

Economic Insights is an idea publication of the Missouri Council on Economic Education, a not-for-profit organization founded in 1969 to promote and improve economic literacy in Missouri.

We feel that an understanding of key economic concepts is vital for all citizens in order to live, work and make informed decisions in our modern economy. Through Missouri's excellent Centers for Economic Education in Kansas City, Warrensburg, Springfield, Northern Missouri, Columbia, and St. Louis, we present high-quality courses designed to provide K-12 teachers with an understanding of important economic concepts so they can then bring these concepts to their classrooms. Topics covered include monetary policy, taxation, spending, inflation, the environment, growth, conservation, trade and energy, to name a few.

MO Economic Insights

VOLUME 1, ISSUE 1

AN IDEA PUBLICATION

The "Great Recession" and the Role of the Federal Reserve Bank

By Paul A. Volcker

The following are remarks by Paul Volcker at the Truman Medal for Economic Policy Award Luncheon.

A couple of years ago, a Harvard professor polled his large undergraduate class: "in all the world in the past 100 years, whom would you rank as first in constructive influence on global affairs?" President Truman – one of only two American Presidents to be mentioned – ranked number seven. I have to tell you he would not have been on the list in my undergraduate days. Quite the contrary. So I am particularly grateful for this chance to atone for that enormous error of judgment about a simple and courageous man from Missouri. There is another irony in my presence today, following by a couple of years my successor as Federal Reserve Chairman Alan Greenspan. The simple fact is President Truman had a rocky relationship with the Fed. For some years, during World War II and thereafter, the Federal Reserve was in practice under the thumb of the Treasury (in the person of one John Snyder, another Missourian). Interest rates were held very low – from 3/8 percent to 2 1/2 percent for long-term lenders. Mr. Truman liked it that way. But as inflation threatened, the Federal Reserve did not. It became increasingly restless. Eventually, there was a public fight. To put it bluntly, that was one fight that Truman lost. The independence of the Fed was affirmed and reinforced. And that, I like to think has been good for the country.

Events and maturity have completely changed my view

of Harry Truman, who indeed stands as one of our most important Presidents, with a lasting legacy. I'd like to think that that same Harry Truman, were he here with us today, would have changed his views as well, and come to respect the importance of a strong and independent central bank.

That is all an introduction to the fact that, for the first time in decades, the role and independence of the Federal Reserve has again become a matter of political concern and debate. We have lived through – are still living through – a financial debacle. That debacle has been a part of – indeed a precipitating factor – in a deep and potentially lengthy economic recession. It has been labeled "the Great Recession", threatening something much worse. That is not an entirely farfetched view. It was only enormously forceful and massive intervention in financial markets by the Federal Reserve and the Treasury that contained the crisis. Each activated long dormant emergency powers, interpreting their existing authority to the very limits. They succeeded in restoring some functioning order to the markets.

While the sense of crisis may have eased, it is true to this day, more than a year after the

About the Author

Paul A. Volcker is currently the Chairman of President Obama's Economic Recovery Advisory Board and continues to be associated with numerous national and international economic organizations. Mr. Volcker has held numerous other public positions, including positions with the Treasury and the Federal Reserve. He was Chairman of the Board of Governors of the Federal Reserve System from 1979 to 1987. Mr. Volcker has chaired a number of commissions for such organizations as the United Nations and the World Bank. This article is an abridged version of Dr. Volcker's speech at the Truman Medal for Economic Policy Award Luncheon on October 23, 2009 in Kansas City, MO.



frantic days of September and October 2008, that the apparent stability of markets is fragile. The flow of credit - incomplete as it is - remains dependent on Federal Reserve support. Then, why is it that a book entitled *End the Fed* by a long serving Congressman, Ron Paul, is on the NY Times bestseller list? I do not want to give credence to Mr. Paul's more extreme views. There are, however, reasonable questions that deserve convincing answers. One of those questions arises from the unprecedented use of the Federal Reserve's dormant emergency power. That authority enacted in the dead of the night in 1930 without legislative history and invoked only in a very limited (and I presume, experimental) way 80 or so years ago. The legislative language - that in "unusual and exigent circumstances" the Federal Reserve could lend against any "acceptable collateral" - has been broadly interpreted to support loans and guarantees of hundreds of billions of dollars to large financial institutions, to justify the purchase of commercial paper in the market, and to support the securitization of mortgages and other loans. All "bailouts", to use the colloquial language, on a massive scale.

