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State of the Economy

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[START TAPE 1A]

MALE VOICE 1: Being director of the John Shorenstein Center on the Press Politics and Public Policy at the Kennedy School at Harvard, and on behalf of the Center, want to welcome you, thank you for coming. I also want to thank Paul Voelcker and David Walker, Larry Summers for agreeing to be with us today, and sharing their thoughts.

I also wanted to single out Walter Shorenstein, who is seated here in the front. Two decades ago Walter endowed the Shorenstein Center. Ever since, he's given us constant support and ideas, including the idea that led to this morning's conference.

Six or eight months ago Walter started to pepper us with phone calls and memos, cutting articles out of various publications, saying there's a looming storm, economically, and the press doesn't seem to be fully covering it. We did a few things in the fall to try to raise the issue to some degree. We did a forum event, C. Floyd Norris is here. He was kind enough to come up and participate in that event.

But the press, I think like most institutions, needs the shock before it's fully attentive, and the shock has happened, and I think the challenge now is to think about going forward through the reporting, how to inform Americans about what's going on out there and what might happen. And we hope today's session will make at least some small contribution to that particular goal.

With that, let me turn it over to my colleague, Dick Cavanaugh. Dick is now on the faculty at the Kennedy School. Back after having been the executive dean through the mid-'90s at the Kennedy School, and then as many of you know, was the CEO for the Conference Board for a dozen years. Dick.

MR. DICK CAVANAUGH: Thank you. Let me just kind of explain the first part of the program this morning, and the first part is that Paul Voelcker and then David Walker, because we're doing this alphabetically by height, will provide short statements of their views of the economy, and then we will do Q and As, and we were do Q and As until you have exhausted yourselves, or until we get to noon, when we have to, for the moment, recess so that food can be put on the tables where you're sitting, and then we will have lunch and some remarks from Larry Summers.

Now, in case any of you have been asleep for the past 30 years I'll do a short introduction of Paul Voelcker, who is or has been the Chairman of the Board of Governors of the Federal Reserve, the Group of Thirty, the Trilateral Commission, the Global Advisory Group of the Conference Board, the International Accounting Standards Board, the Cerebral Palsy Research Foundation, which is a partial list of his public service in both the public service and in the private sector.

David Walker was, until two weeks ago, the Controller General of the United States, which he had served for about a decade. He is now the new Chief Executive of the Peter G. Peterson Foundation, and Peter G. Peterson is here exercising quality control this morning. And David Walker had a distinguished career, both in public service and earlier in public accounting.

So with that let me say one final thing about questions. I am going to moderate the questioning, and I'm going to try to go table by table until we exhaust them. The rule of a question is there must be a question mark somewhere in the sentence. And this is on the record, so with that, Mr. Chairman.

MR. PAUL VOELCKER: Well, I don't know whether to say thank you or not. Here we are faced with all this pressure. I don't know how you're going to be reported, but I can start out by saying you got me here because you said the press needed education on these issues, and my impression is we've got a very complicated economic problem that the press has handled pretty well.

I am amazed at reading--the part of the press I read anyway, that these complicated issues, and the market today, and the banking system--investment banking system, Federal Reserve, and all the rest have been reported with more clarity than I might have expected. So let me say that in the first instance. That doesn't say the remarks I made yesterday in the Economic Club got exactly the headline that I anticipated, since it's the opposite of what I think. But sometimes the press does get things--they try to personalize things, so let me not personalize this by telling you what I think the underlying problems are. Which may be--they have been out there, but let me just emphasize them. And I'd emphasize two points.

One, financial crises generally don't come along unless there are other problems in the economy. Excesses, one direction or another, and we've had a big underlying problem, not just in the American economy, but in the world economy, because the rest of the world is kind of the mirror image of the United States. We've been overall spending consistently, year after year, more than we produce, and that reached about six or seven percent of the GMP, which is a lot of money when you're the United States. And you wonder how it can go on.

Well, it goes on from our side because Americans like to consume and they got to the point where they weren't saving at all, and if you're not saving at all, there are investments you have to make, government deficits you have to cover, where does the money come from. Well, the money was coming from abroad, and it was coming very easily because they thought the United States was an attractive people to invest.

So you had a kind of symbiotic relationship, where we could spend, we could get cheap goods from abroad, kept the inflation rate down, kept interest rates down, and foreigners. Let's call them foreigners, meaning some of them are Chinese. Like to export, they had big excesses of savings, they were glad to send them to the United States, and everybody was happy. The only trouble is you can't go on forever, spending more than you're producing, and you more and more have to rely upon unorthodox finance--let me put it that way, to suspend--to sustain the spending. And in this particular case in recent years the unorthodox finance got to the point of doing a lot of borrowing on home building, on home buying, prices of homes were going up, it looked very easy, very cheap, and it helped--people were taking money out of their homes to support consumption. They were using old savings, in effect, to--or capital gains to maintain consumption.

And when that music seemed to slow down, when house prices finally leveled off and some of these credits didn't look so good, then you had a financial problem.

So the second point I'd make is what is the nature of this financial problem. We have a different financial system than we had, and many people have commented on this now--a different financial system than we had 20 or 30 years ago. In the United States, but even more so in other countries, there is a clear presumption--was a clear presumption that the systemically important institutions in the financial world were the commercial banks.

And because you are commercial banks did not mean you didn't have financial crises. You did have financial crises, but we invented central banks, deposit insurance, and other things to deal with strains in the commercial banking world.

Well, the last 30 years or so we have moved to much less reliance on commercial banks, and to reliance on the open market. On, you know, different theories that that would be more efficient, you get away from heavy handed regulation, we didn't need commercial banks anymore, and it would lead to a growing, more efficient economy.

Well, it may be more efficient in some ways, but it does not deal with the underlying problem of any financial system. The problem that a financial system has to face, which is important for the economy, is how do you reconcile the fact that people with money in substantial part, want to hold it in highly liquid, safe forms. Short term without credit risk.

People borrowing the money want long term money that inherently carries risk of both market changes and credit risk. And you've got to marry those two things. They used to be married, still are to some extent in commercial banks. But we developed ways of trying to marry those disparate desires outside the banking system by virtue of some very fancy and complex financial engineering. And the theory arose that somehow, by mixing, and matching, and taking apart particular credits and putting them back together again in different packages, we could satisfy these demands on the one side for liquidity and safety, and on the other side for length and riskiness.

And, you know, the theory became popular anyway. Very complex, but what did we find in this crisis? Lo and behold, in this new, highly engineered financial system what was happening? People were lending short and borrowing long, and they were doing it particularly in the mortgage market, and particular on these CDOs, CMOs, whatever they had, financed with a lot of short term debt on the one side, just the sort of thing commercial banks used to do, and lending it longer term. And when problems arose, as they used to in the banking system and still do in the banking system, we had a crisis. That is where we are. And how that crisis gets handled, it's a very complicated one, a very severe one potentially, it is what this story is all about, and it involves, by its nature, some new ingredients which are reflected in the fact that the federal reserve, to try to deal with the extremity of the crisis, had to take out of its attic, I guess, not a knapsack, an emergency--some emergency powers that it had to rescue the Bear Stearns situation.

These are powers that never were really used. There was some trivial use when they were first invented in the 1930s, but I think it is a sign of the nature of a new financial system that these new--never used, or seldom used power, had to be taken out of the knapsack and be put to work.

Now, this has some important implications in my view, which we can get into later, and I'll stop, and we can explore some of those implications later. But to say it doesn't have any implications I think is not reasonable.

MR. DAVID WALKER: Thank you. First I want to thank you for the invitation. Walter Shorenstein in particular. He and I had the pleasure of being at a conference together at a not to be named university on the west coast. I would not speak the name here in the Harvard Club, for an annual economic conference within the last month and he invited me to be here today. I'm honored.

Pete Peterson, my boss. Obviously I have to acknowledge Pete and his generosity. Let me, if I can, focus on what I'm concerned about, some disturbing parallels between our current sub prime, quote, end quote, crisis, and a much bigger sub prime crisis that is not getting enough attention, and that's the imprudent and arguable even immoral practices of the federal government in the areas of finance and fiscal policy.

And let me provide you with four possible common denominators.

First, in the case of the mortgage sub prime challenge--crisis, there was a disconnect between the parties who benefited from originating the loans, and those who bore the risk of default.

The same disconnect exists in federal fiscal policy. Today's taxpayers benefit from a low tax, high spend government policy. Tomorrow's taxpayers will pay the bill, and in many cases those taxpayers are too young to vote, and in other cases they haven't even been born yet.

Secondly, there was a lack of transparency, especially with regard to some of the specialized, collateralized mortgage obligations, and therefore many people didn't really realize how much exposure they may have had. And therefore they really didn't know how much risk they had, which led to some surprises. In many cases, unpleasant surprises, and also led to some emotional reactions that had effects on market crisis that we've seen in recent times.

There's a disturbing lack of transparency with regard to the federal government's finances. It's not our current deficits, it's not our current debt levels that are a problem, it's the $44 trillion in off balance sheet obligations that grow by $2 to $3 trillion a year by doing nothing, even if you balanced the budget tomorrow and were headed the wrong direction in that regard. And it's going to get worse when boomers retire in the next few years.

Thirdly, the current sub prime challenge illustrates the importance of competence and cash flow. Bear Stearns found out the hard way that when there is a lack of competence they couldn't get credit, and when there was inadequate cash flow, they had to engage in a fire sale transaction. Well, guess what? The federal government is counting on foreign lenders who actually--other countries actually save. We don't do a very good job of that, which is one of our biggest deficits.

We're counting on foreign lenders basically being able to lend us as much as we think we need whenever we need it, at attractive interest rates. Well, we may have been able to get away with that so far, but we should not assume that we're going to get away with that indefinitely.

And furthermore, we have these things that the federal government calls trust funds. News release; there are no trust funds, they are trust the government funds. I was a trustee of social security, Medicare. They're on paper, they're called trust funds, but just because you call them trust funds doesn't mean they're trust funds. Don't get me wrong, the bonds are worth something. The bonds are backed by the full faith and credit of the United States Government, they're guaranteed as to principal and interest, they have legal, political, and moral significance. They have no economic significance whatsoever, but they will be honored. But guess what; they don't even show up as a liability on the balance sheet of the federal government.

The trillions dollars of bonds that the government has issued because the government spent all the excess cash flows from social security and used it for other government spending, it's not even a liability.

