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REMEMBERING THE FUTURE

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As I thought about what I could usefully say today, I decided to reread my remarks from a year ago. A mistake. It's not that it was a terrible speech – it's that the problems haven't changed, so I have little new to say.

I know we got a little lift, real and psychological, from the better employment statistics last week. But basically, we are still not sure as to how we get out of the economic fix in the developed world -- high unemployment in the face of massive monetary stimulus, stagnating income for almost everyone except those at the very top, unresolved budgetary problems, the European and Japanese economies flat, and maybe slipping back into recession.

I think we now well understand that the breakdown of the modern financial system has contributed to the problem. Among other things, it left in its wake too much debt, too much leveraging. So there has been a focus on financial reforms – home base for me. At best, that is work half done.

Some important areas haven't really been touched – international accounting and auditing practices, credit-rating agencies, money market mutual funds - to mention some important areas that are receiving too little attention. Bank capital rules after years of work remain incomplete. Important parts of the Dodd/Frank legislation need to be nailed down – the parts dealing with derivatives, yes, with the "Volcker Rule" as well, and most importantly with "too big to fail".

I know all that, because those words pretty much parallel what I said to you a year ago. Something is obviously wrong about how we have been going about reform.

I know the complexities are great. The need in some areas for international coordination and consistency add complications. In some areas – but not all – there are still widely different and probably irreconcilable views about the practicality and usefulness of some reforms. That, for instance, is true with respect to draconian limits on the size of financial institutions and the gross excesses in compensation. It's interesting that the old and generally discarded idea of taxing financial transactions is debated seriously in Europe, but that is something that to be sustained and effective would require wider application.

What troubles me is that none of those complications and difficulties can explain the lack of sufficient progress right here in the United States. The Dodd/Frank law enacted almost three years ago, remains in some respects in limbo. In other areas where there is much common understanding of need, we've been stuck or even in retreat.

We can point to the old bugaboos of intense lobbying pressures, reinforced these days by the implied financial support for ever more expensive election campaigns. Extreme ideological positions thwart the efforts to reach common ground and undercut leadership within the Administration and the Congress.

But what strikes me is a more mundane problem, not new but more obvious. There are simply too many agencies and regulators involved with overlapping responsibilities, differing priorities, governance, and zealous in maintaining their turf.

Take the provisions set out in the Dodd/Frank law with which I am most familiar - restricting proprietary trading and sponsorship of hedge and equity funds by commercial banks. The essence of the matter is clear enough: commercial banking institutions providing essential public services and protected by, and benefiting from, direct access to Federal Reserve support and FDIC insurance should not at the same time engage in more purely speculative activity. Of course, to achieve that result the implementing regulations should be uniform for all covered banking institutions.

What is so awkward is that the five relevant regulating agencies have overlapping responsibilities, with sometimes idiosyncratic ideas and preferred approaches. So, we have stalemate, or retreat to an unsatisfactory least common denominator.

The same situation seems to have arisen with respect to regulation of money market mutual funds. It is now well recognized that those funds, as they have grown, have in practice operated as an invasive hybrid between a mutual fund and a deposit-taking commercial bank. They have flourished outside the normal banking or mutual fund rules and regulations. Given their vulnerability to runs in the midst of the crisis and the devastating impact on the commercial paper market, the present arrangements are broadly recognized to be a structural weakness in the financial system. The massive Federal support required during the crisis underscores the need for action.

There are reasonable options for dealing with the problem, most directly and easily by requiring that these funds accept the general rule for mutual funds that their assets be marked-to-market every day. That or other approaches could be adopted without legislation. There are parallel concerns in Europe and elsewhere. Yet somehow the relevant regulators seem unable to act even with encouragement by the new Financial Stability Oversight Council.

Another effort close to my own experience seems to be languishing in part for lack of effective American leadership. I refer to the lagging pace in the work to achieve strong and common international accounting standards. In a world so financially and economically integrated, different accounting standards not only imply substantial added administrative

costs but more importantly impair investment analysis, informed investment decisions and consistent, disciplined auditing practices. I am well aware that there are some important unresolved technical issues, but I fear they will never be resolved without clear impetus, setting out time certain, from the SEC.

In recognition of these and other areas where the need for both executive leadership and regulatory authority is apparent, the Dodd/Frank Act formalized a new coordinating committee under the leadership of the Secretary of the Treasury. While surely a step in the right direction, the evidence so far is that the new Financial Stability Oversight Council will need to be provided a stronger mandate and executive leadership to be effective.

Taken all together, it seems to me time to undertake the review and reform of the regulatory structure that the Congress failed to address several years ago.

In considering the needed action to resolve these apparent institutional weaknesses, I must acknowledge that I have long supported a special role for the Federal Reserve in the regulation and oversight of the financial system. That role has now been more explicitly recognized and reinforced by a provision in Dodd/Frank establishing a new position on the Federal Reserve Board of Vice Chairman for Supervision. The significance should be clear. Amid its preoccupation with monetary policy, the parallel role and accountability for financial oversight should not be ignored.

That is surely a key lesson of the financial crisis. Ironically, more than two and a half years later, the new position has not been formally filled. I know that competent and energetic leadership does now exist within the Fed, but surely that effort should be institutionalized in accordance with the law.

