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Remarks by:

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Henry Kaufman:

Thank you for the honor you bestowed on me tonight. Ever since its founding in 1918, the Foreign Policy Association has played a vital role in shaping our understanding and awareness of U.S. foreign policy and global issues, as well as the foreign policy directions of our government. That role is even more important today than it was when this organization was founded.

Today, the global economic and financial situation is, as economists would say, in disequilibrium. Stated more simply, it is in disarray. No matter where we look, it is difficult to find solid economic, financial and political footings. Europe is mired in a financial quagmire from which it probably cannot escape without a major overhaul of its institutional arrangements. Japan, although still a leading economic power, has been struggling to regain its momentum for more than a decade. The U.S. economy has not languished as long, but it has recovered haltingly and subnormally.

Not surprisingly, therefore, many experts are pinning their hopes for global recovery on the key developing nations – especially China, India and Brazil. This is not a well-founded hope, however. The economic vitality of these developing nations is still linked importantly to the welfare of the more advanced industrial countries. None of these three emerging economies possesses the kind of legal, financial and political institutions – either individually or collectively – that would allow it to replace the US dollar as the world's key reserve currency. To be sure, America's dominance has receded from its earlier heights, when the US helped win two world wars, establish a set of key international economic and political institutions, and rescue quite a few developing nations from difficulties.

Nevertheless, the US remains the world's economic and financial center. But as we struggle to regain stability and reform our financial institutions, I fear we will not create a financial structure that will support a vibrant economy over the long term.

What is the root of the problem, both here and abroad? It is, simply put, the relationship between creditors and debtors. There can be no creditor without a debtor, and no debtor without a creditor. This relationship can swing between harmonious and tenuous over time. It looks harmonious when creditors lend and borrowers borrow. Indeed, under such circumstances the credit environment often becomes quite exhilarating. But just when accommodation between creditor and debtor becomes virtually seamless, the relationship will teeter toward acrimony. And when that happens, instability in the credit system can threaten the very foundations of our economy.

Consider the current situation. Today, vulnerabilities in our credit system are probably much greater than in previous periods of financial travail. Global financial markets are, of course, much bigger than in the past. But more than that, financial markets and institutions are now linked together more intricately than ever before through a nexus of complex financial instruments. Thirty years or so ago, the relationship between creditors and debtors involved mainly loans and bonds. When problems arose, it was easy to discern and measure each party's role. This is no longer the case, thanks to the myriad of financial arrangements, including all kinds of derivatives and many obligations that serve as cash substitutes, such as repurchase agreements, money market funds, and commercial paper.

As some of you may know, I spent part of my early career in the financial markets analyzing credit flows. Those years helped me appreciate the institutions and dynamics of financial markets, especially the interplay between creditors and debtors. Quite a few years ago, I became concerned about debt increasing more rapidly than nominal gross domestic product. By the eve of the crisis in 2008, non-financial debt exceeded GDP by $19 trillion. Compare that with twenty years earlier, when non-financial debt exceeded GDP by just $4 trillion. We are now finding that there are no easy ways to close that gap in order to achieve a viable relationship between creditor and debtor and thus return to a path of more sustainable economic growth.

Although households have been reducing their debt, their total indebtedness is still quite high by historical standards. To encourage them to significantly increase their borrowings would be folly, especially when personal income growth is restrained by high unemployment and global competition. For their part, businesses have also slowed their borrowing in recent years, and quite a few have extended the maturity of their liabilities. However, the much-lauded improvement in corporate liquidity has been overstated because it is highly concentrated in relatively few business corporations in a handful of industries.

The dominant borrower in our credit market lately has been the U.S. government. Without its large borrowings, the economic recession would have been deeper and the business recovery, subnormal as it has been, would have been delayed. At the same time, large increases in government borrowing over a long period are untenable. The US challenge, therefore, is to bring private sector debt into closer alignment with sustainable economic growth and slow the total growth of U.S. Government debt in the years ahead.

