The Economic Club of New York

Breakfast Series

Henry Kaufman, President
Henry Kaufman & Co., Inc.

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Introduction

Chairman Terry J. Lundgren

Good morning everyone. Welcome. I'm Terry Lundgren, Chairman of the Economic Club and Executive Chairman of Macy's, Inc., and I'd like to welcome you all here. I'd like to offer a special welcome to our members of the Economic Club of Chicago and Washington, DC, who are here through our reciprocity program, and I want to welcome you to our event this morning. We are very pleased to introduce to you a fellow Club Member and fellow Club Officer, Henry Kaufman.

As many of you know, Henry is President of Henry Kaufman & Company, a firm established in April of 1988, specializing in economic and financial consulting. For the previous 25 years, he was with Salomon Brothers, where he was Managing Director, Member of the Executive Committee and in charge of the firm's research departments. He was also Vice Chairman of the parent company, Salomon, Inc. And before joining Salomon, he was in the commercial banking business and served as an economist at the Federal Reserve Bank of New York.

Henry received his bachelor's degree in economics from NYU and his masters in finance from Columbia University and then back to NYU, where he completed his PhD in banking and finance. He also received an honorary Doctor of Laws degree from NYU, an honorary Doctor of Humane Letters degree from Yeshiva University and Trinity College.

Henry's latest book, and you should have it in front of you at your seat, *Tectonic Shifts in Financial Markets*, was released in February of this year. And prior to that, he wrote, *The Road to Financial Reformation,* published in 2009, and *On Money and Markets, A Wall Street Memoir,* which he published in 2000. Henry was awarded the first George Eccles Prize for excellence in economic writing from the Columbia Business School for his book, *Interest Rates, the Markets, and the New Financial World.*

Besides his business activities, Dr. Kaufman is active in a number of public organizations, including service as a Member of the Board of Trustees and Chairman Emeritus of the Institute of International Education. He's a Member of the Board of Trustees and a Member of the Investment Committee for the Norton Museum of Art. He's a Member and Chairman Emeritus of the Board of Directors of the Stern School of Business at NYU. He's a Member of the Board of Governors at Tel-Aviv University. He was a Fellow, American Academy of Arts and Sciences, Former Treasurer of the Economic Club of New York, Honorary Trustee and Former President, the Animal Medical Center, and Life Trustee for both NYU and The Jewish Museum.

So, Henry is going to come up and give us a talk, and after he does so, we will take questions. And with that, may I introduce Henry Kaufman. (Applause)

Henry Kaufman, President

Henry Kaufman & Company, Inc.

I'm delighted to speak to you here at the Economic Club of New York. And the only thing your chairman didn't say is I've been a member in this organization since 1973. Some of you weren't around at that time. (Laughter). Now, the phrase tectonic shifts – the title of my talk – comes from my most recent book, which you have in front of you. Today, I'll touch upon some of the themes in that book, but also explore some new territory. Tectonic shifts in the financial market, like those in geology, occur when powerful forces, usually building up for a long time, cause the ground to shift beneath our feet – sometimes with catastrophic results. Financial tectonic shifts typically have two causes.

First, they occur because financial institutions and market participants do not adhere to a reasonable code of behavior. Second, they happen when official institutions, primarily central banks, fail in their market oversight responsibilities. This often involves a failure to anticipate, to recognize, or to act in the face of mounting pressures. Financial institutions play a special role in our society. They hold and manage our temporary funds and our savings. In that sense, they have a very high calling. They need to maintain a balance between their entrepreneurial drive to make profits and their fiduciary responsibilities as managers of the public funds. In overseeing our financial institutions, the central banks must also strive to maintain this balance as part of its central mission of encouraging orderly economic growth and price stability.

When oversight becomes too lax, a host of unwelcome consequences usually follow – from declines – rather dramatic – in financial asset values, to a slowdown in overall economic activity. If financial and economic disruptions become severe, they can endanger the political stability of the country. And that happened, as all of you know, in Germany many years ago.

The Great Depression of the 1930s and the recent Great Recession adversely affected billions of people throughout the world. During the Roaring 20s, individual investors, financial institutions, and corporations all fed the enthusiasm of Wall Street. The Federal Reserve – not yet well centralized in its decision making process – failed to stem the unhinged speculation that took hold towards the end of that decade. And according to modern-day monetary theory, that prolonged and deepened the banking crisis and economic free-fall by failing to ease aggressively.

