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The Subprime Crisis and its International Consequences
What happened and How to avoid Similar Crisis?

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**KEYNOTE ADDRESS**

**PAUL VOLCKER**

**Introduction:**

**Daniel Benjamin**
*Director of the Center on the United States and Europe and Senior Fellow in Foreign Policy*
*Brookings Institution*

DANIEL BENJAMIN: Welcome back. I am sure you have all had enough of me, so I'll be very brief. Introducing Paul Volcker is one of those tasks that can only diminish the person who undertakes it because his accomplishments are so outsized and not only his accomplishments. We spoke before about political leadership or technocratic leadership, bureaucratic leadership, the leadership of civil servants, and I think it is safe to say that however pleased and impressed we may be by what the Fed has done in the last month, it doesn't begin to compare to what Paul Volcker did in the period beginning in 1979 when he began his term as Chairman of the Federal Reserve and really quite heroically ended a decades long period in which inflation had come to plague the US economy. It was a uniquely unpopular course he took. I had forgotten if I ever knew that long before José Bové, the tractors were rolling down C Street in Washington to show their displeasure for Mr. Volcker and his course of action.

Luckily, however, Mr. Volcker was not deterred and we have all benefited enormously from it because the period of prosperity that began in the mid-1980's would have been impossible to imagine without the defeat of inflation. Paul Volcker's public role did not end then, and he has been one of the truly indispensable figures on both the American and the global stage. He served a critical role in the effort to identify Holocaust assets in the 1990's and as the head of the investigation into the Iraqi oil-for-food program more recently. He's really become one of the preeminent public men of his time. Well, there's a time for courage and a time for insight, and I can't think of anyone else who is better positioned by dint of experience and his own record to provide both. Ladies and gentlemen, please welcome Paul Volcker.

## Keynote Address:

**Paul Volcker**

*Former Chairman of the Board of Governors of the U.S. Federal Reserve System*

PAUL VOLCKER: Thank you very much for that overly generous introduction, but let me tell you I was struck by Sam Pisar's comment this morning that I may have been the mentor of Jean-Claude Trichet. If I were in fact a mentor of Jean-Claude Trichet, it would have been the proudest period of my professional career. I mean he has done a terrific job. I think everyone in Europe has benefited by the presence of this Frenchman, his steadiness, his courage. But it's not just in Europe I think he has led the central banking world at a time of considerable crisis and turmoil.

Well, what to say? We've been listening here to a lot of informed comment. What can I say? But yes, I want to acknowledge that we are in a great deal of financial turmoil. I think you can take that as a given. But am I going to say about it? I might say a word about the press. I think this crisis has been covered by the press - it's very complicated - about as well as anybody could cover it cumulatively over time. I think there is a good deal of understanding of what it's all about. You had a very informed discussion this morning. I will talk for as short as time as possible so we have some time for questions and maybe some answers. There isn't much left for me to say except to get out of the way, but I think there are a couple of general points that I would like to make.

One is and my first point is the undeniable and essence of simplicity. As I count them, we have had five major financial crises of systemic importance since 1982. Five crises in twenty-five years, dividing five intro twenty-five says we have one every five years which seems to me a bit excessive particularly when they cumulate into the mother of all crises that we have at present. The subprime mortgage crisis or what started as the subprime mortgage crisis has certainly tested a new financial system, and it is a new financial system. What kind of mark does it get? Certainly not an A not a B, a C-minus seems to me overly generous, maybe a D. I don't think we can say E because E's are politically incorrect in the United States anymore; we don't give anybody an E. But maybe we how ought to look at what every personnel arrangement asks for - the annual review of their employees.

Has performance been exceptional? Not a chance. Not recently anyways.
Does it meet reasonable expectations? I don't think so.
Does it need improvement? I think without a doubt.
Is it totally unsatisfactory? Maybe in between needs improvement and totally unsatisfactory.

It's clear we can't sit back and say there are not substantial and systemic difficulties. So what should we focus on? Let me just make two general points. The first point is internal to the financial system itself. We talk about intermediation and a lot of the talk in the past decade of more has been about disintermediation. By disintermediation, people have meant get it out of the banking system, get it out of the insurance companies, and get it out of the pension funds. Well, I think they've lost sight that the essence of any financial system, however you do it, is intermediation. What do you have in the financial world? You have a group of people, the savers and the investors, who in large part are interested in the most liquid and safest kind of place to put their money. On the other side, you have the people are borrowing: the business men, the homeowners, foreign developing companies, etc. They are interested in the longest term money they can get with the most assurance and what inevitably presents the most market and credit risk.

