

Grano Series – The Future of the Global Economy

The 5th^d annual speakers series, held in Toronto at Grano Restaurant, explores the challenges of the global economy given the world-wide recession and market collapse of 2008-09.

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A profound crisis

Paul Volcker

The following is an edited transcript of Paul Volcker's talk at the Grano Series. Mr. Volcker was former head of the Federal Reserve under Ronald Reagan and is currently economic advisor to President Obama.

There is a certain interest in what's going on in the financial world. And I will disappoint you by saying I don't know all the answers. But I know something about the problem. Let me just sketch it out a little bit and suggest where we may be going. There is a lot of talk about how we get out of this, but I think it's worth remembering, or analyzing, how this all started.

This is not an ordinary recession. I have never, in my lifetime, seen a financial problem of this sort. It has the makings of something much more serious than an ordinary recession where you go down for a while and then you bounce up and it's partly a monetary – but a self-correcting – phenomenon. The ordinary recession does not bring into question the stability and the solidity of the whole financial system. Why is it that this is so much more profound a crisis? I'm not saying it's going to get anywhere as serious as the Great Depression, but that was not an ordinary business cycle either.

This phenomenon can be traced back at least five or six years. We had, at that time, a major underlying imbalance in the world economy. The American proclivity to consume was in full force. Our consumption rate was about 5% higher, relative to our GNP or what our production normally is. Our spending – consumption, investment, government -- was running about 5% or more above our production, even though we were more or less at full employment.

You had the opposite in China and Asia, generally, where the Chinese were consuming maybe 40% of their GNP – we consumed 70% of our GNP. They had a lot of surplus dollars because they had a lot of exports. Their exports were feeding our consumption and they were financing it very nicely with very cheap money. That was a very convenient but unsustainable situation. The money was so easy, funds were so easily available that there was, in effect, a kind of incentive to finding ways to spend it.

When we finished with the ordinary ways of spending it – with the help of our new profession of financial engineering – we developed ways of making weaker and weaker mortgages. The biggest investment in the economy was residential housing. And we developed a technique of manufacturing class D mortgages but putting them in packages which the financial engineers said were class A.

So there was an enormous incentive to take advantage of this bit of arbitrage – cheap money, poor mortgages but saleable mortgages. A lot of people made money through this process. I won't go over all the details, but you had then a normal business cycle on top of it. It was a period of enthusiasm. Everybody was feeling exuberant. They wanted to invest and spend.

You had a bubble first in the stock market and then in the housing market. You had a big increase in housing prices in the United States, held up by these new mortgages. It was true in other countries as well, but particularly in the United States. It was all fine for a while, but of course, eventually, the house prices levelled off and began going down. At some point people began getting nervous and the whole process stopped because they realized these mortgages were no good.

You might ask how it went on as long as it did. The grading agencies didn't do their job and the banks didn't do their job and the accountants went haywire. I have my own take on this. There were two things that were particularly contributory and very simple. Compensation practices had gotten totally out of hand and spurred financial people to aim for a lot of short-term money without worrying about the eventual consequences. And then there was this obscure financial engineering that none of them understood, but all their mathematical experts were telling them to trust. These two things carried us over the brink.

One of the saddest days of my life was when my grandson – and he's a particularly brilliant grandson – went to college. He was good at

mathematics. And after he had been at college for a year or two I asked him what he wanted to do when he grew up. He said, "I want to be a financial engineer." My heart sank. Why was he going to waste his life on this profession?

A year or so ago, my daughter had seen something in the paper, some disparaging remarks I had made about financial engineering. She sent it to my grandson, who normally didn't communicate with me very much. He sent me an email, "Grandpa, don't blame it on us! We were just following the orders we were getting from our bosses." The only thing I could do was send him back an email, "I will not accept the Nuremberg excuse."

There was so much opaqueness, so many complications and misunderstandings involved in very complex financial engineering by people who, in my opinion, did not know financial markets. They knew mathematics. They thought financial markets obeyed mathematical laws. They have found out differently now. You know, they all said these events only happen once every hundred years. But we have "once every hundred years" events happening every year or two, which tells me something is the matter with the analysis.

So I think we have a problem which is not an ordinary business cycle problem. It is much more difficult to get out of and it has shaken the foundations of our financial institutions. The system is broken. I'm not going to linger over what to do about it. It is very difficult. It is going to take a lot of money and a lot of losses in the banking system. It is not unique to the United States. It is probably worse in the UK and it is just about as bad in Europe and it has infected other economies as well. Canada is relatively less infected, for reasons that are consistent with the direction in which I think the financial markets and financial institutions should go.

