Lessons Learned, Convictions Confirmed

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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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Thank you, Joan [Spero].

I paid my way through college in part by working for Irving Pratt, who grew up right here in the Harold Pratt House, long before it became the headquarters of the Council on Foreign Relations and the bête noir of conspiracy theorists. He brought me here on a summer day in 1970 to show me his boyhood home and told me that if "you apply your talents you might someday have a house just like this." As if! Then, in the next breath he warned me of the perils of pursuing the kind of wealth he inherited, closing with William Gladstone's famous dictum: "Not even love has made so many fools of men as the pondering over the nature of money." Mr. Pratt's wisdom was somehow lost on me, for here I am 40 years later, making my living pondering over the nature of money as a central banker.[1]

It would all have been a fool's errand if I hadn't come away from my decades of experience as a market operator and my last five years as a monetary policy maker with some lessons learned—especially against the background of the past two and a half years of crisis management. So I thought I would quickly share with you this morning some of those lessons learned, or at least a set of convictions acquired, before we have our dialogue about globalization and the contours of the recovery.

I come away from my career of contemplating the nature of money with four fundamental beliefs. I am more convinced than ever that financial markets require a healthy dose of regulation to function efficiently. I am more convinced than ever of the importance of regulatory and supervisory authority to the proper conduct of monetary policy. I am more convinced than ever that too-big-to-fail banks are dangerous and should be contained, if not broken up. And I am more convinced than ever that central banks operate most effectively when insulated from political passions.

Reality Bites

I am a fierce advocate of free markets. I believe in the magic of the Invisible Hand. This is not to say that the Hand is always steady or isn't given to loss of control or spastic bouts. Capitalism wasn't designed to be stable. Asset prices overshoot during booms and bubbles; they overcorrect during busts. Panic happens. Nearly 170 years ago, Charles Mackay noted in his *Memoirs of Extraordinary Popular Delusions* that "Men … think in herds … [and] they go mad in herds"[2]—an insight overlooked by whoever wrote the copy at Merrill Lynch's ad agency. Writing in the fifth and last edition of his book *Manias, Panics, and Crashes,* Charlie Kindleberger noted that the madness of the herd has intensified in modern times:

[1] I do not speak for anybody else at the Federal Reserve—a disclaimer that is usually readily apparent in my case but is nonetheless de rigueur.

[2] *Memoirs of Extraordinary Popular Delusions,* by Charles Mackay, London: Richard Bentley, 1841, vol. 1, p. 3.

"… the conclusion is unmistakable that financial failure has been more extensive and pervasive in the last thirty years than in any previous period."[3]

He attributed this in part to the fact "'that there are many more countries in the international financial economy and in part [because] data collection is more comprehensive."[4] Mind you, this was written before the herd turned decidedly lemming-like in the lead-up to 2008.

Even if we accept that markets will always be given to volatility, we know from repeated experience that market failures that roil the financial system can have disastrous repercussions—setting off an adverse feedback loop of contracting credit flows, declining economic activity and sustained, high unemployment. This reminds us of the vital role money and credit play in maintaining a healthy economy. I liken it to the cardiovascular system. In an economy, the central bank is the heart, money is the lifeblood, and financial markets are the arteries and capillaries that provide critical sustenance to the muscles that are the makers of goods and services and the creators of employment. A properly functioning cardiovascular system fosters healthy growth; if that system fails, the body breaks down and the muscles atrophy.

That is what happened in the most recent crisis. Elaborate statistical models and complex securitization products created the illusion of control over credit and liquidity risk in the banking system. Misperceptions of risk and misplaced incentives led to misguided actions. As market participants uncovered the truth—as they always eventually do, however late—confidence quickly gave way to fear and doubt. With uncertainty in full fever, cash was hoarded; counterparties viewed each other with suspicion; no business appeared worthy of financing. A full-blown seizure occurred. The economy, starved of the lifeblood of capital, shut down.

By now, I suspect many share my conviction regarding the need for improved financial regulation. We are even hearing a different tune from those who only a few years ago proclaimed the transcendent efficiency of financial markets—what I refer to as "the elaborate conceit of efficient market theory"—where today's prices are always right, markets are self-correcting and regulation is best kept to a bare minimum.

The Fed Needs to Regulate Banks of All Sizes

In theory, the Fed's monetary policy and regulatory functions are separate. In practice, they are anything but—rather, it is a symbiotic relationship. The past two years have highlighted the interconnections of monetary and regulatory policy: Monetary policy depends upon regulation that ensures the soundness of financial institutions.