The political response to the Great Depression, however, was of tectonic proportions. A series of New Deal banking reforms in the early 1930s separated commercial banking from investment banking. It established a national system of deposit insurance and created the Security and Exchange Commission which brought a new level of transparency and restraint to security markets. It was regulatory regime that would last about, I guess, a half a century.

By the 1970s, in the 1980s however, memories of the 1930 calamity were fading, and structural changes in macroeconomic forces were putting new pressures on banking and finance.

Stagflation took hold in the 1970s. Banks wanted to compete across state lines and offer new products. New credit instruments and trading techniques were introduced and exploited by computer-driven analytics. Credit expanded massively, both on and off corporate balance sheets. Entrepreneurial drive was eclipsing fiduciary responsibility, a reality that was exemplified by the remarks of Charles Prince, the head of Citicorp, when he told *The Financial Times* in July 2007, and I quote: " As long as the music plays, you have to get up and dance. We're all dancing." In essence, he was saying that if you don't compete aggressively, even in a high-risk environment, you might lose market share and profits and, in turn, lose some of your key traders, or the support of the board and shareholders.

Now, in this regard, there are a number of unalterable facts. First, when financial institutions act with excessive entrepreneurial zeal, the immediate outcome is economic and financial exhilaration. Only later, when the loan cannot be repaid, or the investment turns sour, do the debilitating aspects of excess behavior become clear.

Now, why didn't the Federal Reserve take preventative action at least to mitigate the financial excesses leading up to the financial hemorrhaging in 2008? I strongly believe that monetary authorities did not understand the implications and the consequences of the structural changes in the financial markets for the conduct of monetary policy.

So allow me to illustrate this by pointing to three structural changes. The first example goes all the way back to the early 1960s, when the Federal Reserve started to gradually lift the permissible interest rates that deposit institutions could pay on time and savings deposits and the banks moved to floating rate loans. Now this freed both borrowers and lenders from previous central bank restraint. One consequence was that in the 1970s and early 1980s, interest rates had to escalate sharply before lending and borrowing slowed. As a large run-up in interest rates unfolded, it was accompanied by massive growth in debt that brought about deterioration in credit quality for both lender and borrower. The Fed never really conceptualized what these events would do to the effectiveness of monetary policy.

Nevertheless, this structural shift should have raised questions during the Fed's deliberations at that time. Should financial institutions benefit or suffer in any way from monetary restraint? Or should they be mere conduits that pass the full impact of policy to households and business? Through spread banking and other techniques, they have passed on the higher cost of funds in order to protect their profit margin. Much higher interest rates were required to achieve monetary restraint. And as a consequence, more borrowers became marginal, but at the same time, the quality of debt held by financial institutions deteriorated as well.

My second example involves the Fed's failure to anticipate the consequences for monetary policy from the sharp increase in the concentration of financial assets since the 1990s, especially following the demise of the Glass-Steagall Act. The financial concentration that has occurred is startling. Today, the ten largest U.S. financial institutions hold at least 80% of all financial assets compared with 10% back in 1990. As of 1990, there were 15,400 FDIC-insured deposit institutions. Today, there are fewer than 6,300. Some of you may still recall the names of many of the prominent Wall Street security firms of just 20 to 30 years ago. Today, there are only two prominent ones left and even they operate under the bank holding company structure.

Before the Glass-Steagall Act was scrapped, shouldn't the Fed have presented a comprehensive analysis to Congress of the consequences of such actions. Among other questions, they should have asked what is the likelihood of a substantial increase in financial concentration? Would large institutions emerge that would be deemed too big to fail? Would high concentration create conflicts of interest in improper trading, investment banking, and investment management practices? How will increases in concentration affect the secondary market for securities? But by its silence, the Fed must have concluded that the removal of the Act would increase financial competition and, as a result, those who will prosper will do well, those who will do poorly will be allowed to fail. That, however, was not to be the case.

Now, my third example of harmful inaction in the face of structural changes concerns the Fed inability to come to grips with the impact on monetary policy from the securitization of financial assets. Mortgages and high yield corporate bonds were the two most prominent assets that were securitized. They became marketable assets. There is inherently nothing wrong with this conversion to marketability, but it created the illusion that the daily pricing of these securities was the equivalent of high liquidity.

Wall Street also came up with new terminology to encourage buyers to participate in these new liberated assets. For example, junk bonds were referred to as high-yield bonds. And the obligations of under-developed countries were deemed obligations of emerging nations. Market participants did not quantify the extent to which the volume of trading in the markets would change with the shift in interest rates, both up and down.

