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3 Economic Policies for the 21st Century

4 Presents

5 THE SHADOW OPEN MARKET COMMITTEE

6 (SOMC) SYMPOSIUM:

7 MAINTAINING CENTRAL BANK INDEPENDENCE

8 IN CONDUCTING MONETARY POLICY

9

10 KEYNOTE REMARKS BY

11 FED GOVERNOR KEVIN WARSH

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1 Keynote Remarks

2 MR. LEVY: I would like to welcome you

3 to our final panel today where Governor Kevin

4 Warsh is our keynote speaker. Let me begin by

5 saying, by giving you a little bit of his

6 background.

7 As you know, he is a governor of the

8 Federal Reserve. Prior to his appointment he was

9 special assistant to the president for economic

10 policy and was an executive secretary of the

11 National Economic Council. He got his

12 appointment to the Fed in early 2006, I think

13 right when housing was just about peaking,

14 something like that, and he has just an

15 absolutely stellar economic background and

16 tremendous experience on Wall Street and as a

17 policy maker.

18 In anticipation of introducing Kevin, I

19 called the public affairs office at the Federal
20 Reserve and I said, What's the proper way to
21 introduce a governor, and I was told to say the
22 Honorable Kevin M. Warsh, board member, Board of
23 Governors of the Federal Reserve System and in
24 fact I thought about this a little bit and what
25 really strikes me is Governor Warsh is honorable

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1 Keynote Remarks
2 not just because he's a very high-level official,
3 but I have found in all my dealings with you over
4 the years that you're honorable not just in terms
5 of objectives, intentions, but also thoughts and
6 behavior, so we welcome you, we look forward to
7 your remarks.
8 MR. WARSH: Thanks very much, Mickey,
9 to you and to Marvin and to e21 and the SOMC for
10 having me here.
11 It sounds like you have had a rather
12 robust discussion this morning. I entered a few
13 minutes before and I heard some shots taken at
14 the Federal Reserve, so I will do my best to both
15 describe what we're about and what our goals are.

16 Someone saw the title of my remarks as
17 I was coming in. They are officially titled "An
18 Ode to Independence," and this person asked me if
19 that means the speech will rhyme, and it won't.
20 As central bankers go, I am not even
21 sure it's going to be terribly lyrical, but let
22 me give it a shot.
23 I'm going to try to accomplish, I
24 think, a few things in these remarks. First I
25 will begin by a brief discussion of the economy,

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1 Keynote Remarks
2 and I do that not only because it is of some
3 interest but also the economic environment is, in
4 some ways subject to policy anchors, policy
5 foundations, and I think the global economy is
6 looking to see whether old pillars such as
7 central bank independence, are alive and well, or
8 have those pillars somehow been weakened, so I
9 will begin with a brief discussion of the
10 economy. I will talk a little bit about the
11 central bank's assets, but I think unlike you
12 will hear from me and some colleagues, I won't be

13 dwelling on the size of our balance sheet but
14 talking about what I think might be our most
15 important asset.
16 Third, I will talk about central bank
17 independence both how independence is managed
18 during periods of panic like we have been
19 through, but also what are the risks to
20 independence, what are the threats to independence
21 going forward.
22 Now, my focus is on the Federal Reserve
23 because it's really what I know best, but I'm
24 going to try to talk a little more broadly about
25 central bank independence because I think a lot

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1 Keynote Remarks
2 of these lessons learned, a lot of these
3 principles are really quite transferrable across
4 countries.
5 First on the economy. No news to folks
6 in this room, the overall profitability, the
7 strength of balance sheets of large U.S.
8 enterprises I think is quite impressive at this
9 stage of recovery. Equity prices credit terms

10 seem to be corroborating these improved economic
11 fundamentals and for these firms -- again, I am
12 thinking of larger publicly traded firms --
13 financial market conditions appear to be quite
14 supportive of economic growth, but significant
15 economic challenges still persist. While recent
16 trends in personal consumption and business
17 investment are positive, the underlying strength
18 of the economy over the medium term still really
19 draws an uncertain response. Unemployment
20 remains high and stubbornly so, small- and
21 medium- sized businesses which, if we think about
22 the last recession in particular, tended to lead
23 recoveries, don't seem to be doing it at this
24 early point in the cyclical recovery. For these
25 smaller businesses, many of which are not

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1 Keynote Remarks
2 publicly traded, revenue growth is tepid, costs
3 are uncertain and the credit conditions are
4 tougher, tougher than they are for the larger
5 companies with access to public markets.
6 Increases in government expenditures

7 around the world have certainly been top of mind.
8 They were ostensibly instituted as a bulwark
9 against further economic weakness against an
10 extended recession, but those increases in
11 expenditures themselves are raising fiscal deficits
12 significantly and markets are paying attention.
13 Unsustainable projected fiscal debt
14 loads, including large and growing implicit
15 guarantees both from governments to private
16 enterprises -- think of large financial firms --
17 and from larger government units to smaller
18 governments are adding to these sovereign debt
19 burdens and are being questioned in sovereign
20 markets.
21 So if you take account of this broad
22 mix of financial and economic realities there's
23 no wonder that the electorate both here in the
24 U.S. and frankly around the world is a bit
25 unnerved. The uncomfortable juxtaposition of

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1 Keynote Remarks
2 these realities have caused some fundamental
3 precepts of our economic model to be questioned,

4 and I think what you have been discussing this
5 morning is one of those precepts, the
6 independence of a central bank, and so let me
7 join that discussion.