Those are interventions that reach far beyond the normal, confined, and presumably competitively neutral purchases and sales of government securities and lending to commercial banks against good collateral, measures that are a normal part of central banking operations. Significant risk of loss is involved, loss ultimately to the taxpayers who ordinarily benefit from Federal Reserve earnings. Beyond the financial risk is the more amorphous but significant circumstance that these market interventions inevitably involve difficult judgments about which individual institutions should be saved and which left to their fate. Beyond the individual institutions, what sectors of its economy are to be aided? Should those answers be determined by some purely economic criteria, determined by an independent agency, or are they inextricably and legitimately of political interest as well?

I have no doubt that Chairman Bernanke and his colleagues are themselves uncon-

fortable about the position in which events have thrust them. At the same time, the response to those questions seems clear. If not the Federal Reserve, then who and how? What other agency has emergency funds immediately available in the amount necessary? Which is prepared by financial experience and by professional expertise to act in days or literally in hours? To whom should the Congress entrust such powers and funds on a stand-by basis? The practicality seems to me to leave those 1930 emergency provisions in place, but with clear procedural safeguards. Politically responsible officials - the President via the Secretary of the Treasury - should be informed and their approval required. That, I feel certain, has been the informal practice, and it is worth clarifying and enforcing that practice, even at what seems to me a negligible risk of limiting the Fed's independence. Perhaps a reasonable time limit should also be placed on the exercise of the emergency authority. In essence, maintaining the Federal Reserve authority should be viewed as a necessary, if unpalatable, means of permitting response to a really dangerous crisis. But given time, it is an Administration and a Congress that should come to an agreement about the use of

public funds.

The second question about the Federal Reserve role in recent events may not be so easily answered. The argument, quite simply, is that however heroic the response to the financial crisis, was the institution sufficiently alert in its regulatory and supervisory role. Should it have better foreseen and mitigated the financial fragility - e.g., the sub-prime mortgage phenomenon? Beyond that, were Federal Reserve monetary policies, at the heart of its responsibilities, appropriately disciplined and alert to the potential damage of financial excesses?

Those are questions that economists and others will long debate. I would be a biased participant in that debate, but permit me a few relevant points. First, if the Federal Reserve supervisory role was less aggressive and less effective than subsequent events suggest would have been desirable and necessary, let's indeed strengthen that function, and ensure it receives the attention it deserves. One element of that approach could be to designate by law one of the Fed Governors - say a vice chairman - as responsible for supervision, nominated and confirmed in that position and accountable directly to

Support Economic Education

We depend on donations from private individuals, foundations and businesses to fund our important mission of economics education for teachers and their students. With your support we can help students make informed decisions in our modern economy.

Name _____
 Organization _____
 Address _____
 City, State, Zip _____
 Email _____
 Phone _____

Enclosed is my tax-deductible contribution to MCEE for \$_____.
 Check made payable to MCEE is enclosed.
 Charge my: VISA MC
 Exp. Date _____
 Card No. _____

MCEE is a not-for-profit, 501 (c)(3) organization

the Congress by regular reports and otherwise. I would also note that the Federal Reserve was only one of several financial regulators. In retrospect, fairly or not, the question of supervisory adequacy reaches far beyond the Federal Reserve. In fact, experience repeatedly illustrates that official regulation and supervision in the best of circumstances is an imperfect means of maintaining stability in free and open financial markets.

All of that emphasizes the importance of thoroughgoing structural reform. Business as usual simply won't do, however attractive that may be for those Wall Street lions who have become accustomed to huge compensation as a kind of god given right.

I do not have the time, and I am sure at this point, that you will not have the patience, for a detailed analysis of needed financial reform. To the extent you have interest in my personal views, I can do no better than refer you to the current quarterly review of the Federal Reserve Bank of Minneapolis in which I speak my piece. Closer to your home, the Kansas City Reserve Bank has long sponsored symposia at Jackson Hole, attracting both central bank officials and their critics from around the world to discuss needed reform among other policy matters. There is, however, one point upon which there is widespread agreement. There is a need for what I think of as a "systemic overseer". The point is some authority, beyond the regulator of particular institutions, that should be responsible for looking over the entire financial markets looking for points of emerging weakness or strain, potential threats (such as the sudden rise of sub-prime mortgages or the proliferation of speculative use of derivatives).

That would be a large responsibility, requiring experience and expertise, a highly professional staff, and a degree of independence. Clearly, there is more than one way of developing the necessary administrative arrangements. But I believe this, too, is an area in which the Federal Reserve would be especially suited. Let me be direct in summarizing

my position. There will be no surprise in my view that a strong and independent central bank is a critical institutional arrangement both for the conduct of monetary policy and for financial supervision. In fact, I believe some responsibility for financial regulation is an important complement to monetary policy, which, when all is said and done, must be conducted through the intermediation of financial institutions and markets. If those markets are broken, or not operating effectively as at present, then the implementation of monetary policy will be crippled as well. We can design on paper, and in law, arrangements that recognize and facilitate those relationships. But more than paper designs and law is necessary. It is more intangible matters that are key.