Now, consider the following: In January 2008, the assets of Bear Stearns were more marketable than in April of that year. The same can be said about the marketability of Lehman's assets at the start of 2008 versus when it declared bankruptcy in September of 2008. In essence, the marketability of financial assets is a rather complex matter and its stability hinges importantly on the conduct of monetary policy. Structural changes in the financial markets eventually left their mark on the conduct of monetary policy.

As many of you know, in the early decades of the post-war period, the Fed typically ameliorated business recessions through a combination of lower interest rates and reserve requirements. These measures were not enough in 2008. Because of the just-mentioned structural changes, especially the highly financial concentration, the failure of many of the large financial conglomerates posed systemic risk. Monetary policy became much more interventionist in crisis management.

Now, I find it rather ironic that the shortcomings of Fed policy have propelled the central bank into high public prominence and policy dominance. Nevertheless, we won't return to the days of Bill Martin, when he was Chairman of the Fed in the 1950s and 1960s. At that time, the Fed Chairman was known within the financial community, but not to a wider audience. The Fed conducted open market operations then through the purchases and sales of Treasury bills and its public utterances were rather few.

Now the Federal Reserve would like to return to some sort of monetary normality, assuming that the economy will take on the behavioral patterns of decades ago. What was that old norm? Was the old normal typified by the events of the 1950s when financial institutions were highly liquid, business corporations pursued conservative financing practices, and household borrowings were moderate? Or was the old normal reflected in the events of the 1960s and 1970s when inflation gathered momentum, interest rates reached new peaks, and markets and the economy seemed to lose their moorings? Or can it be claimed that the old normal was embodied in the period from 1980 to 2007, one highlighted by excessive financial entrepreneurship and unprecedented credit creation that eventually undermined the American economy. If there's anything like a period of economic normality, it comes out of a statistical construct in which economic and financial data are typically aggregated and averaged to some standard called normal. Nevertheless, despite these differences from the past, the Fed is making an effort to return to monetary normality.

A few weeks ago, it announced measures that will reduce the size of security holdings. These reductions are likely to be relatively small. Indeed, the Fed cautioned markets that it will terminate these reductions if the economy stalls and that it will increase holdings with the onset of another business recession. Given these parameters, Fed holdings of securities may well reach current levels again within five years or so. The Fed also indicating that it will increase the funds rate to about 2 ½% or so within a year or so in order to bring the funds rate to be in alignment with the inflation rate.

However, monetary policy is caught in a quandary as it continues to focus on these two key variables: the rate of unemployment and the rate of inflation. An extraordinary pattern emerged between these two variables following the Great Recession. The unemployment rate has fallen sharply to below 4 ½%, while the inflation rate has not yet gone up to the Fed's preferred target of 2%. That difference in trends has really defied conventional economic analysis.

How is such an unconventional pattern possible? Now, I believe it reflects a fundamental difference between the impact of the industrial revolution and the current technological and information revolution. To be sure, the technological changes that occurred back in the revolutionary days of industry was very large, but the industrial revolution eventually increased the power of labor. After decades or centuries – depending on the country of exploitation – workers banded together to from industry-wide labor unions and the collective bargaining process helped to drive wages higher and were a restraint, therefore, on corporate profits. At least so far, workers in the new information age have not devised effective new ways to counter the downward pressure on wages exerted worldwide by the information revolution.

The power of unions has declined, while corporations – aided by vast improvements in methods of production – have taken advantage of lower labor costs elsewhere. In addition, corporate mergers and consolidations have led to greater market concentration in many sectors, not just in finance, which has given business greater control over the pricing structure for their products and services.

These trends are clearly reflected in the overall rise in corporate profits, including the financial sector, as percent of GNP, as compared with a rather moderate rise in wages. I suspect that this divergence will not be reversed. Vast improvements in technology and in the delivery of information seems far from over. Still, there are some ways this widening gap that I just spoke about might be addressed.

One would be through tax spending measures and legislated by the government. Another is through monetary accommodation. This has already been in process. Continued easy access to credit would allow household to borrow to offset a shortfall in income in order to maintain their spending habits. It would encourage businesses to borrow and maintain profitability and for business to increase market share.