Therein lays the rub. Credit market participants are not known for restraint. The elixir of debt is enticing. For decades, households have been acculturated to continuous borrowing rather than deferring consumption in favor of savings. The value of the home became a source of virtually instant liquidity through new streamlined methods of finance. For households and businesses alike, liquidity has come to mean seamless access to debt rather than savings. Credit cards are the indispensable substitute for cash. Ready access to debt has transformed many luxuries into necessities.

This environment of excessive credit creation over the last few decades boosted demand for products and services and corporate profits, which in turn encouraged firms to engage in financial behavior beyond previous norms. As corporate debt grew rapidly, the number of firms with triple-A credit ratings fell sharply and the universe of below-investment-grade bonds grew sharply. In 1982, Standard & Poor's rated sixty-one nonfinancial corporations triple-A. Today, there are only four triple-A nonfinancials. Apparently, managers of many corporations are quite willing to forsake high credit quality in order to achieve greater short-term profits. Quite a few publicly traded corporations were bought privately through massive leveraging, and some were brought back into the public market with substantial debt burdens.

It is quite unlikely that our government will adopt appropriate fiscal policies any time soon. Near-term pressures are not strong enough to impose discipline. US interest rates are historically low. Buyers of our debt are still easy to find. In that sense, our government faces an accommodating situation similar to what households and businesses enjoyed for many years. Neither restrained their excessive borrowing out of prudence. Rather, they ultimately did so out of economic necessity. But it would be extremely dangerous for our financial markets and our economy to wait until there are no more options to overcome our fiscal laxities. The stakes have grown higher, while confidence in our political will and legislative process has reached new lows. And financial regulators have accumulated a record of acting too little too late.

Financial institutions unavoidably play a central intermediary role in the relationship between debtor and creditor. In order to play an essential role in encouraging reasonable economic behavior and maintaining financial stability, they must fulfill their fiduciary and entrepreneurial responsibilities by making profits, on the one hand, and safeguarding the savings and temporary funds of their clients, on the other hand. But too often in recent decades, financial institutions have compromised that balance by tilting too far in the direction of risk taking. The temptation is exceedingly great. As you know, financial institutions traditionally maintain small capital reserves relative to their liabilities. They have incentives to leverage even more, for greater leverage brings greater return on equity. Unlike many business corporations, financial institutions do not enjoy the benefits of patents or copyrights that would protect their profitability. New financing and trading techniques are quickly copied and exploited by others.

While there are some legal and regulatory constraints on the behavior of financial institutions, overarching responsibility for maintaining stability rests with the Federal Reserve. This is an awesome and essential task. Our central bank should be quasi-autonomous in order to implement effective policies while remaining free of near-term political pressures. At the same time, the Fed's performance should be scrutinized.

The central bank's record since World War II has been checkered. To its credit, we have endured no economic depression in this period. And many of the down cycles in the economy have been mitigated by monetary policy initiatives. However, the Federal Reserve too often has detected and responded belatedly to very critical developments. A small army of Fed watchers will criticize one or another of the central bank's interest rate moves. But from my perspective, the greatest shortcoming in monetary policy has been the Federal Reserve's failure to recognize the significance of structural changes in the financial markets and their implications for the conduct of monetary policy.

Let me offer a few illustrations. In the 1960s and 1970s, two developments had a powerful impact on the creditor/debtor relationship, but the Federal Reserve failed to recognize them. Deposit institutions were gradually allowed to pay market rates of interest on their time and savings deposits, and they shifted their lending financing rates from fixed to floating interest rates. This change allowed institutions to lock in a favorable spread between the cost of deposit funds and the interest rate at which they lent out these funds to borrowers. As a result, lenders no longer were quickly restrained by monetary tightening (as long as they could maintain favorable financing spreads) and borrowers continued to access financing as long as they believed that they would use the funds profitably.

