



## A Conversation with **PAUL VOLCKER** Former Chairman, U.S. Federal Reserve System

**W**hen the Forum gathered for its Aspen Symposium in early October 2007, the extent of the sub-prime loan debacle and resultant credit crisis was unclear—as were whether the U.S. economy would enter a recession or whether inflationary pressures would increase. In this wide-ranging interview, the Hon. Paul Volcker, former chairman of the U.S. Federal Reserve System, noted that the structures created by financial engineers during the last two decades are wrought with uncertainties regarding their regulation and supervision, and had not yet been tested. He opined then that the credit crunch could possibly be weathered successfully if the U.S. and the world economy continued to grow, but expressed deep concern about the financial system should the U.S. economy go into recession. Volcker, interviewed by Robert Klitgaard, president of Claremont Graduate University, also discussed the rise of Asia, academic relationships between the East and West, and the need for more attention on the part of academia to public administration, among other topics.

KLITGAARD: You recently traveled to Asia, where you go quite often. One of the many meetings you had there was with Kishore Mahbubani, dean of the School of Public Policy at the National University of Singapore. About five years ago he wrote a book called *Can Asians Think?* It's a remarkable title. And his answer was yes, but there are issues with the way Asians think about things. He's got a new book now with maybe a more positive vision of Asia.

VOLCKER: Or a more negative vision of the West.

KLITGAARD: Yes. The book is called *The New Asian Hemisphere: The Irresistible Shift of Power to the East*.

VOLCKER: I wrote a blurb for that earlier book, which I thought was very interesting. But this book has a very hard edge to it and focuses a lot on how Americans think wrongly. How the West thinks wrongly. It's about how the 21st century is going to be an Asian century, which in itself I don't think is such a startling concept. There are two or three billion people over there and they're going to



have some impact. If you project ahead 50 years or so, I think that's probably quite a reasonable vision. But what surprised me was the hard edge on this analysis, the unhappiness with what is seen as domination by the West, and particularly by the United States. While that may have been fine and suitable 50 years ago, the book is an attack on our reluctance to change and realize that it's no longer a post-World War II world, it's quite a different world where Asia—particularly China and India—are growing.

What struck me while I was there and then while reading this book on the long airplane trip, [is that] Mahbubani quotes a lot of intellectuals and political analysts who are expressing irritation at the United States, irritation at the dominance of the West, and attacking the idea that everybody's got to have a democracy along the lines of America. He describes the tensions and uneasiness that this gives rise to, as does the failure to recognize the values of Islam as well as some of the traditional values in China and India and so forth. That was all in that book, filled with footnotes and quotations from Asian intellectuals.

Yet while I was in Asia I talked to people from universities in Beijing and in Singapore, but actually the reason I was there was to go to economic conferences, where you get into talking to bankers. I noticed very little of that kind of hard edge in the economic relationships and the academic relationships between the East and West. I just didn't sense it at all. I sensed a great longing still there, in particular among the academic institutions, for connections with American academic institutions, and a feeling that they want to widen and deepen those relationships. And I know from the standpoint of some American universities, anyway, they say, "enough already." We can't handle too many of these relationships and we can't meet the demands that come our way from China, India, and, in this case, Singapore as well.

But you project this ahead, and while now they, in a sense, are the supplicants and they're looking for help, particularly from the United States but from the West generally, given the rapidity of growth there and the spread of education, you just wonder how long that particular balance is going to last. And it's in our interest, I think, to have more and more of our people getting connected with Asia. But how you do that is not so easy.

As for productivity, I'll share a few little factoids. We think of China as overwhelming us with manufacturing, which they are, in a way, but manufacturing employment in China has not gone up significantly in the last seven or eight years. Manufacturing employment has gone down in their state-owned enterprises very sharply, and it's gone up in foreign-owned manufacturing and comes out practically even. But while employment is not very much changed, the rate of productivity growth in manufacturing has ranged between 20% and 25%

a year. Those increases are out of sight with anything that we know currently in the West. Now, obviously they started from a very low level, but as of now that momentum is continuing and they are a force in the international economy, as you know. And it's just unstoppable in the short run.

KLITGAARD: Should presidents at universities in America be concerned about the rise of international universities? We've heard a lot here at the Forum about the threat of the loss of U.S. leadership in various technical or scientific fields. Do you think that's something we should be worried about, or should we be celebrating the fact that other universities around the world are coming up to high standards?