And so we now have a negative cash flow for Medicare, it started in 2007, it's going to get worse every year. We're going to have a negative cash flow in social security within the next ten years, and we're not doing anything about it. And last, the fourth issue; inadequate oversight and action.

This was not just a problem for the federal government; the fact that who was in charge, who was overseeing this, whether or not, you know, it was a surprise by the government. Look at the private sector. There are many corporate boards, there are many risk management functions in the private sector that obviously didn't operate effective. And so we have a situation now at the federal government there's not enough oversight with regard to our longer--it's not long--longer range fiscal challenges, there's no action, and now on the campaign trails what we hear is people making more unfunded promises. Or thinking that you're going to be able to have major expansions of health care and pay for it through not extending the Bush tax cuts. The math doesn't come close to working.

Washington needs to learn the first rule of holes. When you're in a hole, the first thing you do is stop digging, and it hasn't learned that.

But candidly, last--and then we'll go to Q and A. You know, we have four major deficits in the country. We have a budget deficit, we have a savings deficit, we have a balance of payments deficit, they're all interrelated, and we have a leadership deficit, and the only way we're going to solve this problem, and the reason that the Peterson Foundation is headquartered in New York, is because there's four groups that have to become more informed and involved to try to help deal with these issues before we get a real crisis of much greater proportions, with much greater economic disruption, with much more severe hardship on tens of millions of Americans, and that is if, A, young people wake up, and they're all over the country. Secondly, if the business community wakes up, including Wall Street. And thirdly, if the media wakes up, and the last two are headquartered in New York, and that's why we're in New York. I'm happy to answer questions.

MR. DICK CAVANAUGH: Okay. With these uplifting comments why don't we begin the questions, and let me do this, just so that we have it somewhat organized as we'll go table by table, one at each, and then circle around. Is there anybody at this first table who's got anything they want to ask? No? Okay. Table two, the table with Floyd Norris. No one?

MR. PAUL VOELCKER: Sounds like - - now.

MR. DICK CAVANAUGH: My God, this is like a dance at a Catholic grammar school.

MR. DAVID WALKER: If you want to call me out . . .

MR. DICK CAVANAUGH: Mr. Norris.

MR. FLOYD NORRIS: Chairman Voelcker, yesterday in your speech you talked about the need for the Fed to be vigilant in fighting inflation. Their principal tool on fighting inflation is raising interest rates, as I understand it, and they're now doing the opposite. Does that mean you're critical of the decision to reduce the interest rate?

MR. PAUL VOELCKER: You can't take a position that you always have to be raising interest rates to deal with inflation. It depends upon what kind of an economy you find yourself in, and what all the other considerations are. What I would say is that in trying to deal effectively with this crisis, don't think you can find an easy escape by inflating your way out. And it will affect what you do with interest rates and what you do with other things, but it doesn't always mean that automatically you raise interest rates when the economy may be going in a different direction. But whatever you do, you better take care to think about what the implications are of that for inflation in the future.

The history of mankind is littered with the idea you can solve your problems by having a little inflation, and I would have thought--it was very well known in this country I think 20 years ago, that that didn't work--or 30 years ago, that didn't work. We don't want to get back in the situation we were in the 1970s.

MR. DAVID WALKER: Floyd, if I can come back on that real quick. First, as you know the Feds have got a tough job which, you know, Chairman Voelcker knows first hand of trying to balance; promoting economic growth with fighting inflation, and depending upon what the circumstances are, you have to tilt one way or the other.

Here's a key point; with regard to the longer range fiscal issue that I talked about, some people say let's don't worry about it, we'll inflate our way out of the problem. You can't inflate your way out of the problem because the $44 trillion in off balance sheet obligations grow faster than inflation, and they're preprogrammed to grow faster than inflation.

Social security is indexed. You know, the initial benefit to wages, which grows faster than inflation, the benefit at retirement, add inflation. Health care is growing 2.6 percent faster than the economy, which grows faster than inflation.

MR. DICK CAVANAUGH: Okay. Now we're at table one, and if you would identify--there are also microphones, but if you can wait for a moment--and tell us who you represent.

MR. NORMAN PERLSTEIN: Norman Perlstein, the Carlyle Group. Reporters are only as good as their sources, and one of the things that I've observed over the last several months is that a number of the top executives of the most important financial institutions in this country were able to speak with great equanimity and confidence about the solidity of their financial situation, and only later explained that they truly didn't understand what their own firms were doing. Bob Reuben talking about CitiGroup's problems, for example. Stan O'Neal changing his estimates of risk at Merrill Lynch.

It raises a couple of questions in my mind. One, whether you can recall the Nobel Prize for Economics. But secondly, whether somehow we need some better way of understanding exactly where the decisions are made within our major--within the private sector, and if you will, have a better understanding of how we get better transparency within the private sector.

MR. DICK CAVANAUGH: You want to comment on this one?

MR. PAUL VOELCKER: Oh, yeah. I'm going to make one comment. I must say, you know, it's all--where you sit is where you think. Sources sometimes think that they're only as good as the reporters. Now they get reported.

But look, I don't think there's any doubt in your basic point that many managers--top managers, maybe most, maybe all, did not understand fully what was going on in their own organizations. This thing has gotten enormously complex. It's--you're dealing with abstruse mathematical models, and risk procedures. You have organizations that span themselves over commercial banking, investment banking, consumer banking, international banking. It's very hard to get your mind around it in detail. Part of the unstated tendency in financial markets, what a powerful force is, if you get involved in enough different businesses, you're so diversified, you're safe. If something goes bad, the whole organization won't go down. But in the process that implies enormous complexity that has, I think, been very difficult for managers to keep up with.

So yes, I think you had a problem in just a pure lack of understanding. There's a fascination with a lot of risk management tools that I think this situation has demonstrably proved are false. But that wasn't fully understood, it's probably not fully understood now. I keep going back as a basic problem in getting mathematicians to operate in financial markets. Whether they've got a Nobel prize or not. Because they may understand mathematics, but I don't think they understand financial markets, and that financial markets are made up of human beings that are subject to instincts, and fears, and greed that leads to exaggerated results. And that's why you constantly hear, as I'm sure you're familiar with, that gee, how could that have happened? My model says that's only supposed to happen every 100 years, or every 50 years, or that's a 3 sigma event, but the 3 sigma events seem to be happening all the time. It tells you the models are no good, but to expect the managers to have understood that perfectly, or the Federal Reserve, or the regulators is a problem.

MR. DAVID WALKER: Oh, first I mentioned that I thought that the private sector mechanisms failed as well, and that's basically what you're saying. My view is, is for any system to work, whether it's a corporate governance system, whether it's a risk management system, whether it's a tax system, whether it's a health care system, you have to have three things to make it successful and sustainable over time. Pretty simple.

First you need to have incentives, and that doesn't necessarily mean tax incentives, it could be legal framework, could be performance contracts, whatever. Incentives for people to behave the right way.

Secondly, you've got to have adequate transparency to provide reasonable assurance that people will behave the right way, and that adequate transparency could be internal management, it could be the regulators, it could be the press, could be consumers, clients, whatever. We didn't have that.

And thirdly you've got to have accountability, individual and institutional accountability when things go wrong. And when you have problems, whether they be with regard to financial markets, whether it be with regard to healthcare situations, or whether it be with the federal government, when you don't address those three angles you're going to have big problems. It's only a matter of when.

MR. DICK CAVANAUGH: Okay. Let's go to the third table. We'll come back to the second table. We've got to do--we've got to have some equity here.

MR. KEVIN HALL: Thanks. Hi, Kevin Hall with McClatchy Newspapers. A question for Chairman Voelcker and then for both panelists. For the Chairman, Chairman Greenspan yesterday said this is the first time in his memory that you've had a banking and a financial markets crisis at the same time, and that what struck him as unique about this, the combination of the two happening at the same time. Could you elaborate on whether you share that view, and what that might mean for a way forward?

And then for both panelists, Congress is looking at having the FHA backstop loans in which lenders take a haircut, they did write off a certain amount of the principal and then the FHA would get in and back it up, either through some sort of mortgage backed security, et cetera.

Do you feel that that will help or hinder, being that housing crisis in many parts of the country, particularly California, perhaps have not corrected, and would that be trying to put a floor in a market that may not have corrected yet?

MR. PAUL VOELCKER: I'm sorry, I didn't follow the second part of that question. But in the first part this is certainly different from most recent crises that were banking crises because the banks were the financial system, basically.

You didn't have much of a crisis with investment banks when their job was limited to arranging mergers and acquisitions, or selling long term debt, underwriting it, and then off it goes. But now they have become intermediaries, along with the commercial banks, as I was trying to say, probably inarticulately earlier. So you have both. All these big financial institutions are involved.

There is a difference, which I think this crisis again kind of sharply exposed. The commercial banks were in fact, and are, better capitalized and more regulated than the investment banks, and they have not been subject to the same degree of vulnerability. They certainly have some vulnerabilities, but they have not been as fragile as potentially as the investment banks. And that's in a sense the nature of the beast. They were built up to protect against some of these crises, but the rest of the market has begun acting and borrowing short, lending long, and getting in trouble, so they're both in trouble.

But fortunately the commercial banks have absorbed a lot of the risk back from the market, some of which they created themselves, and thank God there was more capitalize as there were when all of this started.

MR. DICK CAVANAUGH: Okay.

MR. DAVID WALKER: On your second question, first, when the Fed intervened to deal with the Bear Stearns challenge with regard to its bondholders, not its shareholders, it made it inevitable that, rightly or wrongly, Washington was going to do something with regard to individuals, because from a political standpoint if you're going to do something from Wall Street, you better do something for Main Street.

And so something will be done, and something will be worked out. There are differences between the House and the Senate, there are differences between what the President would prefer and what the Congress would prefer, but something's going to happen in this regard. I think one of these you have to keep in mind is you can't take a one size fits all approach, and you've got to understand that the real estate market is not the same everywhere in the country, and it's not the same everywhere within a particular market. You can't go by averages. For example, on averages, if you take Pete Peterson and myself, on average we're both billionaires. I can assure we're not, okay?

So you have to understand with a little bit more sophisticated manner what's going on, and you also have to guard against adverse selection. Hopefully things can be done that would prevent a spiraling of foreclosures that could end up causing much larger losses than otherwise might occur if people actually took somewhat of a haircut, had somewhat of a risk, you know, protection against significant downside risk, and that's what they're trying to work on now.

