Remarks by

E. Gerald Corrigan

Managing Director

Goldman, Sachs & Co.

at

Federal Reserve Bank of Atlanta Conference

"A Return to Jekyll Island:

The Origins, History, and Future of the Federal Reserve"

November 6, 2010

Allow me to begin by congratulating Dennis Lockhart and his team at the Atlanta Fed for organizing this Conference. One hundred year anniversaries are always noteworthy in both symbol and substance. In this particular case, pausing to reflect on the origins of the Federal Reserve seems to me to be especially timely given the economic and financial events of the past several years.

In reflecting on the history of the Fed and central banking more generally, I suspect that many in this room have read the book “Lords of Finance” written by Liaquat Ahamed. I find this narrative of the history of central banking in the years leading to the depression to be utterly fascinating. This is particularly so in the riveting description of events associated with the 1929 stock market crash.

The book recounts in some detail the fact that George Harrison, Benjamin Strong’s successor at the New York Fed, took it largely upon himself to cushion the fall in the stock market by injecting liquidity into the system and rejecting calls from some to close the stock market. In other words, Harrison executed a 1929 version of quantitative easing which – for a short period of time – had a measure of success in calming the markets.

As the macro-economic picture darkened, the Fed significantly eased monetary policy during the first half of 1930 – again largely driven by Harrison. However, in that time-frame, differing views within the Fed about policy and the authority of the New York Fed began to escalate. In late 1930, President Hoover appointed Eugene Meyer as Chairman of the Fed. Meyer and Harrison had similar views as to the need for an aggressive easing of monetary policy. However, the internal debate about policy and decision making authority continued. Reflecting this debate, the Fed’s policy making apparatus was re-organized but as Ahamed tells the story, efforts by Meyer and Harrison to achieve a more aggressive easing of policy were largely frustrated by internal differences of opinion at the Fed. The rest, as it is said, is history.

The contrast between the response of the Fed to the recent crisis and the experience of the 1930's could not be more striking. Indeed, while it is common to hear the refrain that the experience of the last few years was the worst since the depression, I have no doubt that were it not for the actions of the Fed (in cooperation with the Treasury) the experience of the recent past would have been worse than the 1930's rather than the worst since the 1930's.

While the "Lords of Finance" provides, therefore, a valuable lesson in financial and economic history, I have one major objection to the book and that objection centers on the sub-title that appears on its cover. That sub-title reads "The Bankers Who Broke the World." As I see it, the sub-title should have been an acknowledgment that monetary policy alone is not, nor can it ever be, a panacea for all economic and financial ills. That reality must remain fresh in the minds of all policy makers at all times but especially in the current setting.

With that observation in mind, allow me to turn my attention to a few personal reflections on the Fed over the past 40 plus years, since I was first employed by the New York Fed in 1967. For starters, even with all the advances in transparency and visibility, there remains an aura of mystique about the Fed. Certainly, for example, if one were to draw an organizational chart of the Fed on the black board at the Harvard Business School, the response of the students would be that the organization could not possibly function – much less function well. Yet, while the Fed, like all institutions, is not perfect, it functions very well indeed.

Fed Chairmen, Governors, Reserve Bank Presidents and staff members come and go but somehow the essential fabric and culture of the institution remains largely in tact. At the risk of considerable oversimplification, I believe that the institutional culture of the Fed remains a constant for two fundamental reasons: First, I believe that even the most junior employees of the Fed understand that the institution's basic mission is public policy and serving the public interest. People like to believe that what they do for a living matters and even the clerks and the security guards at the Fed somehow know that they are a part of an institution that matters. Obviously, that sense of pride and purpose is magnified several times over for those who occupy policy related positions; Second, the collegiality at the Fed – including within the FOMC – is quite extraordinary. That collegiality is rooted in a genuine respect for each other including a respect for and a tolerance of differing opinions and judgments in a context in which decision making at the Fed is almost never simple and straight forward. These cultural traits of the Fed are at the very core of its success and help to preserve the autonomy and independence of monetary policy. I might add in passing that over the years I have had the good fortune to work with dozens of central banks throughout the world. Based on that experience, it is my observation that many central banks share these same cultural traits. Perhaps that is why cross border cooperation among the international community of central bankers comes almost naturally.