8 Monetary accommodation from the world's
9 central banks has been nothing but extraordinary,
10 policy decisions made both in the U.S. and around
11 the world in response to global financial crises
12 have led a dramatic growth in the size and change
13 in the composition of central bank balance
14 sheets. In the U.S. the Fed's balance sheet is
15 up two and a half to three times, including \$1.2
16 trillion today but a couple hundred billion more
17 once all securities have been settled of
18 mortgage-backed and a matched increase in excess
19 reserve balances.

20 But I'd argue the most important asset
21 on our balance sheet isn't any of that, it's not
22 on our swollen balance sheet, it is not found in
23 the lengthy footnotes to our audited financial
24 statements which are coming out soon, nor is it
25 tucked away in the recesses of the Federal

1 Keynote Remarks

2 Reserve Act itself, like the long dormant, now

3 renowned Section 13.3, none of those hold the

4 most important asset.

5 The Fed's greatest asset is its

6 institutional credibility. This institutional

7 credibility is rooted in inflation-fighting

8 credibility and the economic literature talks

9 about credibility generally in those terms, but I

10 think institutional credibility is broader, it's

11 tied up in the full range of our actions and our

12 balance sheet commitments and it is essential to

13 everything we do. It increases the heft of our

14 communications, it gives weight to our economic

15 assessments and it amplifies the effects of

16 announced changes in short-term rates across the

17 Treasury curve. It is in some sense the real

18 money multiplier in the conduct of policy.

19 So where does this institutional

20 credibility come from?

21 We should not forget that this

22 credibility has no birthright, it is much more,

23 it strikes me, nurture than nature, it was earned

24 by our predecessors at the Fed in the conduct of

25 their responsibilities trying to hit the dual

1 Keynote Remarks
2 mandate of price stability and maximum
3 employment. Now, fortunately for us, for this
4 asset to be burnished and bestowed upon this
5 current crop of central bankers, it doesn't
6 demand perfect clairvoyance, it doesn't even
7 demand some kind of perfect track record, but it
8 does require fierce independence, fierce
9 independence from the winds of Washington and the
10 wants of Wall Street, fierce independence from a
11 pernicious short-termism that can undermine
12 economic policy, and I think this independence is
13 needed perhaps now more than ever.
14 So maybe that was the ode part. Now I
15 will talk a little bit more about what lays
16 behind it.
17 Central bank independence is precious,
18 it can be taken for granted in benign times, but
19 it is tested when times get tough and I think we
20 have still got tough times ahead of us. My
21 colleagues and I have to demonstrate that
22 independence has not been relegated, that our
23 long-term objectives not compromised.

24 Ensuring Fed independence at the
25 cornerstone of our institutional credibility is

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1 Keynote Remarks
2 our charge to keep, it's central to what we do
3 and how policy is conducted.
4 Now, this mantra of central bank
5 independence isn't some throw-away line, it's not
6 something that seeks to absolve the Fed from
7 accountability; I think quite the opposite.
8 Institutional credibility demands transparency so
9 the Fed's performance of its responsibilities can
10 be judged on the merits.
11 But I think this call for central
12 banking independence can be misunderstood, its
13 defense misconstrued, its threats dismissed and
14 the consequences of its reach underestimated, so
15 the balance of my remarks, let me try and take
16 that challenge on.
17 During the period of the last couple of
18 years central bank actions both in the U.S. and
19 abroad have been subject to a lot of debate,
20 dispute about the role and responsibility of the

21 central bank. Congress even today in what is
22 being billed by its authors as comprehensive
23 fundamental regulatory reform is in some ways
24 debating the role of the central bank, and it's
25 worth remembering this isn't our first experiment

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1 Keynote Remarks
2 with central banking in the U.S., it's our third,
3 and the experiment really does go on. So as the
4 central bank nears its centennial, the Fed's
5 longevity should not allow our memories to fail
6 us on the nature of its origins or the scope of
7 its remit.
8 Let me explain.
9 The grant of authority to the central
10 bank is a considered judgment of the nation's
11 elective representatives. We in the central bank
12 have been entrusted with this revocable
13 privilege, so declarations by Fed policy makers
14 like me are heartening, but independence is
15 really ours to demonstrate, not principally to
16 declare, and we err if we presume that
17 independence is some inalienable right, some

18 entitlement.
19 I think a misconception on the nature
20 of the central bank's authority gives ammunition
21 to Fed critics. The Fed is not independent from
22 government, it is independent within government,
23 and elected representatives have every right to
24 redraw the map, to redraw the Fed's authorities,
25 even if a fuller reading of economic history

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1 Keynote Remarks
2 considers some of that redrawing perhaps unwise.
3 The Fed's defenders also err if they
4 seek to extend the Fed's vaunted independence
5 into everything we do. My reading has it that
6 Congress granted Fed independence in the conduct
7 of monetary policy. They did not extend us
8 independence into regulatory policy or consumer
9 protection or many of the other tasks that the
10 Fed has responsibility for.
11 In my view, no particular deference is
12 owed, no promise of nonintervention due in these
13 other responsibilities and a sharp distinction
14 has to be maintained.