MR. DICK CAVANAUGH: Okay. Can we move towards the back table, the one that Bob Lenzner is at? And I don't know if there's anybody there who --

MALE VOICE 1: I would like to know what our view is of the Paulson plan of regulation and whether it affords sufficient transparency about what is going on in Wall Street, particularly with the derivative operations, and whether any of these matters that are in the Paulson plan are realistic and can be made effective. It would appear as one--I'm putting this as a question since the Fed had to come in and take $29 billion of the assets off the balance sheet of Bear Stearns and open up the discount window for the investment banks, it would appear that the Fed has already, in some sense, regulating the investment banks. Is that going to be enough? What's your view of the Paulson plan?

MR. PAUL VOELCKER: Well, my view of the Paulson plan is that I think it was a good idea for him to lay out a kind of a view of how financial regulation ought to be set out in the future in an organizational sense. He doesn't deal with what to do with this particular crisis in terms of substantive measures to deal with the present points of strain.

But he has a rather logical view of how to do this, which I--and the future regulatory framework. He says, you know, there's certain types of problems, and let's have one institution to do those types of problems. One is that's basically business practices and disclosure, protection of consumers, protection of investors and so forth, and there's another area of protected sector of the market which ought to have a regulator, that's the banks, and bank related institutions, and then you ought to have the federal reserve kind of overseeing the whole stability questions in the market. And it's an interesting, very broad framework. It's nothing that's going to be acted upon, in my opinion, or in his opinion in this year, but it's a very useful way to look at the system.

You are absolutely right, and one of the questions is how far does the Federal Reserve regulatory interest go, given the recent actions they've taken. They used their authority to lend to non-banks in a big way. That creates a precedent. There's no question about it, and what are the implications of that? What kind of institutions in the end will be eligible now? Before it was quite clear; banks were eligible, nobody else was, except in extraordinary circumstances. Now, that's muddy and I think the implication is pretty clear, which Paulson did not deal with I think adequately anyway, that if you're going to have access to official protection you're going to get regulated by the people who are going to provide the resources.

How far does that go? To who does it go? Those questions are very much in the air and have to be dealt with. I do not--one point I would make, and many other people have made about the Paulson plan, he says well, the Federal Reserve steps in and does that regulation when they get in trouble. I would think that's too late, and if the Federal Reserve is going to get involved they're going to have to get involved before the institution gets in trouble and hope that they can perhaps avoid getting in trouble.

MR. DAVID WALKER: Three quick comments. First, I agree with the Chairman, that nothing's going to happen this year. It's going to be a next year issue. Secondly, Washington's a lag indicator on just about everything you can think of. And thirdly, transparency is a critical element, irrespective of how much government regulation you get, because the private sector system didn't work.

MR. DICK CAVANAUGH: Okay. We have a hand at a table. Right. Great.

MS. CAROLYN BOWNE: Yeah, Chairman Voelcker, out --

MR. DICK CAVANAUGH: Could you tell us who you are?

MS. CAROLYN BOWNE: I'm Carolyn Bowne from Bloomberg News. Alan Greenspan came to the Fed as a philosophical libertarian, laissez faire economist, and yet we saw that at the first sign of crisis he was quick to cut interest rates. Then Bernanke came to the Fed with a lot of academic research on the importance of inflation targeting, the advantages of it. And yet once again the first sign of crisis he cut interest rates aggressively. As someone who sat in the hot seat for eight years, can you tell us what happens so that seemingly principles go out the window? I mean, should we forget all the pretense about price stability and just say that the Fed's a crisis manager?

MR. PAUL VOELCKER: On that question I would refer you to a speech that I heard Mr. Bernanke give when he took office. It happened to be at Princeton. It was one of the most forceful and eloquent affirmations of the importance of the Central Bank paying attention to price stability that I have ever read, and very unusually for an academic he said, you know, the academics were behind the ball on this. We didn't recognize that the stability of the economy recognize--rested on the stability of prices. We've learned our lesson. Now academics are on board and that's why we like inflation targets and all the rest. And really, that speech ought to be in everybody's reading list. I guess that's my answer to your question. You can't forget about the inflation thing because you're going to be in trouble. They have to be a crisis manager at some point. Financial systems through history has been subject to instability and crisis, and somebody's got to be there, or I think that's the general consensus around the world. You just can't leave it to the market without excessive risk to business activity, so somebody's got to be there, and that's why central banks were created, in part. They were also created as regulators and most particularly the Federal Reserve, and it's basic legislation of the Federal Reserve says to more effectively regulate the banking system.

MR. DICK CAVANAUGH: Let's see. I guess we've got someone--whoever Edie gives the microphone.

MR. MARK WHITAKER: Hi. Mark Whitaker from NBC News. I just wondered if you could talk a little bit about how you view the state of the global economy, both in terms of alternative targets of investment and capital flow, and also the implications of the strengthening Euro and the weakening dollar.

MR. PAUL VOELCKER: In a half an hour or so?

MR. DAVID WALKER: This sounds like an exam question at this institution.

MR. PAUL VOELCKER: I just don't know how to start, and the world's still a big place, and actually it's been doing pretty well in recent years. The United States appeared to be doing particularly well during the period I discussed earlier. Unfortunately it had a few disequilibria in the process that eventually had to change.

Europe has been, until recently, expanding more briskly than earlier. Japan was doing a little better, and most important thing in a way was the growing prosperity of the emerging economies. You had both China and India, we're now talking about 2-1/2 billion people are rising at historically very rapid rates of growth, but much of the rest of the emerging world, particularly in Asia was doing better. Even some African countries are doing better.

They had also, and it's an interesting characteristic; influenced considerably by the very big Asian financial crisis some years ago. They've all decided kind of collectively in this turbulent world that they'd like a lot of reserves. They want a financial protection for themselves, and instead of running deficits externally they've been running surpluses and building up very large, I effect, cash balances mainly in the form of dollar holdings, mainly in the form of holdings of U.S. Treasury securities, and Fannie Mae and Freddie Mac securities, they went a long ways towards financing our consumption, either directly or indirectly.

Which brings me to your observation about the dollar and Euro. I think in retrospect it's pretty clear that the dollar was too high and overvalued in terms of a more stable international equilibrium. Now it's come down, come down pretty hard, and I think that has interesting implications. One implication is we talk about all the problems. One result of this crisis I believe must be, and I hope it is rather promptly, a reorientation of our economy away from the consumption and into exports, and into the trade balance. And those imbalances are about--offset each other. The older consumption is about as equal to the trade deficit, and the forces of the crisis itself, this is not unusual. This is what happens. Governments don't act, markets act, and consumption will be squeezed, and exports are being helped, and exports are going up, to me, surprisingly rapidly, given the problems that we've had with manufacturing capacity and all the rest, potentially.

So that's the shining light at the end of this tunnel or dark cloud, or whatever we're in. But the lower dollar helps that process in a way, but the dollar is the world's currency or was the world's currency, as well as the American currency, and having a stable dollar I think is very important to the prosperity of international trade and certainly international finance. And if that gets lost completely I do think we have a problem with never gets on the front pages, doesn't seem to be of direct concern to the typical American, but I think indirectly the lack of stability in the dollar is going to hurt the world economy. So we face that challenge of getting through this crisis without undermining entirely the role of a dollar for kind of public good.

MR. DAVID WALKER: I'd like to touch on three things quickly. First, I agree with the Chairman about the importance of stimulating exports. It's something we need to do more of, especially with regard to small and medium size businesses.

Secondly we've got to get savings up. It's one of more--our critical problems. We can't continue to just to fuel this economy through consumption. Think about what happened right after September 11, that tragic day that affected New York and Washington disproportionately. What did the government say? Go out and spend money. You know, we're in a new situation.

Thirdly, I've done a lot of work international through the auditor generals and others, and ministerial level people, and I think it's only a matter of time before OPEC goes to a basket of currencies for pricing oil. I think that's only a matter of time.

You know, we need to recognize the handwriting on the wall and start doing some things differently in order to make sure that we're in a stronger position going forward. We can't continue to play the same game. It's a new ballgame.

MR. DICK CAVANAUGH: This table that Jeff Madrick is at has been very patient. And since the first shall be last, and the last shall be first, there will be two questions of that people and then we'll throw it open.

MR. JEFF MADRICK: Well, thank you Dick. Jeff Madrick, the New School and Challenge Magazine. David Walker, you talked about transparency and accountability, and I wanted to ask both of you to get more particular and specific on this. Because there was regulatory authority to deal with some of these problems, and they weren't acted on by people running--the federal authorities that could have acted on it. And think maybe it a little bit kind to talk about Wall Street managers as not understanding the nature of risk, when there was so much profit to be made by not bothering to understood that risk. Or looking the other way. It was a highly profitable business to take o all that risk, and it was strong vested interest to do that.

So how in the particular do we deal with--it's one thing to talk about transparency and accountability. How do we make that work? I'd like to push the question to both of you, if you don't mind.

MR. DAVID WALKER: Well, I'll start. First, that's why I talk about three things; incentives, transparency, and accountability. You have perverse incentives where people were incented to take on more risk because of the gain, because of greed, okay? There were inadequate mechanisms, both in the private sector and the public sector to be able to monitor what's going on.

In the public sector, quite frankly the federal government has a human capital crisis, not only with regard to the people who answered John F. Kennedy's call for public service retiring, or soon to retire, but they have a human capital crisis in that they can't attract and retain enough people with the right kind of skills and knowledge to frankly be able to understand, you know, and to effectively discharge the government's responsibilities with regard to some of these, you know, types of sophisticated financial instruments.

You also have a problem where you've got multiple players on the field . . .

[END TAPE 1A]

[START TAPE 1B]

MR. DAVID WALKER: . . . transparency, and that's a key aspect, and I would ask you, where is the individual accountability. You think about what happens. If people make big money when times are good, is any of that money taken back from them when things fall apart? Whether it's CEO, Comp, or anything else. I mean, where's the accountability, you know, from an individual standpoint.

MR. PAUL VOELCKER: Well, I fully agree with what David's been saying on all these points . Behind this financial crisis and substantial product are compensation practices. And I'm not going to belabor that anymore, but it's a big problem.

Staffing is certainly a problem, but let me just add to the transparency point. There's a great feeling. The answer to the problem is just transparency, and I can't possibly argue against transparency, but transparency is not the answer to all problems. These things are so complex that with all the transparency in the world, you have to be a genius to understand the financial reports of some of these organizations. And at least as important as transparency is judgment, and sometimes transparency lead to a conclusion, well, if Citibank's doing it and Morgan's doing it, and J. P.

and Goldman Sachs, particularly is doing it, and they're going overboard I these kind of securities, it must be a good deal. I think I'll go do it too.