So I'll jump over the short-term process, which is how we get out of the mess, and consider what we should be aiming for when we get out of the mess. That, in turn, might help instruct the kind of action we should be taking in the interim to get out of it.

In the United States, in the UK, as well – and potentially elsewhere – things are partly being held together by totally extraordinary actions by a central bank. In the United States, it's the Federal Reserve, in London, the Bank of England. They are providing direct credit to markets in massive volume, in a way that contradicts all the traditions and laws that have governed central banking behaviour for a hundred years.

So what are we aiming for? I mention this because I recently chaired a report on this. It was part of the so-called Group of 30, which has got some attention. It's a long and rather turgid report but let me simplify what the conclusion is, which I will state more boldly than the report itself does.

In the future, we are going to need a financial system which is not going to be so prone to crisis and certainly will not be prone to the severity of a crisis of this sort. Financial systems always fluctuate and go up and down and have crises, but let's not have a big crisis that undermines the whole economy. And if that's the kind of financial system we want and should have, it's going to be different from the financial system that has developed in the last 20 years.

What do I mean by different? I think a primary characteristic of the system ought to be a strong, traditional, commercial banking-type system. Probably we ought to have some very large institutions – or at least that's the way the market is going – whose primary purpose is a kind of fiduciary responsibility to service consumers, individuals, businesses and governments by providing outlets for their money and by providing credit. They ought to be the core of the credit and financial system.

This kind of system was in place in the United States thirty years ago and is still in place in Canada, and may have provided support for the Canadian system during this particularly difficult time. I'm not arguing that you need an oligopoly to the extent you have one in Canada, but you do know by experience that these big commercial banking institutions will be protected by the government, de facto. No government has been willing to permit these institutions, or the creditors and depositors to these institutions, to be damaged. They recognize that the damage to the economy would be too great.

What has happened recently just underscores that. And I think we're at the point where we can no longer fool ourselves by saying that is not the case. The government will support these institutions, which in turn implies a closer supervision and regulation of those institutions, a more effective regulation than we've had, at least in the United States, in the recent past. And that may involve a lot of different agencies and so forth. I won't get into that.

But I think it does say that those institutions should not engage in highly risky entrepreneurial activity. That's not their job because it brings into question the stability of the institution. They may make a lot of money

and they may have a lot of fun, in the short run. It may encourage pursuit of a profit in the short run. But it is not consistent with the stability that those institutions should be about. It's not consistent at all with avoiding conflict of interest.

These institutions that have arisen in the United States and the UK that combine hedge funds, equity funds, large proprietary trading with commercial banks, have enormous conflicts of interest. And I think the conflicts of interest contribute to their instability. So I would say let's get rid of that. Let's have big and small commercial banks and protect them – it's the service part of the financial system.

And then we have the other part, which I'll call the capital market system, which by and large isn't directly dealing with customers. They're dealing with each other. They're trading. They're about hedge funds and equity funds. And they have a function in providing fluid markets and innovating and providing some flexibility, and I don't think they need to be so highly regulated. They're not at the core of the system, unless they get really big. If they get really big then you have to regulate them, too. But I don't think we need to have close regulation of every peewee hedge fund in the world.

So you have this bifurcated – in a sense – financial system that implies a lot about regulation and national governments. If you're going to have an open system, you have got to get much more cooperation and coordination from different countries. I think that's possible, given what we're going through. You've got to do something about the infrastructure of the system and you have to worry about the credit rating agencies.

These banks were relying on credit rating agencies while putting these big packages of securities together and selling them. They had practically – they would never admit this – given up credit departments in their own institutions that were sophisticated and well-developed. That was a cost centre – why do we need it, they thought. Obviously that hasn't worked out very well.

We have to look at the accounting system. We have to look at the system for dealing with derivatives and how they're settled. So there are a lot of systemic issues. The main point I'm making is that we want to emerge from this with a more stable system. It will be less exciting for many people, but it will not warrant – I don't think the present system does, either -- \$50 million dollar paydays in that central part of the system. Or even \$25 or \$100 million dollar paydays. If somebody can go

out and gamble and make that money, okay. But don't gamble with the public's money. And that's an important distinction.

So let me just leave it at that.