits have been met partly by the stimulus program of the federal government but as that phases out some of those state deficits will become even more apparent.

Q: What will be the long lasting impact on the US and world economy of the current crisis?

A: The big challenge for the US is to change the structure of its economy. We need to improve our export ability and capacity. That means more manufacturing. In the last decade we have had the free availability of credit and the great willingness to consume while letting the capacity to produce languish, in particular our manufacturing capacity.

Sooner or later we have to produce something we can sell to the world. That has been declining and the big challenge as I see it, is to stop that decline and regain some lost ground and weaning the consumer away from excessive consumption. We cannot rebuild our economy by trying to get back to 70 percent consumption or housing booms. It will just break down again.

The US can take advantage of the need for technological process in areas such as global warming and environment where there should be big new opportunities. I rather have the feeling the US is inventing some of those opportunities and other people are implementing them. We have to do some implementing of our own in the US too. Windmills and solar panels are an example. Neither of them is going to solve the energy problem, but they are becoming more important. There is a lot of talk about those in the US and also a lot of technological work in those areas, but too much of the production is done elsewhere. We need to get some of that production back to the US.

Q: How?

A: We have to develop some economic forces that will move the US in the direction of more export and less import. One large economic force moving us in that direction are the emerging markets. They are doing very well so their ability to import is growing and as they reshape their economies towards more consumption that will help solve our problem. That process takes a long time, but there is no alternative. Economic forces will force that adjustment eventually.

Q: Is an even weaker dollar also an economic force in that sense?

A: We have a global financial sector and that will stay that way, unless we really make a mess out of things. In that global financial sector there is a demand for an easily usable world currency. We have no official world currency, but the dollar fills that hole. Once it does, it is hard to get rid of it. The fact that people use the dollar because other people are using it, is a very strong force keeping the dollar very useful internationally. You can imagine that when there are too many dollars out there, that the stability of the currency is brought into question. One aspect of that stability is prices here at home, in the US I think it is critical that we maintain domestic stability, so we can at least say that one dollar is worth more or less what it used to be in the world's largest economy. At some point the excess supply of dollars will have to be cut down.

When you look at the dollar, it has had some ups and downs recently. If there is a problem, it arises in China and East-Asia, excluding Japan. That is a problem the US cannot solve alone.

Q: You mean: the Chinese currency, the yuan, must revalue?

A: The Chinese have the opposite problem we do. We have been consuming some 70 percent of our gross domestic product, they some 35 percent. That is quite a contrast. The US ought to get that share down a bit, the Chinese have to get their share of consumption up a lot. That is not unrelated to the exchange rate, but there are other factors as well involved. What China can do, and it is beginning to do, is increase domestic consumption and decrease the investment.

Q: What role do you see for Europe in this game of rebalancing the world economy?

A: Europe has a common currency with different economic situation in different countries. It is not quite like the case of US and China, which in effect have a common currency too, due to the steady exchange rate.
It is very interesting to look from abroad at how Europe deals with those very different situations in different countries of the eurozone.

I have always been a believer in the euro so I want to see this work out in an orderly way. Europe is better off having a common currency than to be in a similar economic situation without a common currency. In that case, Europe would have a great deal of instability on its hands. I do not, however, see Europe being particularly dynamic internationally. The eurozone as a whole is not out of balance but some countries inside the eurozone are, they have for example large current account deficits. Europe is not at the centre of big adjustments that have to take place in the world economy.

Q: What can Europe do, if anything, to help the world economy rebalance in a orderly way?

A: Europe is helping by letting the exchange rate, at least for now, go. That seems appropriate thing to do to me. Everything that is done so that Europe as a whole expands more rapidly would help the world economy, through increased stability. I do not expect Europe to go and have a big economic boom. It would help if that were to happen, but I just do not see that happening.

Another way Europe can help is in the reform of the financial system. It is important we get a consensus between the US and Europe on the main elements of financial reform. I find it

almost comical that when some reforms are suggested in the US, we often hear comments like ‘ you cannot do that, we will not be competitive to the Europeans anymore’. Then I pick up the Financial Times and read in it that European banks are worried about proposals for reform in Europe because those would hurt their competitive position versus US banks (laughing). We have to have some common approach. I think that is recognized in area of capital markets but it is not recognized yet in areas of structural reforms.

Q: You said that if Europe, and hence the eurozone, expands as a whole, that would help. Would it help if the United Kingdom was in the eurozone?

A: Ten years ago I used to think it would be helpful. Then it was much in the British interest to join the eurozone. I am not so convinced of that now. The UK has been able to withstand very large ups and downs in the exchange rate between the pound and the euro, in a sense that that has not done as much damage to the economy as I may have thought it would. What I was afraid of is that with the UK outside the eurozone, people internationally would not want to invest in the UK, due to the exchange rate uncertainty. That seems not to have happened.

More generally, I think the world might evolve towards three big currency blocs, the US dollar bloc, the euro bloc and the renminbi bloc in Asia.

Q: Will that be beneficial to the world economy?

A: If there is a reasonable relationship between those blocs it would be fine. But if it encourages protectionism between them, then it would not be so great for the world economy. If there would be a large degree of exchange rate instability, it would also be detrimental to the world economy.

Q: What is your outlook on the US economy in 2010?

A: The US economy has grown in the third quarter, but we do not yet have the self-propelling recovery in the US. We are still very near the bottom.

I expect the economy to grow in the coming quarters. We have the effects of the economic stimulus working their way through the economy, house prices are as far down as they can go, the inventories cannot be reduced much further, so we are bound to get some upward lift in the coming months from that. But unless we get some real business investment back, I think the US economy will struggle. Business investment has not recovered yet, which is understandable. As a consequence we are going to have big government deficits for a while. We have shifted from a consumption-based economy to a deficit-based economy. Now the US has to get from that to a investment-based economy.

Q: Some economists fear that as a consequence of the stimuli inflation will increase in the future. What should the Federal Reserve do to make sure that does not happen?

A: The Fed should be alert to that danger. They say they are and I do believe they are. But then again, you have to be able to act when needed, which is never easy. That is why we have an independent Federal Reserve.

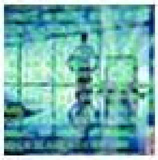
Q: That independence is now under attack. Does that worry you?

A: The Fed is now under attack in ways that are broader than any other time since the fifties. It is a matter of concern. I think that in the end its independence will be preserved. I also think it is important the Fed maintains some role as a regulator.

Q: But inflation will become a problem if the Fed does not act timely, is that what you are saying?

A: Yes, but it is not a concern at this point in time. Amidst 10-per-cent unemployment, an economy that is still not far from the bottom





and a financial system that cannot yet stand on its own, the inflationary threat is not immediate. In the coming years inflation could become a problem, but whether that is in one, two or three years time, I do not know. It all depends on how the economy develops and some other factors. In any case, having 0 percent official interest rate is a very abnormal situation and there is a real question whether there is a bubble building up in Asia. Partly it is due to their domestic policies, but partly also a reflection of this easy monetary policy in the US.