By the time this new period in the creditor/debtor relationship came to a close in the early 1980s, the yield on three-month Treasury bills had risen to 17¼ percent and the prime loan rate stood at 21½ percent. The financial turmoil was brought to a close by the deterioration in credit quality of borrowers – which put at risk the presumed locked-in interest rate spread – and by the corresponding deterioration in the quality of lender assets. For its part, the Fed responded too slowly. The situation was finally brought under control by the draconian measures of incoming Fed Chairman Paul Volcker, who allowed money rates to rise dramatically in order to halt the deteriorating relationship between creditors and debtors and the spiraling inflation that accompanied it.

The Federal Reserve also failed to take proper account of the rapid rise of money market funds; the growing importance of myriad financial derivatives; the spread of new quantitative risk modeling techniques; and, as I noted earlier, the increasing reliance of households and business on borrowing as a source of liquidity. To some extent this is because the Fed acquiesced to the notion of liberalizing the creditor/debtor relationship because market cycles had moderated after the inflationary binge of the 1970s. It also bought into the belief that credit risk was being moderated by the proliferation of new financial instruments and quantitative trading techniques.

Shortcomings in monetary policies are not endemic to the U.S. The Bank of Japan failed to ward off huge speculation in stocks and real estate in the 1980s, with negative consequences still not overcome. In Europe, a massive realignment in the creditor/debtor relationship is now in process. If central banks are the ultimate guardians of credit, as I believe they should be, then it is fair to ask: "Why wasn't the European Central Bank aware of the massive borrowing by the debtor countries of Europe that are now in serious debt trouble?" After all, that buildup was not a one-time event. Also: "Why didn't the European Central Bank track the growing indebtedness of the so-called PIIGS and the huge creditor position of the major institutions within its jurisdiction?" The European Central Bank cannot claim that its principal responsibility is to contain the rate of inflation while at the same time neglecting the stability of the debtor/creditor relationships within its purview.

In the United States, the greatest shortcoming of the Federal Reserve, from my perspective, has been its failure to halt growing financial concentration. It did not effectively oppose the amalgamation of financial institutions, especially following the demise of the Glass-Steagall Act in the 1990s. The powerful new giant financial institutions were a key force driving the rapid growth of securitization, the seamless access to credit through the issuance of credit cards and equity lines of credit, the rapid and uncontrolled rise of financial derivatives, and the modeling of quantitative risk taking that relegated subjective management evaluations to a subordinate position.

Unhindered concentration in U.S. financial services has dramatically changed the financial landscape. The share of U.S. financial assets held by the ten largest financial institutions was 10 percent as recently as 1990. It now exceeds 75 percent. At the end of 1985, there were more than 18,000 member banks of the Federal Deposit Insurance Corporation. Now there are fewer than 8,000. Many insurance companies have merged, while others have been folded into large financial conglomerates.

In investment banking only two organizations of significant size remain independent – Goldman Sachs and Morgan Stanley – and they rushed during the chaos of fall 2008 under the Fed's umbrella to restructure into a bank holding company. The list of key institutions that are no longer independent – some with names that have vanished – is a remarkable roster: E.F. Hutton, Kidder Peabody, Paine Webber, Dean Witter Reynolds, Merrill Lynch, Salomon Brothers, First

Boston, Shearson Lehman, Drexel Burnham, Bache & Co. and Bear Stearns.

During the latest financial crisis, financial consolidation grew by leaps and bounds. And during this crisis official policymakers actually encouraged huge financial institutions to merge in order to avoid insolvency and market disruptions. In the wake of the latest wave of mergers, regulators finally became troubled by what some market observers had been warning about – financial institutions "too-big-to-fail" because their failure would cause systemic risks to the rest of the financial system here and abroad.

The Dodd-Frank legislation, rather than taking on too-big-to-fail, has enshrined it. Besides addressing the problem poorly, Dodd-Frank is unclear and verbose. I read recently that at the time it was legislated, the Dodd-Frank Financial Reform Act comprised 383,013 words. With ongoing amendments, it probably now exceeds 400,000 words. In contrast, consider the brevity and conciseness of some of the world's great documents – the U.S. Declaration of Independence, 1,300 words long; the U.S. Constitution, including all twenty-seven Amendments, 7,818 words; the Gettysburg Address, 286 words; the Ten Commandments, 179 words.