Changes in the fed funds rate and other methods employed to implement monetary policy get transmitted to the economy through the arteries of the financial sector, affecting the rate at which businesses produce and grow employment, the exchange rate of the dollar and, by extension, international trade and capital flows. The process works most efficiently when those arteries are open and healthy and strong. Sclerotic banks cannot lend and properly act as intermediators.

[3] *Manias, Panics, and Crashes, A History of Financial Crises*, 5th ed., by Charles Kindleberger and Robert Aliber, Hoboken, N.J.: Wiley and Sons, 2005, p. 6.
[4] Ibid.

When they cannot lend or are otherwise hampered, monetary policy actions lose their capacity to influence the economy with accustomed efficiency.

Here is the message for those who would peel away regulatory policy from the Fed: We depend on our regulatory arm to provide in-depth, hands-on assessments to guide us as we perform our duty as the lender of last resort. We can't properly operate a discount window or perform the functions of lender of last resort if we don't have firsthand knowledge of our borrowers' financial health. We cannot implement monetary policy effectively without staying abreast of developments in the banking and financial system through the eyes and ears and constant contact of the 12 banks in our system who observe up close and personal the activities of banks of all sizes—from the roughly $1.7 trillion in assets we observe in the 843 state member banks we regulate to the roughly $16.8 trillion in assets of the 5,002 bank holding companies, including but not exclusively large financial institutions, or "LFIs," which we regulate.[5]

During a crisis, you need the ability to make the proper decisions quickly. It is simply impossible to properly evaluate the health of a potentially troubled borrower with information generated by another agency. This was one of the harsh lessons learned from examining the entrails of Lehman and AIG, over whom we had no regulatory oversight at the time they went into cardiac arrest.

In my view, proposals being discussed in Congress to shrink the Fed's regulatory and supervisory responsibilities by placing all state-chartered banks under, say, the FDIC or all nationally chartered banks and their holding companies under some new regulatory agency, leaving us either with no regulatory oversight or solely with regulatory oversight of LFIs, are misguided. To keep with my cardiovascular theme, I would argue that removing the Fed from supervision and regulation of banks of all sizes and complexity—from community banks to the most complex LFIs—would be the equivalent of ripping out the patient's heart. That would surely prevent another heart attack but would likely have serious consequences for the patient. Our job is to keep the patient healthy—to prevent another attack. The best way to do that is to keep the Fed in supervision.

Too-Dangerous-To-Permit

I mentioned LFIs. A truly effective restructuring of our regulatory regime will have to neutralize what I consider to be the greatest threat to our financial system's stability—the so-called too-big-to-fail, or TBTF, banks. In the past two decades, the biggest banks have grown significantly bigger. In 1990, the 10 largest U.S. banks had almost 25 percent of the industry's assets. Their share grew to 44 percent in 2000 and almost 60 percent in 2009.

The existing rules and oversight are not up to the acute regulatory challenge imposed by the biggest banks. First, they are sprawling and complex—so vast that their own management teams may not fully understand their own risk exposures. If that is so, it would be futile to expect that their regulators and creditors could untangle all the threads, especially under rapidly changing market conditions. Second, big banks may believe they can act recklessly without fear of paying the ultimate penalty. They and many of their creditors assume the Fed and other government

[5] Most recently available figures, per Call Reports (state member banks) and financial statements (bank holding companies).

agencies will cushion the fall and assume the damages, even if their troubles stem from negligence or trickery. They have only to look to recent experience to confirm that assumption.

Some argue that bigness is not bad, per se. Many ask how the U.S. can keep its competitive edge on the global stage if we cede LFI territory to other nations—an argument I consider hollow given the experience of the Japanese and others who came to regret seeking the distinction of having the world's biggest financial institutions. I know this much: Big banks interact with the economy and financial markets in a multitude of ways, creating connections that transcend the limits of industry and geography. Because of their deep and wide connections to other banks and financial institutions, a few really big banks can send tidal waves of troubles through the financial system if they falter, leading to a downward spiral of bad loans and contracting credit that destroys many jobs and many businesses.