You know, this kind of mood and herd instinct is very strong, and transparency does not repel the herd instinct, sometimes it adds to it.

MR. DICK CAVANAUGH: Okay. Is there another one at that table? And then we'll start going back, retracing our steps.

MR. DAVID WALKER: Oh, did you want to ask?

MR. JOHN TOWNSEND: Okay. John Townsend at J. W. Townsend and Company. Question for Chairman Voelcker. You made a reference to the seven - - of period that we did not--do not want to go back to. What's your working definition, if you have one, of stagflation, and how do we know that we've got that particular disease?

MR. PAUL VOELCKER: Well, I think stagflation obviously, in the general parlance, refers to a period when you've got inflation and at the same time you don't have economic growth, or not sufficient economic growth, which kind of puts the lie to the doctrine that I grew up with a little bit at the end of World War II, and as you now hear again, that a little bit of inflation is a good thing and that it stimulates the economy. You can't have it both ways.

Oh, the '70s. Yes. I don't think we're back where we were in the '70s Taking the '70s as a decade. But what does attract my interest a little bit is that there is some resemblance of what's going on now to the beginning of the '70s. It's forgotten now, but we had a big oil crisis, and we had high oil prices, we had agricultural commodities going through the roof, we had soybeans getting so high that the government felt they had to put an embargo on soybean exports, but there was a certain amount--well, it's all temporary. This is kind of oddball stuff associated with the devaluation of the dollar. It will go away, don't fight it too hard, it'll go--we'll get back to normal.

Well, we never got back to normal. We went from that period in, say, '72, by '74 we all had WIN buttons because we were going to deal with inflation with a little psychology, and that didn't work very well, and then as--it took a long while, but as inflation then became ingrained in expectations, then we got to stagflation and we had both ingrained inflation and a sluggish economy.

We don’t want to repeat that pattern.

MR. DICK CAVANAUGH: If we can do one question here and then to the man with the purple tie.

MR. PETER COY: This is Peter Coy from Business Week. Mainly for Chairman Voelcker, the Basel II Accord, banking regulation is supposed to replace Basel I, it already has in Europe, and is intended to avoid some of the gaining of the system that Basel I allowed, where banks could manipulate their balance sheets to get the minimum impact from the Accord.

Now, Basel II relies very heavily on the internal risk models of the big banks, which are heavily mathematical, and you’ve criticized the use of math, so how does that make you feel about Basel II?

MR. PAUL VOELCKER: Well, let me make a general comment on capital requirement problem, Basel I, Basel II in the process of answering your question. It’s kind of a no win game. I was there at Basel I. I had something to do with the creation, to say the least. It was a rough and ready thing. Nobody thought that this was the most sophisticated tool in the world. We understood, why we called it risk based, that it wasn’t very risk based.

The object of Basel I was to get capital in banks up and get them more or less equalized around the world, and I think it was successful in both of those things. Now, with its arbitrariness and so forth, it’s possible to gaming, but in fact banks at that point, continuing today, kept their capital well above the requirements of Basel I, which was an appropriate response, a desirable response, thank God they did it, as we entered into this crisis.

But they always try to gain the system, so I got a very sophisticated system. They’ve been working on Basel II for ten years without--and it’s gotten more and more complicated. I don’t follow the stuff anymore, but I was amazed the other day when I got in my mailbox the request for comments from the Federal Reserve, you know, preliminary through the final decision on Basel II. The thing was about an inch thick to describe the complexities of Basel II, and I began reading it. I got to page 2 of the 150 pages, and that was the end off it. But I have always been suspicious that too much weight was put on mathematical models that were unproven and inadequate. I emoted about that earlier this morning, so I won't tell you all over again, but I do think that's a problem which you're going to have to go back and look at.

But the effort to make it--it becomes very intrusive when you make it so sophisticated, and they tried to deal with the intrusiveness by adopting the bank's own models, which obviously now will have to be re-examined.

MR. STEVE LIESMAN: Mr. Chairman, Steve Liesman, CNBC. Do you feel that the Federal Reserve has increased moral hazard now that it's stood behind and made financing available to investment banks? And now that it's done that is there any way that creditors won't think that at the end of the day, when push comes to shove, that the Central Bank stands behind these investment banks?

And for Mr. Walker, if you wouldn't mind; Alan Greenspan yesterday spoke about this idea of it should now be the province of the Treasury to do this stuff; a resolution trust corporation type organization to handle the lending that the Fed is doing.

Given what you know about the politics in Washington right now, is that feasible and outside of the politics do you think it's a good idea?

MR. PAUL VOELCKER: Well, let me make a point which I tried to make yesterday, maybe inadequately in my speech. Taking this kind of action in an emergency does create a precedent in people's minds, and you can't kind of say you never did it. If you did it once in similar circumstances isn't the logic going to be you may do it again if those circumstances arise, and if that's a correct assumption, then it has regulatory consequences, and those regulatory patterns have to be described. Who are we going to regulate, what is the kind of criteria for extending our regulation, and all of that is going to have to be worked out in the fullness of time with some careful deliberation, and I think there will be--have to be changes in law and regulation as we proceed to deal with the problem you describe.

MR. DAVID WALKER: I think that with regard to the RTC, obviously we have some experience there. The experience is both positive and negative with regard to the RTC in the past. I think it's clearly something that will be considered. That model will be considered. I do not expect that you're going to see action on systemic changes, you know, this year, and I think there are three dimensions that are going to have to get looked at. I mean, what do you do from the standpoint of dealing with the institutions, with the individuals who, in this particular case, mortgage holders, and with regard to investors whether it be equity or bond investors, and so I think the jury is out.

MR. PAUL VOELCKER: Yeah, I want --

MR. DAVID WALKER: [Interposing] Yeah, why don't you go ahead.

MR. PAUL VOELCKER: Dave, your comment reminds me of the other part of your question. The more you support the market, whoever it is, the more political questions arise, which David has emphasized one aspect of that. But the Federal Reserve is, in a sense, supposed to be above all that. You operate through the impersonal market, you don't operate with particular institutions.

Well, when they intervene directly obviously you are dealing with a particular institution, and that's been clear when it's been a bank. Now it's a little muddy, but I don't want the Federal Reserve, because I think it's a very important institution that needs to be respected and independent, to get deeply involved with what will be considered very sensitive political questions. As to how much you support this particular industry or that particular industry, or this particular kind of company, and not another kind of company, which is why I feel strongly the Federal Reserve reacted properly in respect to a particular problem that was pressing in the market; a one day emergency which needed a one day--a one night answer.

But if we have a basic problem in the mortgage area right now, that should be the government's problem to resolve, not the Federal Reserve's problem. And the irony of this is we have two big--we've got three big organizations out there whose mandate is to take care of the public interest in the mortgage market, who have been favored by subsidies and implicit government support for decades, who have access to Treasury money in times of emergency. Where are they?

MR. DICK CAVANAUGH: Okay. We've got--heading back.

MS. FLORENCE HUNTER: Chairman Voelcker--I'm sorry. - - Florence Hunter for the - - School. Several times you've talked about mathematical finance and several times you refer to the Nobel Prize as being - - . You are referring to the Black-Scholes formula, which is --

MR. PAUL VOELCKER: [Interposing] Pardon me?

MS. FLORENCE HUNTER: Are you referring to the Black-Scholes formula and the prize given that?

MR. PAUL VOELCKER: No, I--somebody else --

MR. DAVID WALKER: [Interposing] I did.

MR. PAUL VOELCKER: -- mentioned Nobel Prizes, but I'll give you a Nobel Prize story. Black-Scholes formula is too complicated for me to understand, so I wasn't referring to that.

MS. FLORENCE HUNTER: What were you referring to?

MR. PAUL VOELCKER: I mean, I vaguely know what it's about, yeah. But I think relying upon a formula like that, which is quite arbitrary, frankly, to determine the pricing of so much in the markets is illustrative of the problem. Shall I tell you my Nobel Prize story?

MR. DICK CAVANAUGH: Yes. We'd like to hear a story.

MR. PAUL VOELCKER: This goes back five, six years. I was at a conference in Italy, it so happens. There were mostly chief executives from around Europe, and towards the end of the conference some young guy from London came in there and told these people, and this is five or six years ago with, you know, kind of conservative businessmen in the audience. He said, you people have got to understand financial engineering. If you don't understand financial engineering you won't know how to run your companies. I'll tell you, your company will be toast unless you really pay a lot of attention to this. This is the wave of the 21st century, and you better get with it.

Well, by accident I found myself sitting next to a Nobel Prize winner who was one of the inventors of financial engineering, and I didn't know him, and I knew I was sitting next to him, but I'd never met him. And I poked him with my elbow, and I said, you know, what does all this financial engineering do for the economy? Does it increase the GNP, does it help with productivity? And much to my surprise he whispered in my ear, and his answer was one word; nothing. And I said well, what does it do? He says it moves around the rents in the financial system, and besides, it's a lot of fun. But it does move around a lot of rents in the financial system. I'll tell you, a lot of people have made a lot of money.

MR. DICK CAVANAUGH: We're going to take one question here, and then over to the table in the front.

MS. SARAH BARTLETT: Hi, my name is Sarah Bartlett, I'm also with the CUNY Graduate School of Journalism. I wanted to ask you about leverage, which is a word that surprisingly hasn't come up a lot yet this morning, and whether you would like to see specific limitations placed on leverage limits for investment banks, hedge funds, private equity firms. How do we--underling so much of this problem is excessive leverage, and how do we regulate that, what is the appropriate thing so that we don't just encourage more capital to go offshore?

MR. PAUL VOELCKER: Well, and the answer is well, the leverage is a big problem and the question, yes. Does it need regulation? Yes. How you do it? It's difficult, but go back to this Basel I, Basel II. Before there was a Basel there were U.S. regulations which were only imposed in a meaningful way in the '70s, and it was very simple at first. It was a leverage ratio, pure and simple. If you were a bank, you would keep--you must keep your capital at whatever we said; five percent of your assets.

Now, that was considered too simple, which is why we got Basel I. But the point is at the end, to be effective, I think you're going to be crude and simple, and yes, I think investment banks are going to end up with a leverage ratio imposed upon them.

MR. DICK CAVANAUGH: Pete, you've got a microphone there. And then we're going to go to the back by the windows, where there are some very patient people.