VOLCKER: Well, whether we celebrate it or not, it's going to happen. What does disturb me is something that is much commented on. I occasionally sit on graduation platforms of American universities these days, and when the Ph.D. students come up to get their diplomas in mathematics or physics or engineering, you're hard pressed to find a name that looks American. There are very large proportions of Asians—Chinese, Indians, others—but also Eastern Europeans and occasionally some Islamic, and the Americans are hard to find. I think I know part of the explanation for this. Young Americans are not much interested in laboring through a science Ph.D. when they can go to Wall Street and make money that no science Ph.D. would ordinarily think is within the range of expectations. And it's just a very powerful pull. I'm sure there are other factors as well, but I worry a little bit about this enormous emphasis, about some of our smartest young people going into finance. And I get a little cynical about it.

KLITGAARD: Isn't it good to have more and more of these financial engineers helping us figure out how to run the economy?

VOLCKER: Well, I'll tell you my little story about financial engineering. And I'm beyond all this stuff. I figured I didn't have to understand it after I retired from the Federal Reserve. There's been an enormous change and all this slicing and dicing and SIVs and conduits and CDOs and so on. I think I understand it without understanding all the details. Anyway, just three or four years ago I was at a conference in Italy. It happened to be mostly Italian business executives. And they were having various presentations and some young guy from London got up there and said he's with some London investment house and explained to them the joys of financial engineering. And he summarized it by saying if you people running companies don't understand financial engineering, you're going to be losers. And you better get on board, and your companies better learn about financial engineering.

Well I found myself sitting next to Bill Sharpe, a Nobel Prize winner for helping to invent financial engineering. So

I nudged him and asked, "What's this all about? What does it do for the GNP or productivity?" He whispered back to me, "Nothing." Which is not the answer that I expected. I said, "What does it do?" He said, "Well you know, it changes around all the rents in the financial system and besides, it's a lot of intellectual fun."

Now I don't know about the intellectual fun, but I'm not sure that financial engineering has produced much in the rate of growth or productivity in the real world. We would have just as much employment without it. But that's what we're spending all our time on. It sure has created some enormous wealth for relatively few people, including for some universities I guess.

KLITGAARD: Many American universities have programs in public policy or public administration. Does that give you any hope?

VOLCKER: No. See, part of the problem is you say public administration or public policy. The term *public administration* is out of fashion. I don't fully understand why, but it is. We all complain about the government and how it's not running very well and how poorly administered it is. But the idea of encouraging better administration, including in universities, has no support. Even the word "administration" is not in fashion. It is an area that tends to be neglected in universities. And I think it's unfortunate.

Harvard, for example, has worked hard to invigorate its Kennedy School of Government with a lot of spirit and energy and a commitment to administration and management as the core function of the school. But in my observation, even there it has drifted away. They've raised a lot of money and have I don't know how many centers for security, for politics, and so on. The central administrative core is still there, but it's not as strong as it should be, in my opinion. Because it's tough. Nobody quite knows how to teach this, but it needs more effort, in my view, and more attention than it's getting. I think there is this great disconnect between the complaints we have about government and the efforts made to improve government administration. I'm not just talking about the federal government, but the state and local government where sometimes we do a little better. There's a disconnect between that need and the level of interest on the part of universities in addressing it, in my view.

*At this point, the floor was opened to questions for Mr. Volcker.*

Q: What are the one or two long-term worries that you

have about the future of the U.S. economy in the coming generation, especially in a world of intense globalization? Your personal worries.

VOLCKER: Well, I have a personal worry that's not unique to the American economy, but it certainly is relevant to the American economy, and it's a quintessentially difficult area for a democracy to deal with, and that is global warming. And there seems to be a huge amount of evidence that says yes, this is related to human activity and it's going to escalate and it's likely to do a lot of damage with an enormous amount of economic cost if something isn't done about it.

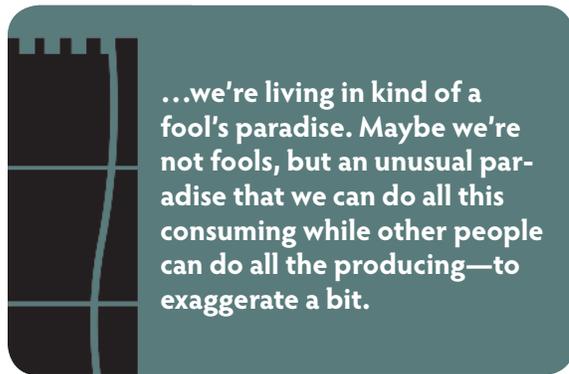
John Adams said we have to fight a war so that our children become engineers so that their children can become artists. I worry, as I suggested earlier, that we aren't producing enough engineers. They may not be able to support the artists,

but in a global context, the rest of the world may get ahead of us on this. And we're living in kind of a fool's paradise. Maybe we're not fools, but an unusual paradise that we can do all this consuming while other people can do all the producing—to exaggerate a bit. But we Americans are consuming 6% or 7% more than we are producing. It's gone on for quite a while and it's been

convenient for us and it's been convenient for China and others that like to do the producing at the moment. But somehow this equilibrium is going to have to be corrected. And I think that's going to produce some big challenges for the economy—including inflationary pressures that we have been remarkably free of for some years. While China has been producing all these low-cost commodities for us, we've been able to sail along with high levels of employment and consumption, but not much investment—without some of the repercussions that we would normally have.