15 So delineating what constitutes the
16 conduct of monetary policy as distinct from these
17 other activities is critical. In normal times
18 there is less confusion, the Fed establishes
19 short-term risk free rates across the economy, we
20 do our best to signal a policy path to provide
21 some clarity to those markets to achieve our
22 mandate and the Fed's lender-of-last-resort
23 authority manifests itself usually only sparingly
24 in the operation of the discount window, lending
25 against good collateral at a penalty price.

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1 Keynote Remarks
2 But in times of more significant
3 economic and financial stress the pace of
4 monetary accomodation often increases and when
5 liquidity becomes scarce, as was the case during
6 the panic of '08, the Fed finds itself charged
7 with more novel and challenging times in trying
8 to find and provide liquidity both to institutions
9 and to markets.
10 History teaches us fiscal and monetary
11 policy in times of crisis tends to blur, capital

12 and liquidity issues become difficult to
13 disentangle, particularly at troubled
14 institutions, and well-intentioned policy makers
15 are compelled to make tough judgments amid tough
16 time constraints.

17 But the central questions remain: What
18 constitutes an emergency liquidity provision
19 backed by good collateral at a penalty price and
20 what is more aptly characterized as a fiscal
21 provision to bolster capital?

22 The Fed must do its utmost to stay four
23 square on the right side of that line as
24 liquidity provider. The Fed's financial
25 stability responsibilities which may well be

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1 Keynote Remarks
2 elevated in the pending legislation should not
3 give license to central bankers to be emergency
4 capital providers.

5 Capital allocation should reside, if
6 anywhere, with the fiscal authority and with the
7 fiscal authority's agent at the Department of
8 Treasury. The Fed as a first responder must

9 strongly resist the temptation to be the ultimate
10 rescuer no matter what the Congressional
11 calendar, the pleadings of the elected, the Fed
12 is not a repair shop for broken statutes, neither
13 is it a repair shop for broken financial
14 ecosystems -- and I am thinking there of mortgage
15 finance -- and the Fed should not be an appeals
16 court to those seeking relief from Congressional
17 appropriators or the fiscal agents of the
18 Treasury and the Fed's credibility is severely
19 undermined if it is perceived to wander from its
20 mission into areas more appropriately handled by
21 other parts of the government.

22 But the panic of 2008 is now prologue.

23 The Fed's actions going forward, especially if
24 and when economic conditions remain unsatisfactory,
25 the Fed's actions should go a long way to

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1 Keynote Remarks
2 demonstrate its allegiance to mission.
3 There will no doubt be added pressures
4 for policy makers to aid and comfort the
5 aggrieved and that help should be forthcoming

6 does not mean it is the institutional prerogative
7 of the Fed to provide it. Even if the central
8 bank can doesn't answer the question of whether
9 the central bank should.

10 So as we move out of the darkest days
11 of the panic and we are in the recovery at hand,
12 there are other threats to independence and
13 credibility which I'd like to take up before
14 concluding.

15 I think at the end of the day I have
16 come to the view there is no such thing as being
17 a little bit independent, being a little bit
18 credible, so dealing with these challenges is
19 really first order.

20 Central bankers must have constantly
21 vigilant during times of fiscal expansion in
22 particular. Net global debt issuance in 2010 may
23 be three to four times the average of the last
24 decade. The ratios of government debt to GDP,
25 particularly if you add in implicit guarantees,

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1 Keynote Remarks
2 are growing rapidly among advanced economies and,

3 as I just discussed, the Fed should steer clear
4 of fiscal policy.
5 But the threats to independence don't
6 stop there.
7 Let me briefly comment on two other
8 pressure points and note that not all of the
9 threats to central bank independence come from
10 outside the walls of the Fed; like in the cliched
11 scary movie, some threats might be coming from
12 inside the house.
13 First, governments be may be tempted to
14 influence the central bank to keep monetary
15 policy looser longer to finance debt and
16 stimulate activity and in the static short run
17 the real burdens of nominal debt may be reduced
18 by higher inflation, but the consequence just
19 over the horizon would be most unwelcome.
20 Higher expected inflation would lead to
21 higher nominal rates increasing the financing
22 needs of the government yet further. Moreover,
23 higher expected inflation could lead to more
24 variable inflation outcomes and reduce living
25 standards which will only hurt those who are

1 Keynote Remarks
2 least protected from unexpected price movements.
3 So central bankers have to take their
4 own counsel when deciding on the timing and force
5 in removing monetary policy accommodation. I am
6 confident that any attempt to influence
7 inappropriately the conduct of Fed policy will
8 yield a strong and forceful rebuke not just from
9 Fed policy makers but from markets themselves.
10 The only popularity central bankers should seek,
11 if ever, is in the history books.

12 The second threat.

13 The second threat, in this case, the
14 central bank credibility, which I think I've
15 tried to describe as a broader concept in
16 independence of itself or inflation-fighting
17 credibility, this second threat may be better
18 intentioned but in my view is no less risky.

19 Some suggest that central bankers
20 themselves should modify their definitions of
21 price stability. If inflation persisted at
22 higher levels during benign times, the theory
23 goes, then we would have more room to cut when
24 the times got tough. This theory, in my view,
25 fails the real test of our own experience.

1 Keynote Remarks

2 Central banks that desire just a little

3 bit more inflation tend to end up with a lot more

4 of it. Some point to a strategy to accept just a

5 little bit more inflation for a little less

6 unemployment as the primary basis of the great

7 inflation of the seventies.