Somehow those two groups have to get together. Historically in the United States and still pretty largely on the continent of Europe, it was done by the banking system. The process is necessarily risky, and we have had quite a few banking crises back in the days when commercial banks were dominant. They were highly regulated for that reason. They had a special support system, a lender of last resort, deposit insurance in many places, a kind of reasonable expectation that they would be regulated and supervised but in time of trouble they would be assisted. Now in this new system, you have a large part of the intermediation taking place in the open market. People were still borrowing and people were still providing money. The borrowing came to be engineered to use the popular word in a variety of ways and we were told that if you engineered it correctly, if you sliced up the risk and sliced up the maturity and diced the various instruments and put them together, you could give them to people able to bear the risk and satisfy their desires for liquidity.

It was quite a nice vision. It was the land of financial ingenuity. It was extremely complex. I think at this stage we can ponder the implications of so many extremely bright young men, including my eldest grandson, confident in mathematics going into the bright new world of financial engineering and devising individually credit instruments in the hope of making great money. But I think we found out that after the investment of many zillions of dollars and zillions of dollars of rewards to those people who have done it successfully, that collectively it didn't work so well.

I was reminded the other day when I was at a quite different kind of meeting, worrying not about the financial system but the long-term infrastructure needs of the United States which many of us think have been neglected during this period. And of course that takes long-term certain money. And we all got finished bemoaning with each other over breakfast about the failures of infrastructure and there was a rather, I have to say, elderly professor from Princeton there who I had never met, but he was a professor of civil engineering. And he had kind of cri de coeur at the end of this discussion. He said, "I am a professor of civil engineering and you know Yale doesn't even teach civil engineering anymore; Harvard doesn't pay attention to their program." The implication was that when he retired and he was probably past retirement date, there might not be anyone at Princeton to take his place. "There is no one in the major American universities paying much attention to civil engineering," he said, "and it shows." He said, "half our bridges cost twice as much as they should, some of them fall down and they look ugly. How much better do they do that in Europe?" And you know, I think that happens to be the fact of the matter which made me think that the imbalance in the American education system was too few civil engineers, too many financial engineers and the result is lousy bridges and a lousy financial system. I think we have something of a problem here.

Now, my second point is external to the system, that's what's going on inside the system. Let me say and this was emphasized this morning by Mr. Pébereau, financial crises typically emerge from imbalances in the real economy. Basically we have had a huge disequilibrium in the American economy and that extends into the world economy in the past decade or so. You know and I don't have to belabor the point, but we are spenders in the United States and we're consumers. Consumption went up from 2/3 of the GNP to almost 3/4 of the GNP. We have been spending six, seven percent more than we produce. The difference is made up obviously by imports. We have a huge trade deficit, and the marvelous part of it was that it was very easily financed because a lot of people like to export, including the Chinese. They were shipping us a lot of cheap goods and financing it at the same time, and helping to keep our interest rates low. I mean, what could be nicer? We spent, got cheap money. They were happy, they were exporting, and they were happy they were getting dollars. Why change? And you could see that this was kind of train wreck expecting to happen but who wanted to change it?

Now what typically happens in a case like this is that it comes to an end because you run into a financial crisis, and we have run into obviously a financial crisis. This process internally in the United States, you know the story, was supported by easy mortgage lending, subprime mortgages, people taking equity out of the houses, expecting price increases. You've heard that story when the prices leveled off, the music stopped playing, and you had a big crisis. Now that crisis was also mentioned earlier this morning is part of, though terribly difficult, a necessary adjustment process. We see consumption declining. There is some tendency to kind of keep pushing it up but in the end, it has to decline relative to other parts of the GNP, and it's got to be replaced for a prosperous economy. And the obvious place to replace it given the nature of the problem is in exports.

It really is reassuring in all this trouble that the basic business of America at least the basic manufacturing business has been pretty healthy but particularly the export business is booming. And that is in the end the great hope for coming out of this with relatively little economic damage, coming out of this an economy that has restored the kind of balance that can make a sustainable base for the future and hopefully another good run of prosperity and maybe even a better prosperity where all the gains are not going to financial engineers and their bosses but a few of the gains begin going out to the rest of the country for the average American and a better balance of course for the world economy.