MR. PETER PETERSON: I believe I've heard both of you say that one important ingredient of a solution to some of these problems is more savings, and I hear both of you saying part of that is reducing government dissavings, and I think you mean also increasing personal savings. Now, about ten years ago I was asked to chair a little Committee for the Congress in the White House on competitiveness, dealing with getting more savings, and I brought together what I was told was the best savings economists in the country, left, right, and center.

And I was very surprised at the virtual unanimity of two things; one, they felt in general that our current tax incentives had a limited and ambiguous effect on savings, partly because people would be inclined to do savings anyway, and using tax incentives would raise the cost.

But when I asked them well, if that's true what do you think we ought to do about it, I think virtually all of these say that we are so consumption obsessed in this country we may have to seriously consider some program of mandatory savings, a la Singapore, Chile, now Australia, and so forth.

I'd be interested in what you two gentlemen think about what would you do to increase personal savings.

MR. DAVID WALKER: Well, first I've been on the record on this, even as Controller General, prior to coming to be CEO of your new foundation, that tax incentives really have not worked to increase personal savings to the segments of society that need to save. And therefore I think that the only way that realistically we're going to be able to increase personal savings is a requirement, and my personal view is that we ought to reform social security, sooner rather than later. It ought to--the foundation of it should be a reformed, sustainable, and secured defined benefit system, but we should have a mandatory supplemental individual account on top of that through payroll deduction that goes into a real trust fund with real investments, with real through share responsibilities and liabilities for a lot of different reasons, and I think we're going to have to get there, and quite frankly I think we can get there if we act sooner, rather than later.

MR. DICK CAVANAUGH: Okay. We're in the back now.

MR. BURTON FRIERSON: Burton Frierson from Reuters. I'm happy that the savings question came up, because it leads into mine. You've both addressed savings quite extensively today, which reminds one that the government is getting ready to send out stimulus checks, which presumably the hope is that consumers will go out and spend their money, and give a boost to the economy.

But given that we have a situation where banks are struggling to find capital and funding of all sorts, and consumers are generally thought to be heavily indebted, would it be better for the economy overall, and in the long term, if they were actually to pay down their consumer debt and put the rest in the bank? Thank you.

MR. DAVID WALKER: Well, if, you know, if they pay down some of their credit card debt, the question is do they still use the credit card and charge it right back up again, you know? I mean, you know, one of the real challenges we have in this country is the country and too many Americans have become addicted to debt, and you know, there are people, believe it or not, and one of the challenges we have and we're going to focus on through the Foundation; one of the things we're going to focus on is financial literacy, because we're graduating people out of high school, the people who do graduate, who don't understand the basics about financial literacy.

I mean, some people think that if you've got a checkbook, that you've got money. Some people think if you pay off a bill, another bill with a credit card, you've paid off the bill. And so the answer is our economy right now actually relies upon personal consumption too much. Come back to--we need to stimulate exports, all right? We have to increase savings. That's going to have to be done mandatory. So the question is not just whether or not they pay down their debt, but do they quit using their credit card.

MR. DICK CAVANAUGH: Okay. Right here. Sir?

MR. ZACHARY KARABELL: Hi, Zachary Karabell, currently of Fred Alger Management, soon to be of something else. In our final moments I have an extremely big picture question, but it's sort of a first principal question, which is what exactly is the goal here of, you know, what is the current failing that the ideal we're striving for would achieve? Is it never to have economic contraction? Is it two percent economic growth, quarter after quarter after quarter with a 5.1 unemployment rate? Is it everybody attesting to the fact that they think that they're happy and that the future is decent, and that the economy is okay?

Because every criticism and every sense of failure is predicated on some sort of assumption as to what would be good and what would be better, and I'm just curious from both of you, having, you know, analyzed problems and dealt with crises, what really is the goal here, and what is a realistic goal to even try to achieve?

MR. DAVID WALKER: Me, sir?

MR. PAUL VOELCKER: You can start.

MR. ZACHARY KARABELL: Yes, this is an essay question.

MR. DAVID WALKER: Well, first I didn't get the memo that said the business cycle has been repealed. Business cycles happen, recessions happen. The question is what's different with this situation that is beyond a recession, if in fact, which it's more likely than not, that we will have one, but hopefully short and not too deep. And that's what we talked about the mortgage sub prime crisis and what's happened to housing prices. That's different than a normal recession, and so we need to treat it differently. What are we trying to accomplish? Economic growth with equity, with modest inflation, and remain competitive internationally.

MR. PAUL VOELCKER: I sometimes get so radical in my old age that I wonder whether there isn't too much emphasis on economic growth, but I grew a hell of a lot richer when I was a poor man, and I'm not sure my children have to be twice as rich as I am. And I'm not all that rich by some comparisons. But anyway, let me just pick up on one comment that David made.

Capitalism has been marked by recurrent cycles, recessions. In the long run it's produced tremendous growth and prosperity. I have a feeling that somehow in our search for perfection we'd like to think business cycles can be ruled out, and the Federal Reserve is so all powerful and so important that somehow, if they just push the right money supply buttons, somehow we can never have a recession.

My fear is that in the effort and some conditions, the situation to avoid a recession recreate conditions that give rise to an unsustainable bubble, and then you run the threat of a bigger recession than what you bargained for. And I think we should be modest in that respect on what we can and cannot do, or we'll make bigger problems for ourselves. I just follow along with what David said in that respect.

MR. DICK CAVANAUGH: Okay. Our final question is over here, the man who has the final microphone.

MR. CLARENCE SCHWAB: Thanks. Clarence Schwab, Schwab Capital Management. One question for the panel. To what extent do you think the specific steps that Sweden took to resolve its financial crisis in the 1990s are appropriate in this instance, in the United States? And what are limitations.

MR. DAVID WALKER: Well, first I don't profess to be an expert on all the things that Sweden did, but one aspect that I do think that we need to do that Sweden did is they recognized that no country, including the United States, can or should write a blank check for health care. We have written a blank check for health care in this country for Medicare and Medicaid. That's the one thing that could bankrupt the country. And of the $53 trillion hole that we're in as a nation, over $34 trillion is Medicare alone. And health care costs are a real challenge, so one of the things that they did was they recognize you can't write a blank check, and that you need to have an automatic trigger mechanism that when health care costs, as a percentage of the budget and/or as a percentage of the economy get to a certain size, and I think it really ought to be the budget, not the economy, that you need to have some--a safety valve and some automatic adjustments that occur.

Now, some in this country want to put a cap on how much of the economy can be in health care. I think that's wrong. I think employers ought to spend whatever they want, individuals ought to spend whatever they want. At the same point in time I think there has to be a cap on what the government will spend on health care because only the government can print money legally, only the government can mortgage the future of our kids and grandkids, only the government can raise taxes, and so therefore we've got to have a discipline on the government that otherwise would not exist because the government is monopoly. It doesn't face competitive forces.

So from that standpoint, the last thing I'll mention. One of the things we did when I was a GAO is we tried very hard to look at international experiences on a whole range of things; social security, health care, taxes, counter terrorism, all kinds of things, you know, because we're a great country, but you know we're not number one in a lot of things. In fact we're below average in some of the things that really matter for an industrialized nation.

I think we can learn a lot from New Zealand, we can learn a lot from Australia, from Canada, from the U.K., and from other countries, including countries with socialized medicine, which I don't advocate by the way, Sweden. We need to do that because there's a lot to be learned so that we can end up crafting an American solution to some of our challenges that are informed by the experiences of others.

MR. PAUL VOELCKER: I presume the question may have had something to do with the fact that they nationalized the banking system. I think we're a long ways from there. We have a considerably banking system than Sweden did, and, you know, I can't imagine we would get to the point where we would rely upon government ownership of the major banks in the country, which is what they did for a while, and quite successfully. They sold them back at a profit to the private sector after a while.

But that is an extreme reaction and a much less complicated economy.

MR. DICK CAVANAUGH: Okay. I think that we have to thank Chairman Voelcker and General Walker. We have to thank you all for--because this would not have been a session without your questions and insights. Logistically this room is where we're going to eat lunch, which means that we have to give the people who are in charge of lunch some opportunity to put food and utensils on the table, which means that we can move towards the back, we can move out and around. I should tell you that there is only one infraction of rules that is enforced with great discipline at the Harvard Club, and that is the use of cell phones in the common area. And you can lose a hand for that. You know, insider trading is fine, anti trust violations are okay, but no illegal cell phone use in the areas outside of this area.

So with that let me ask Edie, who's really running this thing, is there anything else that needs to be said?

[Background noise]

MR. DICK CAVANAUGH: And be back at our tables at 12:15 for lunch and for Larry Summers. Thank you all.

[Applause]

MR. PAUL VOELCKER: Well, I think I will leave you.

MALE VOICE 1: The acting director of the Shorenstein Center, and we have some new arrivals since we started this morning. Welcome, thank you for coming. Thanks again to Walter Shorenstein, who provided the germ of the idea that led to this morning, and of course Walter has been enormously behind the Shorenstein Center ever since he founded it two decades ago.

Well, we're honored and delighted to have Larry Summers with us as our luncheon speaker. As you know, Larry Summers was the Secretary of the Treasury in the last years of the Clinton Administration. Before that, chief economist at the World Bank. Subsequently President of Harvard. As some of you may not know, Larry Summers was tenured at Harvard at age 28, one of the youngest ever to receive that appointment, was the first social scientist to receive the National Science Foundation's Waterman Award For Scientific Achievement, was recipient of the Clark Medal, which is given every two years by American Economic Association to the outstanding economist under the age of 40.

Currently Larry Summers is contributing to the jobs crunch by holding down several positions. He's the Charles W. Elliott University Professor of Harvard, a columnist for the Financial Times, co-editor of Brookings Economic Activity papers, a managing director of the investment firm D. E. Shaw, and today our luncheon speaker. Larry Summers.

[Applause]

MR. LARRY SUMMERS: Thank you, very, very much for that generous introduction, Tom. As you describe the different things I've had a chance to do in my life I'm reminded that when I first got to Washington people would ask me what is different about being a senior treasury official than working as a professor at Harvard. And I would answer them by saying that as a professor at Harvard the single worst thing you could do was to sign your name to something you had not written yourself.

On the other hand, as a treasury official, to the first approximation it was a mark of effectiveness to do so as frequently as possible.

And then I had a chance to return to the University as its President, and people would ask me, what's different about being the President of Harvard from working in Washington, and for those first months I gave an answer that in retrospect is breathtaking in its naiveté.

I would say that the thing about Washington is that it's so political. There's so much opposition, and the University, well, the University is the University.