8 By definition, an increase in implicit

9 inflation targets would lead to an upward move in

10 inflation expectations; that's its purpose. But

11 how could a central bank remain credible? How

12 could they make the case that such a promise

13 would be a one-time event?

14 I don't think we understand

15 sufficiently the determinants of inflation

16 expectations to be confident that we could

17 control a regime change like that.

18 Central banks here and abroad have

19 worked tirelessly over decades to bring down

20 levels of prices so that they are consistent with

21 real price stability. We should not risk these

22 hard-won gains. In changing the goalpost at this

23 time of consequence, substantial harm would be
24 done to a central bank's institutional
25 credibility, its greatest asset, and perhaps lead

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1 Keynote Remarks
2 to an unmooring entirely of inflation
3 expectations. Such damage would lead to market
4 participants to seek alternative currencies with
5 prices of commodities and other hard assets
6 likely to increase.
7 So let me sum up.
8 Independence in the conduct of monetary
9 policy is core to what we do at the Fed and I
10 would also argue it's a core pillar to an
11 economic model which has not emerged unscathed
12 from this crisis but still has a lot going for it
13 and it can be too easily forgotten by those who
14 have only known its benefits.
15 If the Fed lost its independence, its
16 hard-earned institutional credibility would
17 surely fall with it, the costs to the economy
18 would be incalculable: higher inflation, lower
19 standards of living and a currency that risks

20 losing its status.
21 So now more than ever market
22 participants are watching, they're watching the
23 relationship between central banks and their
24 governments, they are keenly gauging whether
25 changes in conditions, policies or practices

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1 Keynote Remarks
2 pierce the veil of central bank independence.
3 Central bankers the world over, we must
4 demonstrate we are worthy of this moment, that we
5 will be steadfast protectors of our institutions'
6 credibility. That means respecting our important
7 but circumscribed role in conduct of policy and
8 it means performing our mission with consistency
9 and competence.
10 Thank you very much for having me.
11 I am happy to take questions.
12 MR. LEVY: Governor, thank you very,
13 very much.
14 Marvin and I are going to ask a few
15 questions and then questions from the audience,
16 but I request that those questions from the

17 audience are from nonmedia, nonpress.
18 The first question I have is when you
19 consider the importance of Federal Reserve
20 independence, what are your priorities in terms
21 of the central bank roles and which international
22 experiences do you draw on in which central banks
23 maybe have lost credibility and with what
24 consequences?
25 MR. WARSH: I think that's a good

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1 Keynote Remarks
2 question, Mickey.
3 As I said in my remarks, sometimes
4 central bankers decide that independence is a
5 really nice thing and we try to take it from
6 places where Congress, I think, gave it to us,
7 the conduct of monetary policy, lender-of-last-
8 resort authority.
9 We might say, Well, it would be a
10 little easier for us to conduct business if we
11 could use that over all of the things we do, but,
12 Mickey, to answer your question, I would think of
13 the core functions of monetary policy as being

14 granted by Congress and subject to Congress to
15 take the grant back a special piece.
16 I think the experience in the U.S. is
17 probably the most telling, and I made reference
18 in my remarks to the 1970s where it was thought
19 that there was a pretty easy and convenient
20 trade-off, we will just move inflation up a
21 little bit, we will get to move unemployment down
22 and no one will be hurt.
23 The short-term consequences of that are
24 arguable, the long-term consequences aren't, and
25 we, as a central bank at the Fed, have really

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1 Keynote Remarks
2 spent the last generation or more earning that
3 hard-earned credibility, trying to be faithful
4 stewards of the credibility we inherited, and
5 when Chairman Bernanke and I and the rest of the
6 team emerged, we emerged more than four years ago
7 at an institution with a ton of credibility and
8 that's really the burden that we still have to
9 keep.
10 MR. LEVY: So once again, in terms of

11 priorities, it would be the Congressional, the

12 dual mandate?

13 MR. WARSH: Yes.

14 MR. LEVY: Marvin?

15 MR. GOODFRIEND: My question is this:

16 Operationally, what kinds of rule or behavior by

17 the Fed this year, this coming year in this kind

18 of difficult period, do you think are necessary

19 to produce the benefits that you expect Fed

20 independence ought to be able to achieve on a

21 longer-term basis?

22 MR. WARSH: Marvin, to make sure I

23 understand that question: What do we need to do

24 in 2010 to make sure that that independence isn't

25 squandered?

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1 Keynote Remarks

2 MR. GOODFRIEND: Yes. The public, the

3 world is watching, it is one of those periods,

4 the world is watching and the Fed is going to be

5 observed.

6 What kinds of objective behaviors do

7 you think the Fed ought to exhibit to produce

8 these benefits the independence can achieve?

9 MR. WARSH: There are a few. One is

10 competence, one is trying to call it the way we

11 see it and communicate it, and I think, Marvin,

12 that partly means not projecting more certainty

13 than we have and making sure that what we are

14 describing is the world as best we see it, so I

15 would start with competence.

16 Second, I would say consistency, which

17 is markets and real economic actors, they need

18 anchors in a world that feels uncertain to them

19 and so the Federal Reserve needs to act with

20 consistency even if the world throws us curve

21 balls in 2010.