That's the prospect. I hope it's a reasonable prospect. But what about how to get from here to there? And what are the implications of this crisis? And what to do about it? It's a long list, and I think every item I can think of practically has been touched upon this morning. I put a lot of emphasis, as was mentioned this morning, on the obscurity of the markets a result of financial engineering. When you make a CMO and a CDO and tranche it and square it and stick in a sieve through a conduit, it's a little hard to know where you are and who is responsible for what. And you envelop it with trillions of dollars of derivates including this brand new market of credit default swaps. Someone said 45 trillion this morning, that's the figure I keep hearing. It's only about four times the total amount of credits outstanding in the world. And what are the implications of that and the failure of credit default swaps by a large institution in that market for a rippling effect through the financial system generally? I think the answer to that has to be we do not know - which is no doubt a long, strongly motivating factor for what the Federal Reserve has done.

So, obscurity is one big problem, and it's inherent in this system. If you don't think it's inherent, now I know I'm old and I don't know about these things very well, but I happened to receive in the mail the other day the annual report of Citibank and now Citigroup. I have no criticism of the place, but I looked at it and it's now three times as big as the annual report used to be, 150 pages. You know the annual reports used to be in glossy paper, have photographs of everybody, happy customers, and their new initiatives. This had none of that. This was facts and figures, 150 pages of facts and figures. Now I only spent two or three hours looking at, but if you think I was well informed about the risks of Citibank after spending two to three hours looking at their annual report, you would be mistaken. I haven't got the slightest idea of what their position really is.

The other day I had a much simpler company and a rather steady business but it has some fancy financing sent me a prospectus. I looked at it and as I leaved through it the startling thing to me was that all prospectuses say risk factors. It's not a very complicated business, but it had fifteen pages of risk factors. And when you begin looking at all the risk factors that the lawyers could think of to stick in this prospectus, you had no idea what the real risks are, which are important and which are not. This thing is just too complex to easily analyze and get comfortable with. And I think unfortunately that includes the mangers of these companies. Maybe some of them are brilliant enough and careful enough like Mr. Pébereau to know what they were doing or know what businesses to stay out of, but I'll tell you not many of them. The people running UBS, Merrill Lynch, Bear Stearns, and on and on, I think it's fair to say did not have a good grip on the risk that their own organization was taking. It's understandable, it's so complicated. It's very hard to understand, and they have other responsibilities.

Now, what about the gatekeepers? Who are the gatekeepers in this bright new open market system? The primary gatekeepers are the credit rating agencies I guess. There's been comment about that. I think the main problem with the credit rating agencies is that they hired the same financial engineers that were making up the instruments, and they got the same answer. They said those instruments were great because that's what the companies themselves thought, that's what the people who made them up thought. The shortcomings of that analysis are now apparent.

If I had to take one single problem in this industry, which is not confined to this industry, it is the compensation practices and how they were skewed toward taking risk with enormously large results in terms of income and not much symmetry when it came to losses. We're in the middle of this great crisis, but I tell you there are a lot of very rich people sitting in Palm Beach or the Bahamas or the South of France, who have escaped any great problem from this turmoil because they made their money and got out. In the meantime, the general run of people in the United States have not been doing all that well in terms of growth of income during what has been a generally prosperous period for the economy.

I think it's clear that on a policy side, we can look at monetary policy. I think maybe it was a little misled by the very fact that the freedom of imports kept a damper on inflation so latent inflationary pressures were maybe a little overlooked, and now we do have an inflationary problem which complicates the resolution of this crisis. But I think it's also true that there was no regulatory control or relatively little regulatory or supervisory control over non-banks and non-banks had become a much more important element in the financial system.

There have been comments about accounting theory this morning, and I share some of those concerns. I was until a couple of years ago the Chairman of the International Accounting Standards Committee, which appoints the International Accounting Standards Board which is rather interested in mark to market accounting. As chairman of the oversight committee, I was not supposed to opine on technical matters, so mark to market accounting is a technical matter I will now comment on it since I am no longer chairman of the oversight board. And I think there are difficulties. I have sympathy for what Mr. Pébereau was saying this morning and others that you get in this kind of situation that marking to market, or to use that wonderful euphemism of fair value accounting, when there isn't any viable market is a rather difficult proposition. You can get caught in a kind of spiral that marking down leads to questions which leads to more marking down potentially beyond what you think of as the real value of the asset but of course if the market gets bad enough the real values will disappear.