Q: You didn't mention the increasing inequality of incomes within America. Some of us are doing just great and others are just struggling more than ever. Is that, in your eyes, a deep-seated concern?

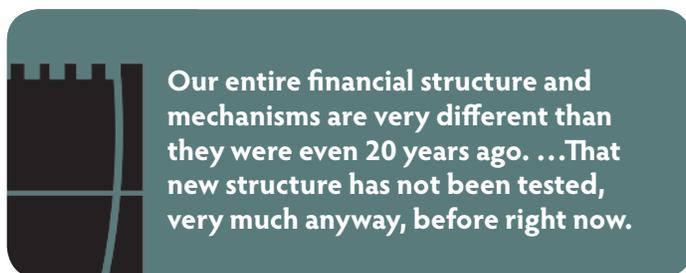
VOLCKER: I have often wondered why there is not more reaction to the extreme end of the compensation level. It just seems unimaginable to me. But there doesn't seem to be much of a political backlash, I guess because, in general, employment has been high and the economy's been growing, but the broadest part of the economy has been gaining little or nothing during this period, and I don't think that can last. It just seems to me socially fragile. The financial engineering we talked about



produces these inequalities, and it is a serious problem to figure out how to get back to some kind of reasonable alignment.

Our entire financial structure and mechanisms are very different than they were even 20 years ago. The structure has rewarded some people enormously and it's gotten a lot more complex, a lot more diffused in some ways. That new structure has not been tested, very much anyway, before right now.

The real test will be if the U.S. economy goes into a recession. The credit crunch has happened at a time of high prosperity with a growing world economy and a growing American economy. And it's one thing absorbing this kind of shock when everything is doing very well, but suppose that shock was compounded by a lot of bad loans or uncertainties arising from what we used to think of as a normal business cycle. It's clear that there are a lot of uncertainties about how to regulate and supervise this new financial system, which have become apparent in recent months.



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Q: For a long time socialism presented a critique of capitalism. But in the last few decades there has been no critical theology, and we've grown into a kind of corporate capitalism. Do you see a critique of this kind of arrangement on the horizon anywhere, or do you think it's sort of the end of history in that sense?

VOLCKER: I don't see that particular challenge arising in a way that the word "socialism" brings to mind. You've got the Chavez phenomenon in Latin America. I doubt that is all that deep seated but it's an interesting phenomenon. But if you look at Asia, the great sweep seems to be in the opposite direction. So I don't think I see that threat, even given all the inequalities and so forth. It'd take a lot bigger crisis than

anything I see on the horizon.

Q: We've heard a lot here at the Forum about globalization and the role of the United States in our world society and the world economy. Are you concerned about the juxtaposition right now of America's record corporate profits and record stock market with its record federal deficits and trade deficits, and the dramatic plunge of the dollar? In 1985 the British pound and the U.S. dollar were almost at parity, and now we're trading half the value of the British pound, and we have parity between the U.S. dollar and the Canadian dollar. There just seems to be a very strange situation going on relative to the American position.

VOLCKER: I agree with you. Judging from normal economic textbooks and analyses, it's been a strange situation to have this long period of very large deficits relative to the GNP, large even for a poor country and so far as I know unprecedented for such a rich country, to proceed so long to be so easily financed without—and partly because of it—without much inflationary pressure. We're not going to stop the globalization. We're dependent upon it, and so are the exporters dependent upon it. But the imbalances can't last, and I think we may be beginning to see the beginnings of the end. And then a natural result is pressure on the dollar. One of the questions will be whether that adjustment can be achieved without upsetting the apple cart, so to speak, without creating pressures on interest rates and pressures on inflation that, indeed, will create a difficult situation domestically so far as the economy is concerned. So far, I think we've gotten by with it, but we are entering a ticklish phase, I suspect, and if you put on top of that concerns about potential uncertainties in the financial system, you've got a lot to worry about. And since I'm a professional worrier, I worry.

Paul Volcker was chairman of the Board of Governors of the Federal Reserve System from 1979 to 1987, and is Professor Emeritus of International Economic Policy at Princeton University. He worked in the federal government for nearly 30 years, serving in office under five presidents. He is currently director of, or consultant to, a number of corporations and nonprofit organizations. Volcker is a founding member of the Trilateral Commission and has been awarded numerous honorary degrees.