22 I think third and maybe most to the

23 subject of the symposium this morning is there

24 will be people knocking on our door seeking

25 relief. There are no doubt businesses and

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1 Keynote Remarks

2 markets that will -- still don't feel as though

3 the recovery has hit them. Unemployment is still

4 very high, but I think the Fed needs to explain

5 to the world as clearly as we can what are our
6 institutional prerogatives and what are not.
7 I can think about some periods during
8 the panic of '08 where people would come to the
9 Federal Reserve seeking relief having been turned
10 down by appropriators or turned down by those
11 that had TARP at their disposal.
12 It doesn't mean that we should be cold,
13 it means we should understand what is the reality
14 of the real economy, but people need to be
15 knocking on the right door and if the door isn't
16 the Federal Reserve I don't think we should try
17 to suggest otherwise.

18 MR. LEVY: Questions from the audience?

19 AUDIENCE MEMBER: Good afternoon.

20 A question for you: The issue came up
21 a little bit earlier during our discussion in
22 terms of what the Fed should be looking at with
23 respect to the behavior of the price level, which
24 is the Fed's primary objective. I note that year
25 over year core PC inflation is continuing to

2 fall, that money growth is dropping gradually but
3 steadily, that velocity growth has been very weak
4 and so I'm wondering if there's a bigger risk of
5 deflation than inflation.

6 MR. WARSH: Thanks, John, for the
7 snowball question.

8 So I'd say first the world's central
9 banks, not just the Fed, have grown the size of
10 our balance sheets. That doesn't mean that
11 deflation is impossible, but I think it has to be
12 accounted for when you are looking at the data as
13 it comes in on short-term trends on core measures
14 of inflation.

15 I don't see things either in the real
16 data or the real markets that make me overly
17 preoccupied with deflation risks. I think that
18 the near-term trends on inflation may give -- may
19 give the Fed an opportunity to review the
20 contour, review the path of the economy, but I
21 don't think we should be complacent about
22 inflation risks even at this moment.

23 Inflation expectations will be anchored
24 until they are not. Reserves that are on our
25 balance sheet will be sitting there until they

1 Keynote Remarks
2 don't, and I think the idea that somehow in the
3 world of 2010 and 2011 and beyond we should think
4 this is going to be a perfectly linear world, I
5 think the panic of 2008 should teach us otherwise
6 and central bankers would, I think, be prudent to
7 keep a very open mind about what are shocks that
8 could happen domestically and overseas. I think
9 we feel much better, I for one feel much better
10 about the state of the real economy than how it
11 looked 12 months ago, financial markets have
12 improved plenty.
13 But I think to your question, John, on
14 inflation risks or deflation risks, if you look
15 at a broad measure of those risks, both data that
16 comes in through various government agencies as
17 well as market signals, if you look at tip
18 spreads, if you look at commodities, if you look
19 at the relative value of the dollar against major
20 trading partners, I think many of those are not
21 giving us the same message, there is a range of
22 messages in that data, and I think at a time of
23 consequence where the global economies are
24 subject to a lot of cross currents I think we

25 should have our minds range really on that whole

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2 mix of data.

3 MR. LEVY: Yes, in the back.

4 AUDIENCE MEMBER: With the talk about

5 expansion of the Fed's regulatory role, one of

6 the things we talked about earlier today was the

7 potential to create friction on the Fed's

8 independence and credibility, put that into doubt.

9 What steps do you think the Fed can

10 take to minimize the potential to create friction

11 from that expanded regulatory role and should

12 that potentially include the Fed fighting the

13 extension of its regulatory role?

14 MR. WARSH: I think your question about

15 the Fed's regulatory responsibilities are,

16 frankly, still to be determined by Congress. I

17 have no confidence that I know precisely how the

18 discussion of regulatory reform ends up.

19 I would say a few principles

20 nonetheless should guide how we think or at least

21 how I think about regulatory responsibilities.

22 One, there should be clear
23 accountability. That is, whoever is responsible
24 for the supervision of firms large and small, it
25 should be obvious. That doesn't mean that there

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1 Keynote Remarks
2 can't be councils to inform judgments, but I
3 think that the system is better off with clear
4 accountability, clear responsibility and so in
5 the event that there are regulatory failures, and
6 I think the history both in the U.S. and around
7 the world suggests that no one has a perfect
8 model, regulatory failures and failures of firms
9 large and small are part of -- are part of what
10 we expect to find.
11 But I think you want clear
12 accountability there and so as Congress is
13 debating the institutional design of where these
14 regulatory responsibilities rest, I think
15 accountability ought not be overlooked.
16 In terms of the Fed's responsibility
17 separate and apart from monetary policy, I would
18 tell you during the darkest days of the last

19 couple of years, having clear insight into what's
20 going on at firms large and small proved enormously
21 helpful.
22 I would suggest that making sure the
23 Fed has a clear ability both in benign times and
24 tough times to be able to roll up our sleeves,
25 understand complex financial balance sheets so we

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1 Keynote Remarks
2 see whether the, what we're hearing from CEOs and
3 CFOs is really justified by what we find on their
4 balance sheets is essential, so that's proven
5 very useful.
6 Maybe as a final principle, I think my
7 own sense is that if the central bank, if the Fed
8 were the regulator only of the largest most
9 interconnected firms but was not the regulator of
10 real banks in real communities where this economy
11 is resting right now, the trajectory of the
12 economy in 2010 will not principally be about, I
13 submit, what happens in New York, it will not
14 principally be about what happens in Charlotte,
15 it will be principally about what happens in