This will be more interesting for me, and I suspect more interesting for you, if we do this more in the spirit of a discussion than in the spirit of my giving a long speech. So I thought what I would do is identify what seemed to me to be the four largest issues that will face the new president, whoever that new president is, on January 20th, and explain why I think each of the four of them is probably more important and more salient than the most important economic issue on the agenda of a new president at the beginning of most presidential terms.

It's a cliché to observe that this is a uniquely consequential election, and that the country is at a key cusp of choice. I am old enough to now have followed ten presidential elections closely, and it has been said in every one of those presidential elections, I think this one stands out in the possibility that the statement is actually true.

The four areas I'm going to say a little bit about are the cyclical and financial situation of the American economy. The challenges--the related challenges of managing globalization and increases in--and associated--perhaps associated increases in inequality and the problem of the anxious middle, the question of health care reform, and the questions associated with global climate change and energy.

I think each of those four issues is, as I say, more important than the most important issue at the beginning of most terms, and I think it’s revealing, and I think David Walker probably wouldn’t completely agree with this judgment; that the aging of the country and the preparation for the aging of the country is probably as important, and it is in fact a critical issue, as it has been. But the fact that it’s not one of the top four now is not a tribute to its lack of importance, but is a tribute to the tremendous importance of other things that have risen on the agenda.

The cyclical and financial situation. My judgment is that it is overwhelmingly likely that we are currently in recession, and that if we’re not currently in recession, we’re certainly in something that feels a great deal like recession. I think there is a reasonable but less than 50 percent--I think there’s a reasonable chance that from a financial market, Wall Street perspective, the worst has passed. One looks at many fixed income securities. They are really pricing in catastrophic outcomes, and the actual outcome is likely to be serious, but less catastrophic.

From the prospect of Main Street and the real economy, I think there is a very large amount of pain left to be felt. I think it is slightly more likely than not that in a technical sense the recession will have ended when the new president is inaugurated, but I think it is a virtual certainty that the economic situation will feel more like recession in--on January 20th, 2009, than it does today.

The irony of financial policy and financial crisis, is that the measures that are appropriate and necessary to prevent it are exactly the opposite of the measures that are necessary to cure it. Our problem two years ago was that there was too much greed and not enough fear. Our problem today is that there is too much fear and not enough greed.

My sense is that the stimulus package that was passed was entirely appropriate, that it will be necessary and appropriate to pass a further package of fiscal stimulus measures, and that it will be appropriate to consider government involvement in supporting the mortgage market on a more substantial scale than we have yet observed. My guess is that will be put in place prior to the choice of a new president.

The issue on which we are making progress, but we are making progress only slowly, is the adequate capitalization of our financial institutions. The IMF has estimated that total losses from this crisis will be about 900--it will be close to a trillion dollars. Several hundred billion of that trillion will be borne by major U.S. financial institutions. We have not seen anything like that as yet in new capital raising, and reality is that we've learned from this crisis that the levels of leverage that we used to deal with were probably excessive.

There is a tendency to focus on this through the prism of excessive leverage. That is part of what is at issue, but I think it misses what is a fundamental aspect of the problem that we don't yet have fully satisfactory policy tools to address.

If an institution is anything like indifferent between reducing its leverage, by selling off assets or avoiding taking on new loan commitments--that's one way of doing it.

The other way of doing it is raising capital and diluting its shareholders.

The tradeoff from the point of view of an institution between those two measures is very different than the point of view of society.

From the point of view of society it is far better that they raise capital than that they shrink balance sheets, with all of their consequences. And so it is very important that we have a stronger public counterweight than we have as yet in favor of capital raising, dividend cutting, and the infusion of capital into the financial system.

From that perspective I am disappointed at the rather feckless commitments that the GSEs have been permitted to make. Yes, we'll raise some more capital at some point in the future and we won't tell you how much, in return for rather significant regulatory forbearance. Getting more capital into the system I think is essential.

The broad question of financial regulation and the future of our regulatory system will clearly sit with the new president. In my view the most important issues are not primarily about the organization chart of the regulators, but about the strategy of the regulation. How are we going to address the ever present tendency towards procyclicality with regulation which encourages more lending when things are going up and less lending when things are going down, and is therefore destabilizing.

How are we going to find a balance between the need for national autonomy in regulation, and the avoidance of races to the bottom across countries?

What is our treatment going to be of relatively illiquid assets that are hard to value on a moment by moment basis?

It seems to me these more conceptual questions, and of course the crucial conceptual question of what is the role of institutions to have short term liabilities, long term assets like banks, but are not formally banks. It seems to me we need to address these issues conceptually before we can get to the issues that are discussed in the treasury report of how the regulatory system is going to be organized.

If we don't address the economic slow down, and we don't address getting finance under control, where people have confidence, it is going to be very hard for the United States to achieve any of the president's other objectives.

The stakes here are very large. One way of framing it that is too dark, but not an order of magnitude too dark, is to suggest that in--as a new century started the United States had three great attributes in the world. It was a moral beacon in many ways. It had a unique capacity to execute and do things in the world, and wield power. And it's economy was a model and example for all.

We, in many ways, squandered the sense of moral leadership and opportunity for moral leadership that was created after September 11th through the way in which we approached the rest of the world from Abu Ghraib to treaty renunciations, to much, much else.

We sacrificed that part of legitimacy which depends on power, which in turn depends on a perception of competence with other things that happened in the world. Most notably in Iraq and New Orleans, where our sense of competence was sacrificed. And today the sense around our economy is very much in doubt, and so I emphasize the cyclical and financial dimension because I really think it is central to our capacity to do anything else.

Nine months ago I would have identified as the central challenge that was going to face a new president, what I call the anxious middle class. The reality, and you see it in stories that came out--you see it in the story in today's Times, but you see it in many, many other things; that somehow the economy is do--has, over some periods, done reasonably well, but even when it has done reasonably well it doesn't seem that large amounts of it are benefiting average families.

In the expansion that probably ended in late 2007 we had a six year expansion. Median family income was no higher at the end of that expansion than it was at the beginning. This is a deep phenomenon. If you look at--we are publishing in the Brook newspapers tomorrow a--the conference is tomorrow, we're publishing it subsequently, a paper by Justin Wolferson, Betsy Stevenson at the University of Pennsylvania, that looks at the relation--looks at a whole lot of data on subjective happiness and satisfaction.

The striking conclusion is that Europeans are happier over the last 30 years, the Japanese are happier over the last 30 years, most people are happier over the last 30 years. The two countries where it's least true are two countries that we would have identified as economic great success stories; the United States and China. And in both cases, while the data are not overwhelmingly clear, it appears that the reason is that the growth in the size of the aggregate economy has not been matched by the increases in income for the average family, and you can see it very clearly in the American statistics.

Here's a statistic--here's another way of making the same point. Imagine that we had the same income distribution in the United States today that we had in 1979. In order to achieve that we would have to take $650 billion a year--a year, $650 billion, or about $500,000 per person from the top 1 percent and give it to the bottom 80 percent, where it would represent an extra $7,000 per year, and it would double the growth in their median incomes. The middle group, between 80 percent and 99 percent, has kept its share roughly constant.

So the average family is falling way behind of the performance . . .

[END TAPE 1B]

[START TAPE 2A]

MR. LARRY SUMMERS: . . . tragic milestone. For the first time since there were statistics kept in the United States, and in a phenomenon that has not been observed in any other country to my knowledge, the group of Americans who are currently retiring is as educated as the group of Americans who are now entering the labor force.

Part of the headwind of economic growth for the last century has been that every generation is more educated than the last. The fraction of Americans between 25 and 34 who have graduated from high school is no higher than the fraction of those 54 to 65. Similarly the fraction who graduated from college is no higher.

We are no longer becoming more educated as a society, in contradistinction to our past and the past--and the rest of the world. In such a situation it is less than miraculous that our middle class is lagging, and I would suggest, as one who has spent a certain amount of time with schools both lower and particularly higher, that while it is easy to stress the quantitative dimension, it would be a serious mistake, looking at the United States, and particularly looking at our public schools, to suppose that what we are lacking in the quantitative dimension we are somehow making up in the qualitative dimension. If anything, the statistics suggest that the problem is reinforced by the qualitative dimension.

Health care. This issue is back where it was in 1992, only there are many more people without health insurance, and health insurance, as a share of health costs, as a share of GNP, are a third higher than they were then, and if you look at the simplest and most basic indicators of the system it is not a happy story.

Here’s one; comprehensive hypertension. Hypertension is controllable, and treatable, and overwhelmingly important for health. You are an American 50 year old, 55 year old adult with hypertension. The chance that your hypertension has been recognized by our health care system is about 50/50, and the chance that if it has been recognized it is currently being successfully controlled is also about 50/50. So of all hypertension that could be controlled, about 1 in 4 is.

If you did the same analysis with respect to diabetes or two or three other chronic conditions, you would find the same kind of conclusion.

It is just not right to suggest that yes, American life expectancy is terrible, by international standards, but that is in spite of our health care system. We are discovering, to a distressing extent, that it is closely related to the failings of our health care system.

What is the right approach? My guess is that as a country we will experiment with variance on the Massachusetts model of mandates to try to get to universal coverage, incremental one bit at a time, along with more comprehensive negotiation. I don’t rule out the possibility that it will succeed. I think it is likely to be a step forward, but my guess is that the degree of systemic reform that is necessary to achieve truly impressive results is being underestimated.

It is also a crucial issue for the international competitiveness of the country. I just returned from spending some time in Mexico and trying to understand various issues of Mexican economic policies. Not a small competitive advantage of Mexico is countries migrating to Mexico because of the high cost of health insurance premiums in the United States.

We always--people always talk about NAFTA. The truth is that there never were terribly large tariffs. Certainly not after the Uruguay round passed on Mexican exports to the United States. And yet the migration for health insurance reasons is quite substantial.

And so the health insurance issue is critical, not just because it’s Americans’ health, not just because it’s Americans’ budgets, but also because it’s a critical issue in terms of our competitiveness and in terms of the job generating capacities of our economy, and it will be very high on the new president’s agenda.

Fourth, energy and global climate change. This is an issue with which the rest of the world is seized, and increasingly Americans are seized with its importance, and no one serious can suppose that the path that we are currently on is indefinitely sustainable.

There is a well known political device, it certainly is one that the Clinton Administration was party to on occasion, and it’s certainly one that I’ve been party to at Harvard, which is there’s a really important issue. There’s--it’s a very difficult issue, and there are a lot of problems with trying to do anything real, quickly, because it is complicated and because it is politically difficult. And yet one has a strong urge to be visionary with respect to the issue.