Does the central bank maintain an independence (independence not only from partisan political pressures but from narrow private influences), a professionalism, a sense of continuity and resourcefulness that commands respect and confidence? If some of that has come into question, or been lost, let's by all means repair the damage and reform the institution.

The other day, I came across some words of Tom Hoenig, here with us today after long years of service in the Kansas City Fed. He emphasized that the Federal Reserve System "was designed to assure broad input to decisions and to provide a mechanism to build national policy consensus across broad regional, economic, and cultural differences. And it was designed [to be] accountable to, and yet independent of, the Government . . . [while] assuring trust in the institution". Trust – a simple word and an essential quality that we, as citizens have too often lost in our governing institutions: in the Congress, in the bureaucracy, sometimes in an Administration.

To my mind, that is a grievous loss – a loss since the days of Harry Truman when, by and large, Government was seen as a constructive part of society, not as a problem. One thing is absolutely certain. It was Government that, at

the end of the day had to ride to the rescue of our broken financial markets. That cannot be a permanent situation. Let's carry out the needed financial reforms and in the process build and reinforce both public and private institutions that can deserve and justify our trust.

MCEE Events

Check out

www.moeconomics.org for a complete listing with detailed descriptions.

Parent Workshops

MCEE, with a grant from the Bank of America Foundation, is currently engaging Missouri Parent Teacher Associations in a discussion about Personal Finance. For more information or to schedule a seminar, please contact MCEE at (816) 235-2654.

Stock Market Game

The Stock Market Game, sponsored by MCEE, is an educational program for grades 4-12 based on a real-life simulation of the stock market. To learn more about the game, visit www.moeconomics.org. Contact MCEE today for information about corporate sponsorship opportunities.

MO Economics Data Corner

Missouri Unemployment Rate
(Seasonally Adjusted)
September 2009 9.5%

Missouri Payroll Employment
September 2009 2,709,900
Change Over Year -80,300

Source: Missouri Economic Research and Information Center

MCEE Board of Trustees

Orlo Shroyer, Chair

*Deputy Commissioner of Education
(Retired)*

Chris Nicaastro, Co-Chair

Missouri Commissioner of Education

David Giuntoli, Vice Chair

Principal, Buck Consultants

Alan Robbins, Treasurer

Northwestern Mutual

Dan Thornton, Secretary

Federal Reserve Bank of St. Louis

Bryan M. Bezold

Ameren Services, St. Louis

George Bukaty

George Bukaty & Co., Inc

Hon. Robin Carnahan

Secretary of State, State of Missouri

Dr. Phyllis Chase

North Kansas City School District

Max Cook

President, Missouri Bankers Association

Mike English, President & CEO

Missouri Council on Economic Education

Bill Gerling

MO Department Elementary and Secondary Education

Craig Hakkio

Federal Reserve Bank of KC

Josie Hernandez

School Administrator (Retired)

Whitney Hicks

Professor Emeritus Economics, MU

Roshara Holub

President, MO Credit Union Association

John Huff

Director, Missouri Department of Insurance, Financial Institutions, and Professional Registrations

Matt Kitzi

MO Securities Commissioner

David Lankford

Missouri Chamber of Commerce

Dr. Joan Mansfield

University of Central Missouri

Hugh McVey

President, Missouri AFL-CIO

Scott Niekamp

Northwestern Mutual

Sam Overfelt

Attorney (Retired)

Dr. Deborah Orr

Warrensburg School District

Gerhard Petzall

Guilfoil Petzall & Shoemaker, L.L.C.

Paul Rainsburger

Labor Education Program, University of Missouri – Columbia

Gary Sage

Metropolitan Community College

Mark Towster

Cookie Factory Bakery Owner/Operator

Dr. Richard Wallace

Chancellor Emeritus, University of Missouri

Clint Zweifel

Treasurer, State of Missouri

MCEE Staff

Mike English

President & CEO

Mark Gravenstein

Program Director

Janine Hogan

Executive Assistant

Views expressed in MO Economic Insights are those of the author, and do not necessarily represent the views of the Missouri Council on Economic Education and its affiliates.

MO Economic Insights

Missouri Council on Economic education

5100 Rockhill Road

104H Manheim Hall

Kanas City MO 64110

Phone: 816-235-2654

E-mail: englishmi@umkc.edu

www.moeconomics.org