16 small banks and small businesses in places
17 between the east and the west coast.
18 I would not want to have those banks to
19 be regulated by another institution whose name
20 Congress is probably still deciding and have a
21 two-tiered bifurcated system. You can see it
22 from a market participant standpoint, so the
23 Federal Reserve with its \$2.3-trillion balance
24 sheet is the supervisor, the systemic risk
25 regulator, the coin of the realm of these large

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1 Keynote Remarks
2 firms and some other regulator that regulates
3 everyone else.
4 Well, I am afraid that market
5 participants will say, coming out of the panic of
6 2008, that maybe that is the group of
7 institutions that are too big to fail, maybe
8 that's the group of institutions where we don't
9 need to do our homework if we are buying their
10 debt because the government is going to make sure
11 that everything is okay.
12 I think a bifurcated system is a

13 dangerous one, I think a bifurcated system is
14 likely to end up in a world that is less
15 competitive.
16 I am fine with the idea of having large
17 firms and small, but small firms want to be large
18 firms and we shouldn't dissuade them. We
19 shouldn't make it impossible for them to go from
20 one category to the other and similarly, when
21 large firms have large problems they should be
22 able to fall out of that top group and so I worry
23 about a set of regulatory responsibilities that
24 puts a hard wall between those two sets of firms.
25 AUDIENCE MEMBER: Your discussions of

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1 Keynote Remarks
2 what went wrong in the seventies I agree with and
3 you were implicitly talking about how the
4 Phillips curve by its output gap model led the
5 Federal Reserve astray over and over again and
6 yet policy statements in recent times continue to
7 talk about how we have an output gap and
8 therefore we don't have to worry about inflation
9 yet and those seem in conflict and since a lot of

10 people seem, you know, are too young to really
11 remember the seventies experience and the lessons
12 from it, it worries me.
13 I would like you to reflect on that.
14 MR. WARSH: Sure. Thanks Anne Marie.
15 Academics both in think tanks and
16 universities, from my first days as an undergrad
17 and actually long before that have been debating
18 the Phillips curve, have been debating the size
19 of the output gap, how predictive it is. I don't
20 think we will resolve that anytime soon.
21 I think that the output gaps which are
22 still part of the structure of models in most
23 academies are still with us and output gaps might
24 be telling us something about short-term
25 determinants.

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1 Keynote Remarks
2 John was talking earlier about
3 suggesting maybe that output gaps may be driving
4 the cost of wages, the cost of some inputs low in
5 the near term, so I think they have some validity
6 there.

7 But in a world that looks like ours,
8 Anne Marie, I think we would be prudent to look
9 at a broader set of indications of inflation,
10 inflation expectations. We spend an inordinate
11 amount of time trying to measure inflation
12 expectations and it is an imperfect science to
13 this point, but if you look at the breadth of
14 commodities, you look at the relative strength of
15 the dollar and you ask yourself are these moving
16 because of relative interest rate differentials or
17 changes in growth? That's one thing. But are
18 they also maybe giving us a signal at different
19 points over an economic cycle of inflation risks.
20 I think we have to have a broader view
21 than a pure Phillips curve model, but the debate,
22 I think, on that is likely to go on for at least
23 another generation.
24 AUDIENCE MEMBER: Good afternoon.
25 The banking sector seems to be largely

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1 Keynote Remarks
2 fixed at this point in time, but the financial
3 sector seems to be broken. We talked about

4 shadow banking in the previous session as well.
5 So one reason why perhaps the commercial bank
6 credit has not been growing is because the shadow
7 banking has not been alive and well, so I would
8 like to get some thoughts on where you see the
9 securitization market going forward and what kind
10 of new manifestation that it would appear.

11 Thank you.

12 MR. WARSH: First in terms of
13 commercial banks, coming out of the stress tests
14 of about a year ago, I think that what the
15 Federal Reserve did at some risk in sending SWAT
16 teams of people, economists and others, into 19
17 large firms was searching for truth, searching to
18 understand what are the real risks in balance
19 sheets, and we took the opportunity to reveal
20 those findings broadly so that markets would say
21 and come to their own judgments based on our
22 assumptions about the macro economy, GDP,
23 unemployment, what are the risks to capital.
24 I think markets almost within 24 hours
25 found that exercise to be informing to take a lot

1 Keynote Remarks
2 of uncertainty away and from that moment until
3 this the financial markets have been largely open
4 to most publicly traded banks, both securities
5 firms, finance companies, smaller institutions,
6 and part of that is a recovery, so part of that
7 is improved economic fundamentals from that March
8 to this, but given how quickly those markets
9 opened, I also think a lot of the uncertainty was
10 removed.

11 So my view is that if you look
12 fundamentally at why we are not seeing a lot of
13 new credit creation by real banks in real cities,
14 supply has something to do with it, uncertainty
15 about the supply of credit, uncertainty about
16 capital rules that might come from Washington,
17 but I would say what looks to me most
18 determinative is demand.

19 Real users of credit are less certain,
20 particularly smaller, medium-sized enterprises
21 that I referenced at the outset of my remarks,
22 they don't feel nearly as good about prospects,
23 about their costs, about what their revenue is,
24 so they are not banging down the doors of these
25 banks seeking credit.

1 Keynote Remarks

2 My own suspicion is that the credit
3 that's extended from real banks to real
4 businesses in 2010 will turn out to be an
5 excellent vintage, it is a market where there is
6 pricing possible for banks and so I think that
7 the credit creation across the country is not
8 strong, as you rightly point out, but I think
9 there will be nothing like a recovery with some
10 legs to change that.