It was a standard technique. Triple the horizon and sextuple the ambition. So you say well, look, we don’t want to think about this problem in incremental terms by actually doing something over the next three years. What we need to do is really put this--take a holistic view of the problem and so we’re going to set a goal for X years from now, and we’re going to not just set the goals that everybody else is talking about, we’re going to set--good to see you, Mort. We’re going to set really ambitious goals for the long run.

That’s basically been the world’s approach to global warming to date. And I would think it was much more impressive to hear any proposal to reduce American carbon use by 6 percent from its current level in the next 5 years, than to reduce it by 80 percent from its current level in the next 35 years.

And yet our political debate, and much of the discussion in the rest of the world, is very much oriented towards that long run view.

These considerations are only reinforced when one considers the dangers associated with the democratic world’s near complete, as a collective, dependence on the authoritarian world for its energy supplies and its oil supplies, in particular. A dependence that is going to increase.

I put it in terms of the democratic world and the industrial world so that I avoid falling into what I think is a common and fairly dubious way of discussing these issues, which is to frame the issue in terms of our energy independence.

First, we're not going to become energy independent in 2025 or 2030, it is not going to happen, there's no serious projection that suggests that it could.

Second, even if we did, it really wouldn't matter because there's one world price of energy and if we had a lot of oil come into us, and Europe had no oil coming to it, what would happen is that some of the oil that was coming to us would be diverted to Europe, at which point we wouldn't be energy independent. And so what really matters from the point of view of understanding vulnerability is not some concept of our own energy independence, but the degree of dependence of our allies.

And if you think about it, the democratic world is going to be almost completely dependent on the authoritarian world, and the strategy of treating the authoritarian world as a universal hostile monolith may not be a very adroit strategy for addressing that situation, rather than seeking to drive division within that authoritarian world.

Here, too, is the problem is profoundly difficult, but the starting steps aren't that hard. Is there anyone who could believe that we are spending too much money on research on various kinds of nonpetroleum, clean technologies?

Is there anyone who could believe that the price of energy is really too low in the United States, and that there are excessive incentives to conservation and efficiency?

So the right broad directions are, I think, clear if vast amounts of policy are enormously complex.

These four challenges; energy, health care, the inequality, keeping the economy supported by a strong financial system, humming and moving forward, mean that the choices that a new president makes, and the choices we all make with respect to a new president, will be enormously consequential. It may be a perilous time to be a citizen, but it is a very exciting time to be an economist. Thank you very much.

[Applause]

MR. LARRY SUMMERS: I'd be happy to respond to anybody's questions or comments. Yes, sir. Let me introduce--why don't people identify who they are also.

MR. PEDRO DE COSTA: Hello? Hi, Pedro De Costa from Reuters. My question is I'm wondering what your view is on whether the repeal of Glass-Steagall [phonetic] under the Clinton Administration has anything to do--and the sort of level of deregulation that occurred during the 1990s has anything to do with the crisis right now.

MR. LARRY SUMMERS: Gee, I'm really glad to come here and get that question. I think it's a hard--I think there are some important issues around regulation. Clearly there was what, in retrospect, is quite inadequate regulation in the mortgage area, and particularly with respect to a variety of mortgage lending practices.

We proposed a variety of legislative measures directed at preventing what seemed to us to be potentially predatory mortgages in 2000, and Congress wouldn't move forward on any of it, and the Fed was reluctant to adopt very much of it, and I think ex poste it would have been better if there had been significantly more mortgage regulation.

I think the kind of things that Arthur Leavitt was working on at the SEC to push financial institutions into greater transparency with respect to their accounts, that would have had the potential of bringing closer to view much more of what was on balance--on what was off balance sheet, on balance sheet, would have operated as a discourager. Would have operated as some discouragement to those practices, and I think that kind--that would have probably been a contributor to the prevention of some of the problems that we have seen.

I have--I thought about this set of questions with respect to Glass-Steagall reform, and I guess I find that a very difficult case to make. It may be that you can--it may be that somebody can make the case, but when I've heard people try it's all kind of broad brush, yet there's too little regulation and Glass-Steagall was deregulation, therefore Glass-Steagall repeal must have caused this, which I don't think is a very strong argument.

When I think about what happened in our--in the Gramm-Leach-Bliley legislation that passed in 1999, for the most part it codified a set of existing practices in which a variety of investment banking activities had found their way into commercial banks. You've thought about the fact that the

Citigroup merger had already happened, if you thought about what was happening at that time with J. P. Morgan's merchant banking activity, whatever you thought, it had already happened, and it's hard to see why having it happen with a level playing field set by law, rather than by periodic administrative exemption for the connected was a better way.

But more fundamentally even than that, it seems to me that you have to weigh whatever concerns you have about consolidation against the reality, as the financial people would put it; it's much cheaper to hold a put on portfolio-- to write a put on a portfolio than to write a portfolio with puts.

That is to say that if these financial institutions were less diversified there is a substantially greater risk that the losses would have been concentrated to the point where there would have been a larger failure, and that failure would have implicated the safety net to a greater degree.

After all, suppose Bank of America or Deutsche Banc had owned Bear Stearns. That would have been better. If we had not had any combinations of investment banks and commercial banks I think we would have been dealing with several more Bear Stearns type problems.

So I don't want to argue that Glass-Steagall reform has made the financially system--financial system a lot stronger, and that certainly wasn't the rationale for pursuing it, but I think the argument that would seek to blame these problems on Glass-Steagall deregulation, I have not yet seen made in a way that was very compelling. Maybe somebody, by looking at interfiliate rules of how they've influenced leverage lending and such, will find a way to make that argument compelling, but I have, as you can see from my answer, tried to follow the issue thoughtfully, and I at least haven't seen that case yet compelling made, and I think the Bear Stearns observation should raise a substantial question in people's minds. Yeah.

MR. JUSTIN LANEHART: So on the middle class and the --

MR. LARRY SUMMERS: Why don't you just introduce yourself.

MR. JUSTIN LANEHART: I'm sorry, Justin Lanehart at the Wall Street Journal. On the inequality that we've seen really expanding over the last, you know, three decades and I guess we're really seeing it in spades in the last--during this decade, how do you--it seems like a lot of that comes from the way that the market distributes wealth. And how do you think that we bring down increment equality? Do you do an ex poste distribution after the market has distributed well, or, you know, are we going to see more regulation. And, you know, which would you prefer, and which do you think we're going to actually see?

MR. LARRY SUMMERS: I think unfortunately I'm guessing, and you can tell me whether you think I'm right or not, but if you thought about all the reporters at the Wall Street Journal, some of them are higher paid and some of them are lesser paid, and if you said which ones would management rather lose; the high paid ones or the low paid--lower paid ones, I'm guessing that for the most part management would rather lose the lower paid ones. Certainly if you held age constant. That is, certainly if you asked, as between the lower paid 45 year olds and the higher paid 45 year olds, I'm guessing they'd rather lose the lower paid 45 year olds. Certainly that would be true in most organizations of which I've been a part.

And the reason I say that is what it suggests is that the differences in pay are probably less than the differences in productivity. After all, if the pay was the same, relative to the productivity, you would be indifferent.

So I suspect it's a feature of the market's system that as pay is driven in closer and closer to productivity, unfortunately in many cases we're going to find that that means more and more inequality, and so I'd be rather skeptical of the proposition that there are good ways to regulate pay into greater degrees of equality, and I suspect that a rather larger part of how we achieved equality is going to have to be through various kinds of ex poste redistribution.

Ex poste redistribution can be explicitly a matter of the progressivity of the tax system. It can also be a matter of if we all pay proportionally to our income for health insurance, and then we all get health insurance. There's a kind of implicit redistribution that takes place in that way.

I would like to see good ideas for the ex ante reduction of inequality, rather than having inequality and then having--

and then having redistribution. I'm just not altogether certain that there exist so many good ideas for pursuing that objective that don't have very substantial adverse collateral consequences.

But I think it's a mistake also to be too confidently predictive in these matters. Typically, you know, people declared that the income distribution was really a great constant of nature, and that there was a fundamental stability to the U.S. income distribution just before inequality started to explode.

My Harvard colleague, Richard Freeman famously wrote a book in 1976 called The Overeducated American that argued that the return to education had fallen in a substantial way. So any views on the future of income inequality have to be held with a certain humility, and tentativeness.

I do think, and the last comment, that one very important sphere for cooperation is in the international dimension, where we are losing the ability to tax profits and to some extent returns to cognitive capital in a substantial way because of tax competition across jurisdictions, and if we were successful in cooperating in those areas we would be able to maintain a greater commitment to equality. Yeah.

MS. CAROLYN BOWNE: Carolyn Bowne from Bloomberg News. Dr. Summers, your statistics on the hypertensives, that only one in four are getting treatment, you didn't say why. Is it because they're not seeking out health care, they can't afford it, and is there any system of health care; mandate, universal health care, that on some level doesn't require the individual to take ownership of his own health?

MR. LARRY SUMMERS: Some of you may have heard this talk and think I'm not an authority on anything. But among the subjects here, the health aspect--the medical aspects of health care is an area where I am truly at a comparative disadvantage, relative to some other subjects.

My impression of the--my understanding of the evidence in this comes from work that my former Harvard colleague, Chris Murray, now at the University of Washington, has done, is that these figures are considerably better in a number of European countries, and that there is significant variation within the United States in the ability--in the success with which we implement these things. And that while it is a fact of human nature that even when it’s fundamentally important for human health, an individual told if you ask people to take one pill a day, every day for six months, the number of people who will do it successfully is less than one would like it to--is less than one would like to believe that it would be. That a fragmented health care system like ours, with doctors disconnected from pharmacies, with doctors focused on their specialty, rather than treating the overall health of patients, with medical records that are fragmentary with respect to the comprehensive history of the care an individual has received, that all of those things contribute to the performance being less good than it is elsewhere. Yes?

MALE VOICE 2: In your analysis of Clinton and Obama positions on economic issues, what do you see as significant differences and similarities?

MR. LARRY SUMMERS: I don’t think I want to answer that. I really don’t want to answer that question in an interesting way on the record, and since we are on the record I’ll probably answer it in an uninteresting way, and therefore I’ll keep my answer brief.