Turning from the philosophical to the pragmatic, the history of the Fed over the past four decades has not been without its high points and a few low points. The lowest of the low points almost certainly can be traced to the fact that the Fed was at least partially responsible for the chronic and highly debilitating inflation of the seventies.

The high points in Fed policy over this period start with Chairman Volcker's leadership and courage in reversing the inflation of the seventies. One had to be there to appreciate the drama of that day-long Saturday meeting of the FOMC in October, 1979. That initiative paved the way for almost three decades of virtual price stability in the U.S. Having said that, it should be remembered that maintaining a non-inflationary environment requires constant vigilance. We should never forget, for example, that in the late 1980s price pressures escalated to the very edge of the danger zone of a self-reinforcing return of inflation. Needless to say, the other high point in Fed policy was its response to the recent financial crisis.

Not surprisingly, over the last 40 plus years, there were periodic challenges to the Fed's autonomy and independence that tended to be highly correlated with the interest rate and the business cycle. Few of us realized at the time, but Congressman Patman probably did the Fed a favor in that his focus on what came to be called "discretionary" expenditures played a helpful role in shaping the cost-effectiveness and operational efficiency of the Fed.

The one challenge to the Fed's autonomy that I recall most vividly was a lawsuit filed by Senator Melcher of Montana that argued that the appointment process for Reserve Bank Presidents was depriving him, as a Senator, of his constitutional duty to confirm the Presidential appointment of officers of the U.S. Government. The argument got my attention because it seemed to me – knowing nothing about constitutional law – to have an appealing ring of common sense. It also got my attention because part of the argument that was used <u>against</u> the Melcher suit was that senate confirmation of Reserve Bank Presidents was not needed because they were said to be "inferior" governmental officers. The case went to the Supreme Court and the Court chose not to hear the case. Needless to say, I was pleased with the outcome but not crazy about my inferiority.

Given the role and responsibilities of the Fed, future challenges to its autonomy are inevitable. That is why standards of the professional integrity and the rigor, objectivity, and transparency of the policy process are essential to the Fed's autonomy.

As is well known to this audience, the Fed has a statutory mandate to foster maximum employment and price stability. If fulfilling that mandate was not difficult enough, the Fed also has an implicit mandate (made more explicit by the Dodd-Frank legislation) to foster financial stability – a goal that has proven to be very elusive. For example, the last 30 years have witnessed an alarming incidence of financial disturbances having at least some degree of contagion or systemic risk characteristics. By my count, there have been eight[1] such events since 1980 culminating with the crisis of 2007-2009.

While I believe that the financial reform efforts that are underway in the United States and elsewhere are on the right track to reduce the probability of such events and to better contain their damage when they occur, such an outcome is not certain. Further reducing the probability of these events will entail a broad based effort across the public and private sectors. The Fed – by virtue of its experience and its people – is uniquely positioned to make a major contribution to this effort. The many building blocks for greater financial stability will take time to put in place but the greatest challenge to the financial reform effort may lie in our ability to better anticipate sources of contagion and systemic risk. That is the area in which I believe the Fed is especially well equipped to distinguish itself in our quest for greater financial stability. I say that because of the Fed's cadre of well-trained economists, bank supervisors, and financial market experts and because the Fed is the only public authority that operates daily in the financial markets.