11 But I'm like you, I share the view that
12 securitization has an important role to play.
13 Securitization in Washington is a dirty word, it
14 goes up there with a range of others, but I think
15 securitization, if you go back to its fundamental
16 notion, is an important and necessary product for
17 this economy to get back to the kind of growth
18 that we want.

19 I think securitization is broadly
20 thought of to be securitization around subprime
21 mortgages, mortgage-backed securities, and we
22 shouldn't be surprised that the mortgage finance
23 market is in some ways quite hobbled.

24 We have a mortgage finance system with
25 the government playing an extraordinary role.

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1 Keynote Remarks

2 This isn't just an extraordinary role in times of
3 panic, it's an extraordinary role for the last
4 generation, and it's hard for market participants
5 to have any certainty about how mortgage finance
6 is going to look over the horizon given the role
7 of mortgage finance right now.

8 I heard just a little bit of the
9 discussion on Fannie and Freddie from Charlie
10 when I was entering, but here you have entities
11 with objectives that are hard to define in this
12 environment, incredible market share and an open
13 credit line from the Treasury, so I think it is
14 difficult to suggest that private market
15 participants know exactly how to get that market
16 to work.

17 But if you look at securitization
18 outside of mortgage finance, look at credit card
19 securitization, look at auto finance
20 securitization, I won't tell you those markets

21 are back and booming as they looked in the height
22 of the boom, but I with tell you those markets
23 are improving, they are improving almost monthly.
24 There is renewed emphasis on transparency on
25 disclosure, there's reasonable expectations being

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1 Keynote Remarks
2 put on the value of automobiles that are in these
3 pools, so I think securitization has an important
4 role to take, I think securitization and mortgage
5 finance will get -- will ultimately find its way
6 back into these markets, but public policy needs
7 to anchor in order for that to happen.
8 AUDIENCE MEMBER: How should we deal
9 with the "too big to fail" problem?
10 MR. WARSH: We shouldn't make it worse.
11 I'd say that there are real
12 opportunities to deal with "too big to fail" and
13 "too big to fail" should be the test of the bill
14 that's going in Congress called fundamental
15 regulatory reform. If it effectively deals with
16 "too big to fail," then that strikes me as
17 something that is well worthy of its name and if

18 it doesn't, then I think we need to be honest
19 about it. It doesn't mean there aren't
20 improvements in the regulatory posture, there's
21 improvements in regulatory design, but I think we
22 run grave risks if we overpromise and underdeliver
23 and we will be doing that if we haven't dealt
24 with "too big to fail."
25 So how should we deal with it?

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1 Keynote Remarks
2 Number one, in order for market
3 discipline to help regulators do our jobs, in
4 order for market discipline to be good policemen
5 to help regulators, markets need to have better
6 information about what are the risks of these
7 very large firms.
8 Markets had better understandings of
9 what's going on in these firms when the Fed did
10 its stress test a year ago, but I don't think it
11 is the government's job or the Fed's job to have
12 rolling stress tests, but I think market
13 participants -- by which I mean shareholders,
14 creditors, counterparties -- need to understand

15 sources of liquidity, sources of capital, so they
16 can make their own judgments about how the firm
17 will perform.
18 I don't think they have access to that
19 sort of information, so I think a much more
20 robust, clear set of information by big firms to
21 stakeholders is essential, otherwise we are not
22 going to get the market discipline that we need.
23 Second, I think that the firms
24 themselves, particularly those that are very
25 large and very complex, they need to overcome the

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1 Keynote Remarks
2 burden of persuasion and tell, persuade bank
3 regulators like the Fed that in the event of an
4 unexpected shock that they have a clear and
5 convincing way to unwind their operations and the
6 burden should be with them, not us.
7 They should be permitted to be in these
8 businesses if they can get out of them in
9 extremis, and if they can't, they don't have the
10 right risk management, they have a legal
11 structure that is too complex, if they have

12 assets that are somewhere ambiguous between
13 sovereigns and areas of the world, capital that
14 is not within the borders it needs to be, then
15 those are businesses that are too big to fail and
16 we shouldn't tolerate it.

17 The reason why I think that this
18 matters so much is if we end up throughout, after
19 this panic with a class of institutions that are
20 special and different and subject to their own
21 set of rules, then what we need for this economy
22 to turn, which is competitive credit markets, new
23 behaviors, new models, aren't going to come into
24 being and I don't think in the U.S. we want a
25 quasi-utility model that is driving our credit

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1 Keynote Remarks
2 intermediation.
3 We see this in other countries and I
4 don't think the record is a strong one. We have
5 8,000 banks in the U.S., thousands of other
6 institutions that are in the credit intermediation
7 business. This is something we should encourage,
8 not discourage, and I think we are doing

9 ourselves no favors if we have two tiers of
10 institutions, one on a special list and then
11 everyone else.
12 AUDIENCE MEMBER: Thank you, Governor.
13 You referred to the formerly obscure
14 13.3 authority of the Federal Reserve and have
15 now given an eloquent exposition of the
16 importance of "too big to fail."
17 Much of the legislative reform is
18 focused on circumscribing the 13.3 authority in
19 the future.
20 Could you comment on that and
21 particularly imagine that, if 13.3 authority had
22 been severely circumscribed in 2008, how it might
23 have affected both the Fed's choices and the
24 economy itself?
25 MR. WARSH: With respect to 13.3, we