I touch upon that, the answers are not easy. Accountants were considered bookkeepers, not very important, not a very glamorous profession. I'll tell you one thing I've learned in recent years is that accounting is very important. Auditing is very important, and it's intellectually as well as practically very difficult in this complicated financial world in which we live.

Well, what to do about all of this:

Let me summarize. I think that the first thing I would say, as I've said already, is that in terms of the real economy, I believe we are moving toward a better equilibrium. The danger of course is that we overshoot it and we end up with more than we bargained for and a really deep recession. I don't think that's inevitable, and I hope we don't overshoot it. But that arguably is certainly necessary, and I hope it will be constructive.

I don't think we can sit back passively on the financial system. There are too many points of vulnerability. One point of view is that Adam Smith will take care of all this. The free workings of the market will teach those who took too many risks a lesson. They'll behave in the future. Let's go ahead and let this new market proceed in its most optimistic way and its most constructive way. I would remind you that even Adam Smith had a rather long passage in his book saying that banks won't necessarily be able to take care of themselves. They need a little special attention. He thought that was true in 1776, and I think that lesson remains true.

Now what about the financial world? It's clear that the concern extends beyond banks, commercial banks. That is the lesson of the Federal Reserve's action. What do we do about it? Securitization, credit default swaps, enormous leverage, they all extend questions. It's not peculiar to the regulatory system in the United States, as fragmented as that is, as difficult it is. I think a lot of us ex-central bankers or current central bankers had their mouth dropped open when the British felt compelled to guarantee a medium-sized bank in the UK all of the sudden for fear of infectious results in the rest of the market. And if our jaw didn't drop open then when the Chancellor of the Exchequer promptly announced that all creditors of all banks operating in the UK would be protected for the time being. Now, if that is really necessary, it really does raise quite serious questions about the operation of the modern financial system and about the role of governments, about the role of central banks.

The Federal Reserve faced an emergency. They took action, and it seems to have had a constructive result as was mentioned this morning. But it does raise questions for the future. Can you lend to a non-bank today and say you are not going to do it tomorrow in somewhat similar circumstances as the Secretary of the Treasury seems to be saying? That doesn't seem to be a very likely assumption. So therefore, you have to do something about the investment banks. But what's an investment bank? It's nothing like what used to be an investment bank when I was a young man. They do all sorts of things. Which comes within the safety net and which ones don't? Or don't we know? Is it a question of size or not size? Or what? If you are going to regulate them, what do you do? Some people say regulate all these compensation plans. I don't think you can regulate compensation plans, but you wonder why there isn't a little more self modesty in the companies themselves in arranging some of these things.

But this is a difficult question. The Federal Reserve has done something that they don't do, that central banks don't do. They have taken onto their balance sheet uncertain assets. What is the limit of that process? What does it do for potentially politicizing the central bank when it is directly providing credit with uncertain assets to parts of the system that go beyond the defined commercial banks and good liquid assets? You know Walter Bagehot's old saying, "God for central banks. Lend freely at a high rate on good assets." It's not exactly the definition that's being used today, and it raises important questions. I think this question of the appropriate role of government and the appropriate role of central banks has to be thought about quite a lot as we resolve this situation.

I'll just make two points in conclusion. When caught up in the midst of a crisis of this sort and concerned about the economy, it is easy to say well, inflation will have to take second place or the fight on inflation will have to take second place in these circumstances. How well I remember that mantra in the early 1970's. You know this is a temporary oil shock. I remember soybeans prices went way up in price; you've got to do something about soybeans. The wholesale price index went wild and the consumer price index began going up, but that's alright. It'll go away after awhile. But it didn't go away and once it gets in people's minds that it's there then you have larger problem. And you're not going to settle the financial system for the United States, or in my opinion, given the importance of the dollar for the world, if you lose sight of the importance of price stability and some attempt to get more stable international financial arrangements, in particular a more stable dollar.

