AN OUNCE OF PREVENTION IS WORTH A POUND OF CURE

Opening Remarks
Policy Workshop on the Future Role of Central Banking: The Urgent and Precedent-Setting Next Steps

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Old sayings often contain wisdom. I like the one that says, "An ounce of prevention is worth a pound of cure." Actually, I think it should be quite a few pounds of cure.

Prevention can take many forms. No doubt, the most important, from the standpoint of the topic of this conference, is learning how to prevent the need for crisis-driven intervention in financial markets by the government. That is partly an issue involving financial institutions and the way they work, partly one addressing the markets themselves, and partly developing procedures and guidelines for the appropriate actions of government policy makers in the future. I look forward to learning more about these issues today, starting in the first session on the crisis in credit markets and then on to interventions in particular financial institutions -- Freddie, Fannie, and Bear Stearns – and finally in the session on the lessons learned for the next steps and future reforms. I thank you all for coming, To get us started I'll say a little about all these issues, staring with how I see the reasons for the current turmoil and my initial reflections on the implications of what has been done.

The effort to identify the sources of the problem can easily lead us into staggering complexity, but there is also a simplicity to it.

People and institutions behave more responsibly when they have some of their own equity at stake. This situation emerged in such a way that this principle became virtually **inoperative**. In an effort to make housing more affordable, financial wizards with the implicit backing of the federal government, figured out how to give away houses: no down payments and easy terms. When you give something away, demand rises rapidly and so do prices, so rapidly rising prices made the easy terms look reasonable and seemed to validate them.

Meanwhile, financial intermediaries packaged these mortgages and traded in them, in all too many cases with very high (30-or-so to 1) leverage.

All this separated the originator of the mortgage (that is, the risk) from the eventual holder and, at the same time, created financial instruments that were obscure. So people had little equity in the game but made lots of money even while not knowing exactly what they were doing. What a party! As Charles Prince, then head of Citicorp, said, "As long as the music is playing, you have to keep dancing."

In the meantime, I am driven to say that a massive regulatory failure occurred. Apparently, the regulators couldn't understand these instruments either, but they didn't insist. I'm reminded of the great pitcher, Walter "Big Train" Johnson, who, when the hitters were asked why they struck out so much, said, "You can't hit what you can't see." But the regulator is not in the position of the hitter. The regulator can say, "I want you to show me all your pitches and tell me what you're going to throw before you throw it."

All of this took place in a prolonged period of exceptionally easy money.

The federal government has acted massively and in many cases in an unprecedented fashion to deal with the financial crisis that has ensued. They have the human problems and social costs of foreclosures, the threat that turmoil in the field of finance will spill over into the rest of the economy, and the lack of confidence in the wisdom and integrity of many people entrusted with the management of huge sums of money.

Everyone talks about moral hazard, and properly so. I don't want to second guess what the authorities have done. If I had been there, I may well have done the same things. The pressures are immense and the stakes are very high. Nevertheless, we now confront the necessity of damping down sharply the expectation that the answer to every problem is government intervention.

What to do? How to conduct ourselves so that financial institutions operate with a lot of capital at stake and are accountable for their actions? If they fail, they fail. And how to create financial markets that have the resilience to withstand shocks, as has been true on many occasions in the past?

Perhaps the wheels are starting to turn. The Fed's stiffening of rules about the conditions of mortgage lending seems to be on the way. More equity will be required. The Federal Reserve needs to reexamine Chairman William McChesney Martin's famous injunction that the job of the Federal Reserve is "to take away the punch just as the party gets going." The problem is that the punch bowl has been spiked so that you can't just simply take it away. First, you have to remove some of the spikes before you remove it. At any rate, the job is more complicated because of unprecedented steps that have been taken.

Here are a couple of examples from my own experience:
When I came into office as labor secretary in 1969, a major strike of longshoremen all along the East and Gulf coasts had been the center of

attention for months. President Johnson had intervened, invoking the Taft-Hartley law, which allowed him to seek and get an injunction to stop the strike for eighty days. He did this after finding and declaring the strike a "national emergency." The unions contested this finding, and the issue went on a fast track to the Supreme Court, which upheld the president. By the time I took office in January 1969, the Taft-Hartley time period had run out, and the strike had started again. All of the statutory measures available to deal with it had been used. So when I arrived, I had a stubborn strike on my hands that had been authoritatively declared a national emergency.

I went to President Nixon, then preoccupied with the Vietnam War. "I have a strategy for how to handle this strike," I told him. "Let the pressures produced by the strike cause the union and management to settle it themselves through the collective bargaining process. We should announce that we will *not* intervene." By saying that, I was also saying, in effect, that the former president of the United States and the Supreme Court were wrong in their finding that the strike was a national emergency. I argued to Nixon that the economy was resilient and that while disruptions could be expected, buyers and sellers had all sorts of ways of finding substitutes for scarce goods: "There will be no dire emergency, and in the end the pressures will work to bring about a private settlement."

If we avoided direct intervention here, we would deliver a forceful message signaling the administration's commitment to the free collective bargaining system. We would also teach labor and management an important lesson about allowing private economic processes to work. The president supported me in this strategy. He successfully withstood tremendous pressure on the White House to intervene.

Meanwhile, pressure continued on labor and management. Finally, lo and behold, after about six weeks, labor and management got together and settled the strike. The longshoremen went back to work. The result was much as I had predicted: the collective bargaining process was reinvigorated. By allowing the pressures inherent in the market to have their effect, people were forced to find their own solution. This approach was a sharp contrast to that taken in the Kennedy-Johnson period, when high-level intervention and "jawboning" in major disputes were routine. The result then had been a predictable flow of cases right into the White House. As I said to Nixon: "If the president hangs out his shingle, he'll get all the business."

I had a somewhat parallel experience not long after becoming director of the Office of Management and Budget in 1970. I learned that the Penn Central had badly mismanaged its affairs and was on the verge of bankruptcy. My friend and esteemed colleague, Arthur Burns, as chairman of the Fed, was deeply concerned about the potential impact on financial markets and had somehow arranged through a reluctant David Packard a large bailout, courtesy of the Pentagon. I found myself arguing in front of the president against this action on the grounds that it would set a terrible precedent and that financial markets were basically strong (who was I, a simply labor economist, to argue with Arthur Burns about financial markets?) At a critical moment, in walked Bryce Harlowe, the most savvy congressional and political adviser ever. He said, “Mr. President, in its infinite wisdom, the Penn Central has just hired your old law firm to represent it in this matter. Under these circumstances, you can’t touch this with a ten-foot pole.” So Penn Central went bankrupt. No dominoes fell. The financial system was strengthened by the realization that mismanaged institutions were on their own.

We have all observed a similar experience with uneasy and sometimes tumultuous international financial markets. The bailouts starting in Mexico, going through many countries in Asia, and for a while in Russia. But the bailout for Russia was suddenly switched off in 1998 surprising many in the markets. I had long since been out of office, but an irate chief executive of a leading bank berated me: “When **you** bailed out your neighbor Mexico and all these other countries, I was entitled to think that you would bail out Russia, with all its nuclear arms."

The Russia episode gave the system a jolt, but the system was still unstable. How to fix it to bring the problem under control and to put the idea of bailouts into the background? Along came the idea, advanced by John Taylor, then Under Secretary of the Treasury, for a new type of sovereign bond—one with "collective action clauses"—for emerging market countries. With these new bonds the countries and the international financial system would be less susceptible to default, thereby reducing the need for bailouts by the IMF. People said countries would not sign up, but they did. The effect has been calming. That is an ounce of prevention that is worth tons of cure. That's the kind of action we need to look for **now**