Here too, looking to the past can be helpful in better anticipating the future. For example, while each of the financial disturbances of the past thirty years had their own unique features, there are certain common denominators which are present in most, if not virtually all, episodes. Maturity mismatches, concentrations, excessive leverage including "embedded" leverage, inadequate capital and liquidity cushions and the illusion of ever present market liquidity are cases in point. However, a strong case can be made that the single most important of these common denominators may be shortcomings in the credit origination process whether in the form of (1) sovereign lending; (2) leveraged finance; or (3) commercial and residential real estate lending. Stated differently, by far, the largest source of write downs and losses experienced in the recent crisis – and most other financial disturbances – can be traced to credit problems.

[1] *The Latin America debt crisis, the S&L crisis, the 1987 stock market crash, the late 80s, early 90s banking crisis, the 1994-95 Mexican crisis, the Asian dept crisis of 1997-98, the Long Term Capital episode, and last but not least, the 2007-08 crisis.*

Solving this problem will not be easy especially since excesses in lending – sometimes magnified by securitization – have played a role in financing asset price bubbles. Elements of the financial reform process that are on the table – including prompt corrective supervisory actions – will help. However, it may be that the authorities – including central banks – should reconsider their largely passive posture with regard to emerging asset price bubbles.

I do not make this suggestion lightly since recognizing the relatively few asset price bubbles that can cause systemic damage is not easy. Moreover, the consequences of errors in judgment in this regard can be very serious. Nevertheless, there are instances, certainly including the real estate and stock price bubble in Japan in the eighties and the recent housing bubble in the United States, in which the “red flags” of serious imbalances became quite clear in part because the build-up of the bubbles extended over a period of years. Therefore, I believe that there is something to be said for a carefully crafted approach to the introduction of contra-cyclical elements of supervisory policy -- such as capital adequacy standards -- along the lines that are being examined by the Basel Committee and other supervisory bodies. In exceptional circumstances, a case may also be made that a modest tilt in monetary policy might be justified by evidence of potential systemic risk factors growing out of asset price inflation.

Allow me to conclude with a few observations about the Fed’s dual responsibilities for maximizing employment and sustaining price stability in the current setting. For starters, I believe that the policy dilemmas faced by the Fed today are more acute than at any point in the 40 plus years that I have been a participant in, or a close observer of, the monetary policy process. Taken together subpar and still fragile economic growth, alarmingly high unemployment and under employment, huge budget deficits, a weak dollar and persistent global imbalances are about as difficult an environment for sorting out monetary policy options that can be imagined.

In these circumstances I want to make four broad observations that, I am sure, are well understood by Chairman Bernanke and the FOMC but may get lost in the scramble in the marketplace and in the media for instant analysis and sound-bites.

The first among these broad observations is to repeat a comment made earlier in these remarks; namely, monetary policy is not a panacea for all of our economic and financial ills. Second, one of the insights I have learned over the years is that the underlying resiliency of the U.S. economy should not be underestimated. Third, when the risk of a policy miscalculation is high in either direction, the prudent course of action should be to proceed slowly. Finally, sooner or later – and hopefully it is sooner because the economy is performing much better – the Fed will have to return to a more "normal" monetary policy. Even with a wider range of policy tools – as for example the payment interest on reserves – this transition will be challenging, to put it mildly.

While I have a very high degree of confidence in the Fed's ability to navigate through these uncharted waters, I must confess to a sense of unease about one particular aspect of today's policy setting. Specifically, even in the face of substantial margins of under utilization of human and capital resources, efforts to achieve an upward nudge in today's very low inflation rate make me somewhat uncomfortable. Inflation is, by its nature, a cumulative and self-reinforcing process. Thus, there is a risk – however small – that once that nudge takes hold, it may not be easy to cap inflation and inflationary expectations at levels that are still broadly compatible with price stability.

As I think many of you know, I am rather good at thinking about low probability contingencies. That tendency on my part in no way detracts from my admiration and respect for the Fed and its tradition of great leaders past and present. Ultimately, it is that leadership, and the culture of the

Fed that I mentioned earlier that will help us find the way to an era of greater stability and prosperity not unlike what followed the dark days of the early 1980's.

xxxxx