How many financial institutions will be designated too-big-to-fail under the Dodd-Frank Act? The answer is still unclear: perhaps as many as forty to fifty. Global regulators have designated twenty-nine large financial institutions, including eight based in the U.S., as systemically too-big-to-fail. The new U.S. legislation also is dramatically enlarging financial oversight entities, and introducing new ones. All will function under the auspices of an institution called the Financial Stability Oversight Council. I suspect that this will be a very cumbersome structure that will have difficulty acting decisively.

The Dodd-Frank legislation also calls for the orderly dissolution of a too-big-to-fail financial institution that might become financially vulnerable. A government organization will manage the process. But orderly dissolution is extremely difficult to achieve. Our financial conglomerates are entangled with many markets and many financial instruments here and abroad. Untangling these credit relationships will affect prices and other market relationships. Who will take the losses? Who will take over the assets and liabilities as the dissolution proceeds? It is reasonable to assume that, one way or the other, a good portion of assets and liabilities will be acquired by other institutions that are themselves deemed too-big-to-fail, or perhaps by one of the official institutions of government. Either way, the entire process will increase financial concentration.

My opposition to the rapid increase in financial concentration is rooted in some basic observations. First, the high concentration of assets raises troubling questions about how the Federal Reserve will be able to conduct monetary policy. When monetary restraint is required, who will be affected the most? The fact is, institutions deemed too-big-to-fail will be largely insulated from central banking constraint. That will leave the smaller institutions to experience the brunt. Under increasing pressure, some will be financially incapacitated, will fail, or will be forced to merge with other institutions. As a result, financial concentration will increase.

Second, as financial conglomerates continue to grow, conflicts of interest will be unavoidable. After all, these firms operate on both sides of the market – as portfolio managers and institutional investors on the buy side, as underwriters and dealers on the sell side, and as financial advisors on both sides.

Third, in the tradable market for securities, the spread between bid and ask prices will widen, reflecting the market power of the few remaining market makers. This is especially troubling given how few players there are today compared with a decade or two ago.

Fourth, the volatility in the value of securities will increase with growing concentration. As the number of market makers dwindles, the depth of secondary markets will decrease as well. The high concentration in money management will harmonize market views rather than encourage diverse opinions. Under these conditions, views on the value of financial assets will change sharply, which in turn will periodically encourage more rather than less governmental intervention.

Fifth, financial concentration will reduce ready access to financing by small businesses. Large institutions are not geared to be ready and flexible lenders to small organizations. This is because, among other things, their lending and investing policies tend to be centralized, and their local managers do not aspire to dedicate a lifetime of service to the community in which they are assigned. Most aspire to move up in the management structure of the financial conglomerate.

Sixth, financial concentration will increase the flow of funds to large business corporations, enhancing industry concentration here and abroad.

Seventh, financial concentration does not necessarily support the role of U.S. as the center of world financial markets. Not too many years ago, one prevailing (and self-serving) view held that it was necessary and desirable to allow American financial institutions to grow very large in order to compete with foreign competitors, especially the so-called “universal” banks in Europe. But where are many of these competing foreign institutions today? Look around. Their governments have a stranglehold on many of them. Being home to giant financial conglomerates obviously is not the answer to maintaining our world standing in financial markets.

We can avoid these negative consequences, but only with strong political will. No financial institution should be considered too-big-to-fail. We need to require these behemoths to downsize, until they no longer pose systemic risk, by spinning off some of their activities. To be sure, there is no precise formula for quantifying optimal size. The process will require judgment. Still, by restructuring our financial system in this way, however imperfect, we will benefit by having more institutions subject to the ebbs and flows of the marketplace, and therefore positioned to play an effective role as intermediaries between creditors and debtors. If we do not reverse the current course, however, we will continue along the same path as the other leading economies of the world – toward socializing our financial institutions. That will be to the detriment of all.