Now this kind of accommodation is far from ideal and obviously holds long-term risks, but it would ameliorate some of the present wage squeeze. In time, the Federal government will probably need to increase Social Security payments to offset the shrinking pool of pension payments that were once a hallmark of post-American business.

Now given these realities, monetary policy, I believe, will continue to command a high visibility for years to come. The Fed's role as the guardian of credit will be extremely challenging, especially in markets with diminishing credit quality. The real risk for the Fed is whether it can prevent another crisis in the financial markets. Continued liberal monetary accommodation will eventually confront the Fed with this risk. More borrowers will be rated below investment grade. In a few decades from now, they will dominate the markets. The next time around the Fed may well try to curtail this risk through selective credit allocation measures – a departure in policy equal to its recourse to a quantitative easing of several years ago.

In the coming decade, the Federal Reserve will benefit from continued improvement in technology and information delivery services. Check writing and the use of currency will virtually disappear as will the need for financial institutions to operate many branches. The quality and the quantity of financial and economic data and the speed of its delivery will be far better than what is coming, what is presently coming into the Federal Reserve. The central bank will come to know everything almost from our health to our wealth. Many businesses and financial transactions in all sectors of the economy will be quickly transmitted to the government for review and analysis. At that time, will the Fed have the analytical competence to act wisely?

Tectonic shifts in the financial markets create serious forecasting challenges because they alter the structure of the markets and invariably lead to unintended consequences. Many long to return to some phase of normality. It certainly would make forecasting a lot easier, to say the least. However, we can't return to the financial landscape of the period that ended in 2008. The reverberation of that shock and of the more silent tectonic shifts that build up beneath it are still being felt. And as I noted in the last chapter of my new book, we cannot go home again to the less-threatening financial landscapes of the past. Thank you very much. (Applause) No questions? I knew Bill would stand up.

QUESTION AND ANSWER PERIOD

QUESTION: Thank you, Henry, for your always very intelligent remarks and your foresight on so many things. Most importantly, let me thank you for your service to the financial community here in the United States and worldwide. You are an example to so many of the people that are seated here. In addition to the roles of the Fed, which you've mentioned, on inflation and growth, I would like to get your comments on the growing importance of the Fed on the regulatory process which, as you know, has come and gone. Under Paul Volcker it was very important, under Alan Greenspan, it wasn't so important, and where you see it today and going forward? Thank you.

HENRY KAUFMAN: Well, I was not in favor of the Dodd-Frank legislation. It's too long. It's too big. It's too cumbersome. It was an attempt by the political body to put everything in there and to really remove its own responsibility from the behavior of the financial system. It should have been shortened substantially, maybe to 10% of what was contained, and much more summarized. At the same time, it would seem to me the effort now is to deregulate the financial institutions at a time when we are in transition. The dilemma with the deregulation process is that we will still have institutions that are too big to fail. And in a sense, I've concluded those institutions, no matter what, will be, continue to be financial public utilities. Those institutions do exceedingly well, that are financial public utilities, when there's liberal monetary policy. They then come under the umbrella of the government when a credit squeeze occurs. I think that is inappropriate and we are not about to go back to really downsize institutions and make them more competitive along certain financing lines rather than have multiple lines of activity in them. I suspect we're not going back to that. That is, I think, unfortunate. Now, the political body also is emphasizing we have to do more for smaller financial institutions, smaller banks. I think that's a very nice thing to do, but we better recognize, no matter what we do for those smaller institutions, they are a small percentage of the financial system of the United States – 20% maybe, maybe 20%. Now, that 20% is not going to save America. The 80% has to save America. And I'm really a little bit disturbed that we're moving to a deregulatory process without a real theme behind it and cogent analysis that sits behind it. It is a political move and I don't think it's based on pure economic and financial analysis.

QUESTION: I'd like to echo, I enjoyed your comments a great deal. I have two somewhat related questions. One is that a greater number of public equities are owned now by passive funds, more and more by ETFs and indexation and so forth. And their responsiveness to change seems to be indifference. And I'd like your thoughts on, as more of the capital markets are in these funds, how does that affect the ability to change corporate behavior related to unknown consequences or unknown risks? And then the other question I have is basically as a result of the privatization of many companies, you have a substantial amount of debt being built up in the private equity markets that's not being visible in the corporate world. And as more and more of these private equity firms infiltrate the markets, they present unknown consequences. I'd like your thoughts on that as well please.