Obviously, the Federal Reserve has come to play an extraordinary role in maintaining the economic recovery. In doing so, it has stepped out from the long-established, but more limited, institutional role of a central bank. Instead of confining its operations to intervention in the money markets and control of bank reserves, attention is today directed toward massive support, directly and indirectly, of capital markets, and most particularly of the market for residential mortgages. It amounts to the Fed becoming the principal intermediator in American financial markets, acquiring several trillion of dollars of securities of varying maturity on the basis of short-term monetary liabilities that it itself has created – in common vernacular by "printing" money.

Those efforts are not unique in today's world. In Europe and Japan, where recovery is weak and the possibility of renewed recession is evident, sweeping commitments have been made to do "whatever it takes" to hold the Euro together, and to speed expansion, in Japan even by explicitly seeking inflation.

All of us, in the United States, in Europe and in Japan, indeed the entire world economy, have a large stake in the success of those really unprecedented steps toward monetary expansion. Equally clearly, there are obstacles and risks. Those obstacles lie notably in the underlying imbalances within and among developed economies, in the inevitably slow progress dealing with the overhang of excessive

indebtedness, the remaining dislocations in the financial system, and the pervasive fiscal deficits. Those are each matters that are not easily corrected by monetary policy, however aggressively managed.

Indeed, extreme monetary easing, with the suggestion that approach will continue indefinitely, could encourage elements of speculative activity undermining the very process of restoring sustainable growth and financial stability.

I make that point because I believe that the Federal Reserve, or any central bank, must not minimize or neglect its responsibilities for oversight of the financial system as it devotes attention to the conduct of monetary policy. In retrospect, a heavy cost has been paid for failure to recognize the implications of the behavior patterns and speculative excesses in the financial markets that culminated in the crisis. The complexities and opacity imposed by rapid innovation and financial engineering require skills and a depth of personnel beyond previous experience.

These concerns – and finding effective approaches to deal with them – are not confined to the United States. Recall that the United Kingdom has now reversed arrangements for placing responsibility for financial regulation in a single agency outside the central bank. The Bank of England again has a central role. More widely, within Europe and particularly in the Eurozone, efforts are underway to better coordinate and centralize the existing diffuse regulatory and supervisory responsibilities. Again, a large role is being assumed by the European central bank.

The importance of strong and consistent capital standards internationally has long been recognized. The related approach of "stress testing" the ability of major financial institutions to withstand shock is an important initiative also very much of concern to central banks.

There is one key element of financial reform in the United States and elsewhere that goes beyond the mandate of the Federal Reserve or other central banks. That concerns the matter of "too big to fail" – the conviction that faced with the risk of amplifying a financial crisis, large, "systemically important" institutions will inevitably be supported by governments, with creditors, and sometimes management and stockholders protected. The difficulty, of course, is that such conviction tends to promote precisely those behavior patters – excessive risk-taking and lack of financial discipline – that lead to the crisis.

To my mind, too little attention is being paid a promising approach. Substantial progress is being made in developing an orderly "resolution process" for large failing financial institutions. Such a process, set out in Dodd/Frank, is aimed at liquidation or dismemberment of failing institutions in a manner that provides continuity in the money markets while stockholders are wiped out, management and directors are replaced and unsecured creditors placed at risk.

That cannot be a simple process. It is inevitably complicated by the need to reach consistent and cooperative arrangements reaching across borders. But in this instance we do have strong leadership emerging. Close working arrangements have been developing between the FDIC and the Bank of England, and I anticipate with the

European Union – thus encompassing the key jurisdictions.

The intervention by central banks generally and the Federal Reserve in particular does raise unfamiliar risks and uncertainties. In particular, Chairman Bernanke and members of the Federal Open Market Committee, amidst lively debate, have themselves recognized the possibility of speculative excesses and imbalances. That is one reason for reinforcing the capacity of the central bank to identify and deal with the emerging points of strain and weakness.

The challenge as I see it is not technical but human and political. Experience is clear: steps to initiate more restrictive policy approaches as unemployment declines and an economy moves toward its potential is never popular. This time, the depth of the recession, the nature of the prolonged unemployment and continuing financial strains, and doubts about the fiscal outlook complicate the decision-making. It will take integrity in analysis, cool judgment, and a high degree of insulation from political pressures to do the job. Those qualities are, of course, precisely the reason we have an independent central bank.

Need I at this time, to this audience, emphasize the importance of rejecting the siren song that a little inflation can be the path to prosperity?

Long ago, a wise man, a central banker with long experience, set out an axiom that bears repeating. "If we hesitate too much about being too soon in adopting restrictive policies, then we will certainly be too late!"

Let's get on with the job of completing financial reform, of providing the Fed with the authority and tools it needs, and creating a fiscal environment that can in the present time frame sustain recovery while also offering reassurance that over time we can, indeed, restore budgetary balance.

Then we will have solid grounds for confidence that the recent signs of renewed economic growth can, indeed, be sustained for years ahead. There is a clear sense that the whole developed world is looking in our direction for renewed leadership. There is a lot at stake.

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