The dangers posed by TBTF banks are too great. To be sure, having a clearly articulated "resolution regime" would represent steps forward, though I fear they might provide false comfort in that a special resolution treatment for large firms might be viewed favorably by creditors, continuing the government-sponsored advantage bestowed upon them. Given the danger these institutions pose to spreading debilitating viruses throughout the financial world, my preference is for a more prophylactic approach: an international accord to break up these institutions into ones of more manageable size—more manageable for both the executives of these institutions and their regulatory supervisors. I align myself closer to Paul Volcker in this argument and would say that if we have to do this unilaterally, we should. I know that will hardly endear me to an audience in New York, but that's how I see it. Winston Churchill said that "in finance, everything that is agreeable is unsound and everything that is sound is disagreeable." I think the disagreeable but sound thing to do regarding institutions that are TBTF is to dismantle them over time into institutions that can be prudently managed and regulated across borders. And this should be done *before* the next financial crisis, because it surely cannot be done in the *middle* of a crisis.

Independence

While my views on TBTF may be slightly radical, my perspective on the importance of central bank independence is, I believe, very much mainstream.

Central banks must take a long-term view of the economy and craft appropriate policy responses. We must have the leeway to raise interest rates when others want cheap credit and rein in risky financial practices when others want easy profits. A Fed committed to wringing out the economy's excesses and keeping banks on the straight and narrow is not going to win popularity contests. Some of those displeased by Fed decisions will seek to satisfy their desires by resorting to political pressure.

Independent does not mean unaccountable. We have always been subject to oversight, but since Ben Bernanke took the chair we have ramped up our efforts to be as transparent as is prudent in the conduct of monetary policy. For example, the Fed is the only business in America that I know of that provides a public accounting of its balance sheet every week—it is called the H.4.1 release, and it is available on the Internet on a weekly basis. We now release more fulsome economic projections and minutes of our meetings. At the twice-yearly reporting and testimony before Congress required under the Humphrey–Hawkins legislation, the Chairman responds directly and distinctly to questions from members of the key oversight committees. And we have responded to those suggestions we feel further our mission. For example, in the recent Humphrey–Hawkins sessions, the Chairman made clear that we are willing to go the extra mile of letting the GAO peek behind the curtain of the special credit and liquidity facilities we created—even unto identifying the firms that participated in them “after an appropriate delay” so as to allow those firms to conform to their own reporting obligations.

I believe we have significantly improved transparency. There are limits, however. Some advocate making the monetary policy deliberations held by my colleagues and me at the FOMC subject to GAO audits, for example. Were this to come to pass, I believe it would lead to the politicization of the FOMC process, injecting Congress at whim into monetary policy and, if so, eventually putting us on the on-ramp to a road that could lead the United States directly to the fate suffered by once-great economies like pre-Weimar Germany, Argentina and others that allowed monetary policy to become the handmaiden of fiscal policy.

A politicized central bank is a crippled central bank. Only a Fed insulated from short-term, political impulses can focus on crafting the right mix of policies for the economy in the long term. It needs enough space to make the tough calls—most notably, when interest rates have to be pushed upward to slow the economy in flush times. Fed independence does not just matter for monetary policy. A central bank insulated from politics and the accompanying lobbying can also be a tougher regulator, insisting on strict adherence to capital and leverage requirements, as well as prudent management and lending practices.

We see in the current debacle in Greece a significant example of one of the great virtues of an independent central bank. Historically, profligate fiscal authorities in that country have turned to the monetary authority to print their way out of the corner they painted themselves into, debasing their debts through inflation and currency depreciation. That is no longer possible in Europe. The burden of correcting for fiscal malfeasance now rests squarely on the shoulders of those authorities who are responsible for it. And that is the way it should be—be those authorities Greek or Irish or even American.

I started out by noting that booms propelled by greed and busts born of fear are as old as time itself. This quirk of human nature will always ignite the euphoria that fuels the ups and exacerbates the downs. Nonetheless, we need a monetary policy that leans against that propensity. We need regulatory and supervisory powers that lead to policy that ensures a sound financial system, capable of most efficiently channeling monetary policy actions to the real economy. We need to keep monetary and regulatory authority united, so we can work together in the interest of the entire financial system—not just the interests of the largest institutions and those too big to fail. And we need to ensure that this authority is free from short-term political pressures.

Mrs. Spero, that is my sermon for today. I’ve had to race through it. During the Q&A I would be happy to harangue you further on supervision and regulation matters, or we can talk the economic outlook as seen from the Elysian Fields of Texas, the impact of globalization, or whatever suits your fancy.