So, that is a big challenge and the other big challenge seems to me is that "we're all in this together," the Americans, the Europeans, British, Japanese, developing countries sooner or later. It is not possible in this world for one country, even the United States, to develop a regulatory system and a good regulatory system and hopefully a good supervisory system suitable for the United States if the rest of the world isn't on the same wavelength. That is a source of great concern amongst financial institutions in the United States. I think it's probably not a real source of concern. My sense is that here in Europe, in particular, you are just as concerned about getting a stronger regulatory system and wondering what to do about hedge funds, wondering what to do about leverage, and wondering what to do about supervision as in the United States. If that's true and I think it is true, it is important - and there are arrangements to do this - that with a matter of some urgency as we move towards trying to align regulation and supervision with the new system, that we do it as much as possible together, so that you don't have a danger of competition in laxity or the appearance thereof between different regulatory systems. So with that much let me shut up. I can't imagine I left you with any questions, but if you have I would be glad to try and answer them.

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QUESTION: I've got a quick question regarding the size and complexity of financial institutions today. You mentioned that sometimes it was overly complex, does that militate to have smaller, more manageable institutions or do big super markets make any sense?

PAUL VOLCKER: It's interesting that you asked that question. I think my answer is that it's very difficult to manage that process downward in size. Part of what has happened here is that as things got more complicated and in some sense more risky, whether they said so or not, managers of banks in particular but other financial institution wanted to be as big they could and diversified as they could. The theory was the bigger we are the safer we are, the more diversified we are, the safer we are. So there's been a great momentum to get big rather than small. It's interesting you raise this question because I went back and read some of these passages in *Wealth of Nations* of Adam Smith, and his answer to this was don't make individual banks too big because if one of them fails, we don't want it to have too big of an impact, so have a lot of small ones. It would be nice to go back to that, but I don't think we're going to manage it very easily.

Let me make one other comment. You know the banks have been regulated and there are all kinds of failures that you can talk about in bank regulation, but one thing that has happened in bank regulation in the past twenty years is bank capital has been strengthened greatly compared to what is was in the late 1970's and early 1980's when I was there. Fortunately that's been the case because these banks have been able to absorb very large losses without capsizing.

QUESTION: We've been talking a lot about - and that's why you're here today - the subprime mortgage crisis and its impact on the American economy and the world economy. Where do you think the future is with that? Do you think the worst behind us?

PAUL VOLCKER: I am not in the business of forecasting. This has been a pretty big shock, and it's going to take some while to work through it. I think the question is not that it disappears – I hope it doesn't disappear right away since we have a lot of things to reform. But you want to get through it in a way that is conducive to the kind of basic economic restoration of equilibrium that I talked about. I think that should be the aim and that's possible.

QUESTION: In order to prevent inflationary risk, do you think the only way to avoid these perils would be relate a lot better real economy value creation to what I would call the regulation of financial products? In other words, in order to prevent some people to sell the value that they their [missing] and to leave out today or future profits, is it necessary to have supervisory boards that would make it no longer possible for financial products to be decorrelated of real economy value creation?

PAUL VOLCKER: I guess everyone would share an objective of having a financial instrument reflect real economic strength and genuine risks or benefits of the loan or the security. How you do that is the challenge. You're never going to get it absolutely right. A lot of people this morning talked about waves of optimism and pessimism and that characteristic of human behavior. In a large part, I think you have to approach it indirectly. Have they got enough capital? If they are taking that kind of risk, do they have enough capital to absorb it? Have they got appropriate liquidity provisions to absorb it? Those are the two main things. It's all obtrusive, but those are the least obtrusive things you can in terms of regulation and supervision. But even that's not easy.

We have an infinite capacity for inventing new financial institutions. And if you regulate some, people will invent new ones. And when things are going well, you can talk all you want about regulation and supervision. It's the hardest thing in the world, when things are going well, for a banking supervisor to come in and say "no, be careful, pull back, raise some capital." I've been there, and the answer they give you is I know more about than you do. You're sitting there a bureaucrat in Washington I know what's going on. And you try and regulate me, I'm going to send another 10 million dollar contribution to my congressional friends and tell them to get on your back and off my back. That's the way the system works.

QUESTION: Is it time for the Fed and maybe other central banks to abandon their oft proclaimed maxim that bubbles cannot be recognized except in their aftermath?