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1 Keynote Remarks
2 could not have done much of what we did for
3 better or for worse without 13.3 authority. This
4 wasn't authority that the central bank dreamed
5 up, this is authority that was granted to us by

6 Congress. So first I'd say it's in Congress's
7 every right to take it back, that's their
8 judgment.
9 I think I would personally not be
10 uncomfortable if our 13.3 authorities with
11 respect to individual firms were substantially
12 curtailed. That means in some ways that Congress
13 would be making the decision that there will be
14 potentially tough judgments that need to be made
15 and will be assigning those responsibilities, I
16 presume, to other agents of the government, and
17 if what Congress has in mind are capital
18 infusions under some range of circumstances, my
19 own judgment is those shouldn't be coming from
20 the Federal Reserve anyway.
21 So I am not uncomfortable with a
22 curtailment of the 13.3, but Congress needs to
23 recognize that they then take the burden and they
24 can either decide to keep the burden themselves,
25 Congress can act as quickly as necessary often,

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1 Keynote Remarks
2 otherwise they can give authority to the fiscal

3 agent, but I think a general rollbacking of some
4 13.3 authorities are useful.
5 I would separate the lender-of-last-
6 resort authority broadly defined from what is
7 described as IPC authority under 13.3 where a
8 loan can be given to any individual partnership
9 or corporation.
10 I think lender-of-last-resort authority
11 has a long tradition not just in this central
12 bank but in virtually every credible central bank
13 around the world and so to the extent that the
14 Fed has, sees a need to provide liquidity -- not
15 capital, liquidity -- to a market or to broad
16 sets of markets in extreme, that would be
17 authorities which I think is useful for a central
18 bank to have and we must feel very comfortable,
19 if we extend that kind of liquidity to a market,
20 we are doing it with very good collateral and
21 following good dictates of central bank policy by
22 charging a penalty price, so I would separate
23 that from one-off transactions with individual
24 firms and I would separate that further in
25 separating liquidity provision from capital

1 Keynote Remarks

2 provision.

3 AUDIENCE MEMBER: Over the last 20

4 years, the Fed has been unwilling to promote a

5 specific numerical target for the rate of

6 inflation.

7 Does the Fed still feel that way?

8 That's one question.

9 And in a related but somewhat different

10 question is what about an operational and

11 verifiable way of adopting the Greenspan

12 definition, which was inflation that's close

13 enough to zero that it doesn't substantially

14 affect the behavior of households and businesses?

15 MR. WARSH: I can only speak for my own

16 views on inflation targeting. I would say this:

17 Markets and real economic actors, they

18 think they understand what the Fed is solvent for

19 over a cycle in terms of an inflation target, it

20 is described in the financial press as an

21 implicit inflation target.

22 My own judgment -- and I know there's

23 been a lot of ink spilled going back generations

24 about hardening those implicit targets, making

25 those more explicit -- if I thought we were

1 Keynote Remarks
2 having a hard time explaining, the markets were
3 having a hard time understanding what we were
4 striving for, then I think that there might be a
5 stronger justification to hardening that up and
6 being more explicit.
7 I don't think we are having that
8 translation problem. I think markets tend to
9 understand what price stability means in the Fed
10 context, I think they have slightly different
11 views but generally consistent views about what
12 price stability means among major central banks
13 around the world.
14 So among all of the challenges we have,
15 and if I were to run the narrative of the last
16 few years, I think the difference between an
17 imputed implicit inflation target and explicit
18 inflation target that diverges a couple of
19 tenths, isn't where I would spend a ton of
20 intellectual energy given the huge range of
21 challenges we have got.
22 I think what matters more than what we

23 say is what we do, I think actions matter a lot
24 more than policies and inflation targets move, in
25 the views of real economic actors and markets,

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1 Keynote Remarks
2 depending on how central bankers act and if we
3 act as though our inflation target is higher than
4 we have expressed, we will hear about it, and so
5 I think that that is a reasonable check on where
6 we are to this point.
7 In terms of the Greenspan definition of
8 inflation, I would sort of share the sentiment
9 that we don't want changes or expected changes in
10 price levels to interfere with Congress and we
11 want business people to understand what they
12 think the change in price level will be when they
13 are setting their projections for the next 12
14 months and beyond and so to the extent we are
15 interfering with that clarity they need to run
16 their businesses then we have in some degree not
17 done our jobs, so I think that is a reasonable
18 definition of the best way forward.
19 MR. LEVY: With that very clear answer,

20 I want to conclude this section.
21 I want to thank Governor Warsh
22 immensely for his presentation and for the
23 answers to your questions.
24 Thank you, Governor, very much.
25 (Timed noted: 12:26 p.m.)

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2 CERTIFICATE
3 STATE OF NEW YORK)
4 : ss.
5 COUNTY OF NEW YORK)
6
7 I, CARY N. BIGELOW, RPR, a Notary
8 Public within and for the State of New York,
9 do hereby certify that the within is a true
10 and accurate transcript of the proceedings
11 taken on March 26, 2010, to the best of my
12 ability.
13 I further certify that I am not related
14 to any of the parties to this action by blood
15 or marriage and that I am in no way
16 interested in the outcome of this matter.

17 IN WITNESS WHEREOF, I have hereunto set

18 my hand this 26th day of March, 2010.

19

20 _____

21 CARY N. BIGELOW, RPR

22

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