Paul Adolph Volcker (born September 5, 1927) is an American economist. He was the Chairman of the Federal Reserve under United States Presidents, Jimmy Carter and Ronald Reagan (from August 1979 to August 1987). He is currently chairman of the newly formed Economic Recovery Advisory Board under President Barack Obama.

Paul Volcker is now widely hailed as the last great Fed Chairman with the downfall of his successor, Alan Greenspan's, considerable reputation. The causes of the present credit and economic crisis are being traced by many to policies and laissez faire approach to regulation of Alan Greenspan.

President Obama has turned to Paul Volcker to chair his Economic Recovery Advisory Board and Mr Volcker's assessment of the causes of and strategies for dealing with the current crisis as presented to The Joint Economic Committee of the United States Congress, are well worth reading.

PAUL A. VOLCKER: JOINT ECONOMIC COMMITTEE

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STATEMENT OF PAUL A. VOLCKER
BEFORE THE JOINT ECONOMIC COMMITTEE
WASHINGTON, DC FEBRUARY 26, 2009

Madame Chairwoman and Members of the Joint Economic Committee:

It is no secret that we are living in a difficult time for the economy, with unprecedented complexities, complications and risks for financial markets and financial institutions. You have entitled this hearing "Restoring the Economy: Strategies for Short-term and Long-term change".

I appreciate the invitation to address those issues, but I am sure you understand that any brief statement may elicit as many questions as answers. In the circumstances, I will proceed by making a few points that I consider highly relevant in the effort to achieve recovery, greater stability, and protection against a future financial crisis. We must not again leave the markets so vulnerable that a breakdown will again threaten the national and world economies.

1. My first point is to emphasize an essential longer-term reality.

The present crisis grew out a serious and unsustainable imbalance in the United States and world economies. Specifically, over recent years, until the outset of the recession, Americans spent more than our country produced or was capable of producing at full employment. That spending, reflected in exceptionally high levels of consumption generally and in housing in particular, was made possible by a high level of imports, a collapse in personal savings, and large trade and current account deficits. The consequence was the nation became dependent on borrowing abroad hundreds of billions of dollars a year.

For a while it was all quite comfortable. Imports from China and elsewhere satisfied our strong consumption proclivities without inflationary pressures. China, Japan and other countries were eager to export and willing to acquire and hold trillions of U.S. dollars, keeping our currency strong and helping to keep our interest rates low.

The trouble was it could not last. The process came to be dependent upon an enormous build-up of domestic as well as international debt, facilitated by the low interest rates and sense of "easy money". The bulk of that debt came to be mortgage-related. It was supported by the strong increase in housing prices, giving the illusion of wealth creation. When housing prices leveled off and then declined, the weakest mortgages – so-called subprime – came under pressure, and the highly engineered over-extended financial structure began to unravel. As the financial crisis broadened, the recession was triggered.

I repeat that story because the first and most fundamental lesson of the crisis is that future policy should be alert to, and take appropriate measures to deal with, persistent and ultimately destabilizing economic imbalances. I realize that is a large and continuing challenge of international as well as domestic proportions, but it is the essence of prudent economic management.

2. Secondly, I turn to the problem in financial markets. The rising debt, particularly mortgage credit, was facilitated and extended by the modern alchemy of financial engineering. Mathematic techniques that have developed in an effort to diffuse and limit risk turned out in practice to magnify and obscure risks, partly because, in all their complexity and opacity, transparency was lost. Risk management failed. At the same time, highly aggressive compensation practices encouraged risk taking in the face of misunderstood and sometimes almost incomprehensible debt instruments.

As we look ahead, the obvious lesson is the need for more disciplined financial management generally and better risk management in particular. Plainly, review and reform of compensation practices are particularly difficult matters that defy rigid specification.

3. As the financial crisis evolved, weaknesses in accounting, credit rating agencies and other market practices were exposed. "Fair value" accounting rules were inconsistently applied and have contributed to downward spiralling valuations in illiquid markets. Credit rating agencies failed to analyze collective debt obligations with sufficient vigor. Clearance, settlement and collateral arrangements for obscure derivative contracts created uncertainty and need clarification.

These are all highly technical issues, not readily dealt with by legislation. They do need to be resolved as part of a comprehensive reform process.

4. More directly of governmental concern are the lapses in financial regulation and supervision that permitted institutional weaknesses to fester, failed to identify exceptional risks and deal adequately with conflicts of interest, and did not expose large personal scandals after warnings. This area will require, and I'm sure will receive, close attention by the Administration and the Congress in the period ahead. I will be surprised if you do not conclude that substantial changes will need to be made in the administrative structures for oversight of the financial system.

Taken together, the need for change is both obvious and wide ranging. In approaching the challenge, I do urge that all these matters be considered in the context of a considered judgment about the appropriate role and functioning of the financial system in the years ahead.

At the most general level, I am certain we all would like to see a "diverse, competitive, predominantly privately owned and managed institutions and markets, able to efficiently and flexibly meet the needs of global, national and local businesses, governments, and individuals".

Those words are taken directly from a recent report of the Group of 30 setting out a Framework for Financial Stability. It points up the challenge of making those broad generalities a strong and lasting operational reality. I chaired that effort and naturally recommend it to you.

The Report makes some eighteen broad recommendations, touching upon most of the points I enumerated earlier. One area it does not cover are specific proposals for restructuring the agencies responsible for regulation and supervision. I believe judgment and legislation in that

area should logically follow and not proceed judgment about the overall design of the financial system.

The G-30 Report recognizes what I believe is common ground among most analysts. Specifically, all banking organizations should come with the framework of an official safety net, with the natural corollary of regulation and supervision. It is also recognized that a few of the banks (and possibly some other financial organizations) will be so large, and their operations so intertwined in complex relationships with other institutions, as to entail "systemic risk". In other words, the functioning of the financial system as a whole could be jeopardized in the event of a sudden and disorderly failure. Consequently, those institutions should be subjected to particularly high international standards directed toward maintaining their safety and soundness.

Taken together these banking organizations should be predominantly "relationship-oriented", providing essential financial services to individuals, businesses of all sizes, and governments. To help assure their stability and continuity and limit potential conflicts of interest, strong restrictions on risk-prone capital market activities e.g. hedge funds, equity funds, and proprietary trading – would be enforced. At the same time, trading and transaction-oriented financial institutions operating primarily in capital markets could be less intensively regulated, although stronger registration and reporting requirements would be appropriate. In instances where the institutions are so large or otherwise so complex as to be "systemically" relevant, capital, leveraging and liquidity requirements would be imposed.

Implicit in this approach is the need for strong cooperation and coordination among national authorities and regulators. Some approaches - accounting standards, capital and liquidity requirements, and registration and reporting procedures - should be internationally agreed and consistent in application to minimize regulatory arbitrage and any tendency by particular countries or financial centers to seek competitive advantage by tolerating laxity in oversight.

All this will take time if the necessary consensus is to be achieved and a comprehensive rather than a piece-meal approach is taken. I also recognize that a coherent vision of the future should help guide the emergency responses to the present crisis and, even more important, the steps taken as the truly extraordinary measures now in place are relaxed and ended.

Let that debate proceed. I will, of course, welcome the opportunity to participate in your deliberations.