PAUL VOLCKER: Well, that's a bit of law which you say central bankers because I know at least one central banker that doesn't particularly believe in that. In fact, there are several. I think yes, that needs some rethinking. But part of the problem too is that as a result of success - and this is pure psychology - there is less recognition than there used to be that it is an almost inevitable part of the capitalist system to have an recession every once in awhile. Once you think you're so smart and so able and have all the right models to run monetary policies to prevent a recession, you are likely to just delay it and have a bigger one in my opinion, but that's a good old sour old central banker's comment.

QUESTION:  I have sort of a different type of question.  I don't remember you ever coming out before and endorsing a candidate for president and yet you did this time.  And given the fact that probably many of us in this room share your broader macro-economic outlook, I would be curious if you are willing to share some of the why or a little bit of insight into that decision.

PAUL VOLCKER: Well, since I did endorse a presidential candidate and I said why, I think I can reasonably repeat it here.  I thought it was kind of inappropriate for a Federal Reserve guy to get involved in politics and be endorsing candidates.  I never did it except for Bill Bradley who is an old friend.  My endorsement didn't help that much, I think it's fair to say.  This other time I did it some months ago, and I didn't do it because I thought Barack Obama had a great economic program.  I had no idea what his economic program was or what Hillary's economic program is or Mr. McCain who says he has no economic program.   I'm not very happy about trends of things in the United States: the divisiveness, the partisan bickering, the ideological positions taken by both parties.

And there a lot of challenges.  There's obviously the foreign challenge, the international challenge.  There is obviously an enormous need to repair relations with the rest of the world.  We've got Social Security, we've got Medicare, we've got global warming, we've got the infrastructure - all these problems aren't going to be dealt with, in my opinion, without some degree of better cooperation among the parties and better understanding on the part of the people.  And this young man comes up with a mixed background, preaching in eloquent terms the gospel of needing to change the direction of the country and get cooperation among disparate parts of the country and begin attacking some of these problems.

I spent a lot of time worrying about administration fruitlessly in the United States, but there are tracking polls over decades literally asking standard questions.  One of the standard questions is, "do you have confidence that the government of the United States will do the right thing most of the time?"  It doesn't sound like a very commanding question, but that has declined.  In the old days, it used to be 70 percent would say yes, now it's 30 percent that say yes.  And when 70 percent of the population is not exhibiting much faith in government, you've got a problem.  I think that's particularly true of young people.  I'm giving a campaign speech, I guess, I don't know.  It's interesting seeing the polls, if you are below 30, you vote for Obama, if you above 60, you vote for Clinton.  I happen to be in the over 60 group, it's not quite unanimous.  But when you look at the kind of problems we have, I think it's important that we bring those young people back into the political system.  So, I think there's some promise there and that's why I decided to endorse him.

QUESTION: What do you think is the appropriate role of a central bank in regulation?  Not just what we should be regulating, but who should be doing it?

PAUL VOLCKER: This question is obviously front and center. I come from a particular background. I spent fifteen years of my life in the Federal Reserve in various positions, and I thought that partly by virtue of the independence and prestige of the organization and I would like to think the quality of the organization and given their responsibilities as lender of last resort, they are naturally in a position – they have to have some regulatory responsibilities - to do a better job than most other organizations that are more vulnerable politically in particular and don't attract the same good people or don't attract the same quality of people that the Federal Reserve can do fairly automatically. So yes, the Federal Reserve ought to be at the center of it. Except - I still believe that but I still raise the question - if you give the whole thing to the Federal Reserve, it's a huge controversial responsibility and at some point you worry about whether it does detract from the central responsibility of monetary policy.

I don't want to disinvolve them, you can't dissolve them and shouldn't disinvolve them, but whether they should do it all. Back when we had banks and the banks were the question, I would say the Federal Reserve could do it all. But now we're not talking about banks, we're talking about banks, investment companies, hedge funds, and on and on. Is it too much? That's we're going to have to debate in the next year or so. I think we have to give Secretary Paulson a lot of credit for putting out his plan which I think is quite logical in its conception. But many people have commented he says give the Federal Reserve some kind of broad oversight authority, but they don't get serious, not the way he puts it, but he's not going to get serious until the crisis comes. Well a lot people said it's a little late to get serious when the crisis comes, so that's a problem in his conception.

DANIEL BENJAMIN: Mr. Volcker, thank you very much.