Look, I think any differences between Senator Clinton and Senator Obama are pretty small compared to the differences between them and the republicans, and I think they’re pretty small compared to the differences between the exigencies of campaigning and the exigencies of governing. So I don’t see much in the way of differences that I find to be highly salient in their impacts. Probably the difference which has generated the most discussion is the one regarding mandates on health care, where there’s a sense in which having a mandate seems to speak to a greater degree of commitment to universalism.

But when you have--and I think that’s a compelling argument. On the other hand, a mandate, depending on the punishment, isn’t a--if you don’t read the mandate, is in some sense more or less mandatory and there are a variety of ways of providing encouragement that don’t involve mandates.

So I’ve found it difficult to see large differences in the nature of the positions in the two candidates. Bob?

MR. BOB LENZNER: Yeah, Bob Lenzner of Forbes Magazine. First the Paulson Plan. Sorry, the Paulson Plan for regulating Wall Street, and the things that have been done; the opening of the discount window, the issue of transparency, and also what Mr. Voelcker raised, the necessity perhaps to--I don't know how you would do this; regulate the amount of leverage that there is in Wall Street. What are your thoughts about that, and about the Paulson Plan in general.

MR. LARRY SUMMERS: I think there are a set of crucial issues, some of which I tried to touch on, that in a way that are I think more fundamental, and I rather suspect are more set--are more difficult than the issues that the Paulson Plan takes up.

The Paulson Plan primarily takes up the organization of the government's regulatory structures, and no doubt they can be profitably reorganized in some ways, and I think there's some valuable suggestions in that regard.

But I think the really important--really more fundamental questions go to how much capital should financial institutions be required to have, how should that amount of capital have been required to have, the cause to vary with changing economic conditions over the cycle.

Given the reality that, just as you can't ever really credibly promise not to pay ransom, you can't ever credibly promise not to provide government financial support in certain kinds of emergencies. What should the modalities of that support be? What should the range of protections that you have with respect to avoiding the need to provide that support be? Those questions, it seems to me, are in a way logically prior to the question of how the different regulatory--than what the Fed should do and what the SEC should do. And so in a way I think we're going to have to work our way through those questions before we can decide whether the particular Paulson recommendations are wise or are unwise.

I share the anxiety that, you know, in a way the point that you made, and I suspect that Paul probably made about leverage, is the mirror image of a point that I made a little while ago. I made the point that if you were deciding whether to issue equity or not, that your incentive to issue it was weaker than the social incentive to have you issue it because of the dilution.

It's essentially the same observation to say that if you're thinking about taking on more leverage your private incentive to do it is greater than the social incentive to have you do it because you don't internalize the externality that comes from the greater risk.

So I'm sympathetic to the impulse to less leverage. I think the question is what, if any, kinds of regulatory policies can you have that are credibly constructive in achieving that objective.

If you pursue policies that regulate some institutions but not others you have the difficulty that if you--if the regulations are very binding, then you're going to put those institutions at a competitive disadvantage and your unregulated sector is going to grow, and then you're going to have a problem that a lot of what you're worried about is taking place in the unregulated sector. That's the kind of problem we have already seen.

How do you define leverage? Well, there sort of becomes a slippery slope. It is tempting to say leverage should be the size of your balance sheet, and you can't get your balance sheet bigger than X.

On the other hand, it is hard to believe if I buy a nine year treasury bond and I buy a ten year treasury bond--I buy a nine year bond and I buy a ten year bond, and then you say well, how much capital should I have to hold in order to accept the risk associated with a nine year treasury bond and a ten year treasury bond, that's transaction A.

Transaction B is suppose I buy a ten year bond and I sell a nine year bond? In some sense it's got to be the case that I'm bearing vastly less risk in the second case than I am in the first case, since on almost any contingency you can imagine, if a ten year bond goes up, a nine year bond will go up, and so if I bought one and sold one, they'll largely cancel each other out.

So then you say well, so is my leverage supposed to be how much leverage I can have? If it's just how much leverage I can have it almost doesn't make any sense because it surely should depend upon what it is I'm levering, and what the risks are of what I'm levering, and if I've got offsetting positions like the ten year and the nine year, then I probably should be required to have less leverage than if I've got reinforcing positions like I own both the ten year and the nine year.

But then you say okay, well, you know, suppose I've got a whole complicated portfolio of things. To figure out how much leverage I need do I have to figure out what all the correlations are and what the underlying risk is? Well, that's kind of what we have now with the capital requirements based on the risk models that depend upon the correlation matrices, then the correlations prove to be wrong, and unstable, and that's what we're worried about.

On the other hand, if we go back to saying look, just you only have so much leverage, it sort of doesn't make any real sense because how do you think about the situations where there's offsets and the situations where there's not. So is there a reasonable way of defining a [background noise] I hope that's not my Blackberry.

However, I hope that's not a hint either.

So the question is how do you, and can you define less leverage in a way that has any kind of operational meaning, and I worry about the law of unintended consequences when you engage in various kinds of regulations. So I guess I share the impulse to concern about leverage, but I have the slightly fatalistic view that not all problems can be solved, and I worry that the effort--I worry about how you're going to achieve effective regulation of it, though I totally support the desirability of doing so and the effort to explore ways of doing so. Yeah.

MR. KEVIN HALL: Thanks. Kevin Hall with McClatchy Newspapers. [Coughing] excuse me. The previous panel touched on--Chairman Voelcker in particular mentioned he thought there was perhaps a greater than advertised risk in the weakening dollar, and there may be a day of reckoning, and Mr. Walker I think suggested a decoupling may be coming soon in OPEC or a basket of currencies. Where do you see the--I know you in the past have been among those who have said you support a strong dollar. Where do you realistically see the risk of a weak dollar and kind of that evolution. And secondly, on the

GSEs, both Chairman Voelcker asked where are they? Clearly the Democrats are in control right now and they're not moving expeditiously. Where do you see the real issues on GSEs, or what needs to be done quickly?

MR. LARRY SUMMERS: The great part--the great thing about two part questions is you can choose the part you want to answer, and answer that. So I'm going to duck the dollar part and answer the GSE part.

I don't think this is very hard. The GSEs have benefited enormously for many years from the unbudgeted public commitment that their implicit guarantee represents. I don't think there's any question that they would not be viable, and this has been true for a long time, in their current operating model without the implicit guarantee that the government provides.

And I think in that context--and I think it is quite clear that if whatever the merits of the GSE structure, that at a moment like the present is a moment when we need the GSEs to be taking a larger role, not a smaller role. Therefore, it seems to me very clear what should happen. The GSEs should raise substantially more capital, their--that will undoubtedly mean some dilution of their shareholders' interests. It will mean some greater protection of the government's interests, and it will give them an incentive, and give the society the wherewithal to have larger credit made available to the mortgage sector to the benefit of the financial system as a whole. To the benefit of potential homeowners, and probably potentially ultimately to the benefit of housing values.

And that regulators, since the institution's viability is dependent on the support of the government, should be in a position to ask the GSEs to do what is necessary. And so the GSEs should be raising capital on a very substantial basis. I welcomed the decision to announce that there would be larger reduction in the punitive aspects of the leverage ratio that will enable them to lend more, and that they would raise more capital.

I did not welcome the fact that there was no schedule for the capital raising, and that there was no specified amount of the capital raising, and that the GSEs seem to regard this as a rather diffuse commitment.

I think it is central to their future, it's central to the public financial response to this crisis, and it's central to the protection of taxpayers, and so I think there's no higher priority than insistence that the GSEs raise capital on a substantial scale. Yeah.

MR. ZACHARY KARABELL: Zachary Karabell, Fred Alger management. I'm going to give you another opportunity to duck one of the following two questions. One entree --

MR. LARRY SUMMERS: Well, now that we've established the precedent.

MR. ZACHARY KARABELL: Yes.

MR. LARRY SUMMERS: This is terrific.

MR. ZACHARY KARABELL: But you --

MR. LARRY SUMMERS: [Interposing] Go right ahead.

MR. ZACHARY KARABELL: I'm not sure you can duck both.

MR. LARRY SUMMERS: Okay.

MR. ZACHARY KARABELL: Although you probably could. On a question about trade. I mean, obviously there's a backlash against trade which is not particularly uncommon in an election year. What's more interesting is the kind of professional backlash against free trade from an economist and a policy maker. I'm wondering what your thoughts are about that, and the directionality of that.

The other is really more of an economist question, but it plays to policy, which is, you know, to what degree are you comfortable with the statistical framework that various government agencies collect as adequately, actually capturing the reality of the kind of economy we're in. Particularly when almost all that statistical analysis is national based, there's no such thing as, you know, a global inflation calculation, nor could there be easily.

But does that create distortions in the policy response, insofar as we may be playing off kind of an inadequate playbook and making certain conclusions on the basis of it?

Trying to figure out which of those two to --

MR. LARRY SUMMERS: [Interposing] I think the failures of our conceptual apparatus; the weak public understanding of the benefits of international trade, the difficulties that the policy debate often has in recognizing the difference between the fact that if I loan Walter Shorenstein money, since he's credit worthy, to the first approximation, the cost to my family is zero, and if I give Walter Shorenstein money, then the first approximation and the second approximation, the cost of what I gave Walter, is what I gave him, and while they both could be described as X million dollar programs of support for Walter Shorenstein, they're profoundly different. I think the conceptual problems in having an intelligent debate are far greater as constraints on good policy than a lack of statistical precise knowledge about various aspects of the economy. Though our statistical system is, in many ways, rooted in a world where value is mostly tangible. There was things like tables and chairs, rather than things like concepts, and so we are--I would agree with those who feel we are substantially underestimate--under investing in this statistical system. But if you said are there really large policy errors that we're making because we don't have a better statistical system, I find that a difficult case to make.

With respect to trade in the economics profession, I'm not sure there's been as much abdication of the economics profession as there has been difficulties in the political process, and I think the problem is that the very real problem is inequality. The very real phenomenon of globalization have been projected onto the question of international trade agreements when the reality is that the phenomenon of inequality has many causes. The phenomenon of globalization is primarily about new technology and communication, and about the greatly enhanced economic capacity of many developing countries, and trade agreements are, at most, a tertiary factor and I think that's a sort of unfortunate feature of a political debate, that the trade agreements have been so elevated as central.

MALE VOICE: Do you have time for one more question?

MR. LARRY SUMMERS: Thanks very much. I've enjoyed being with you.

[Applause]

MALE VOICE 1: Well, Larry Summers, thank you. Thanks to Paul Voelcker and David Walker, Dick Cavanaugh, and thank you for coming.

[END TAPE 2A]