HENRY KAUFMAN: Well, I'll try to remember the first one, but to get to the second one, which is fresh in my mind, it is true, private equity funds are growing very rapidly. And I sit on a number of boards, investment committees where there is great desire to get into private equity funds. But I think anyone who does that has to recognize that the deals that are coming to private equity funds today are not as good a deal as they were ten years ago and five years ago. The leverage that's being employed to finance those activities is very high. And as you go out here, with the quality of credit deteriorating, I really question whether that action is a good one for institutional investors, to dive in when the value is deemed to be very high, and not low, where the opportunities are not as good today as they were years ago. It is an interesting development because as you well know, valuing your investment in a private equity fund in the first four or five years is haphazard. So when markets change, the risk is that your value is changing a lot but it isn't being recognized on the balance sheet. So, I would recommend caution going into those areas, but I have a minority view on that. Now repeat your first question.

QUESTION: The first question is as a result of more passive funds becoming market participants in the capital markets, there seems to be about 30% of all equities now are owned by index funds, ETFs, and so forth, and their governance seems to be less responsive to these risks that have evolved. That was the question I was initially asking.

HENRY KAUFMAN: Well, I think this is another indication that the capitalistic system isn't functioning the way it should be, that somebody has to hold corporations accountable. And the extent to which this indexing is going on, they're being held less accountable because I think the index funds are not going to go out there and vote up or down on what is being requested by business corporations. I think this increases really the power of the business corporation and decreases the power of stockholders.

QUESTION: Thanks a lot. You mentioned the need to be mindful of the risky behavior and kind of this entrepreneurial spirit within the financial services companies. So, I was wondering what would be your advice on setting the risk appetite for the companies in this economic climate?

HENRY KAUFMAN: Well, you're asking me what will be the cures? Those are not easy to come by. For example, I don't think interest paid on corporate bonds should be tax-deductible. I think an emphasis should be, would be there to increase the equities of a position of a business corporation, not to diminish it. If you look very closely, it's what's happened to the corporate balance sheet, not based on market value. But on the corporate balance sheet, debt has been rising and equity isn't going anywhere because shares are being repurchased very significantly and a lot of debt is being piled up to acquire assets. That is not a wholesome development for business corporations even though we hear today that, oh, corporations are in better shape than they used to be. I ask you: how many times do you read in the *Wall Street Journal* or *New York Times* that the corporate credit quality of a business has been raised? You don't hear that. You don't see it. Today, I think there are only two corporations in the United States rated Triple A. Back in the 1980s, there were 60-some odd. So all of this has resulted in a period in which corporate profits have been very good, to say the least. But corporate finance has not focused on the corporate quality. It's on the basis of what can we acquire next and how much can we squeeze the balance sheet. That is part of modern financial theory today, and at some point in time there's going to be a vulnerability reflected in the marketplace.

QUESTION: Even though the banking system has the greatest concentration of financial assets that we've ever seen, the growth in financial assets has really happened outside of the banking system – the resurgence of securitization, the meaningful growth in private credit. Eventually we will happen upon the next recession. Do you think the Federal Reserve has the tools today to address that in the way they have in the past?

HENRY KAUFMAN: Well, I think the Federal Reserve knows more about what's going on in the shadow banking system than it did years ago. One of the governmental entities in the Treasury has done a number of studies on what's off-balance sheet and the magnitude of it. I think there's an improvement in knowledge. Is it well incorporated in the approach we have to our financial system? I don't think so. One of the shortcomings in policy is that policy doesn't have an indicator for the credit structure, the size of the credit structure. You have the recognized side that we all see in the flow of funds and so on, but these off-balance sheet developments aren't encapsulated in this, and that poses a risk. Now, as I tried to indicate in my talk, as we continue with this monetary ease – and it will continue, it isn't going to be a quick restraint on the system here – we increase the risk of another financial crisis. Don't ask me when. But there will be another financial crisis, and it will pop out somewhere, and we'll all say how did that happen?

QUESTION: Can you offer your views on what extent, if any, there should be criminal individual liability for the crisis of ten years ago? And if so, in what areas prosecutors should look at?

HENRY KAUFMAN: No. I can't give you a view on that, but I can give you a little bit of an analogy. When I was a partner at Salomon Brothers or when I became a partner, Sidney Homer, my then boss, called me and said, Bill Salomon is going to offer you a partnership. And then he said, I want you to tell your wife that when you sign the partnership papers next week, you're going to be personally liable for $2 billion. (Laughter) That's the difference between Wall Street then and Wall Street now because financial activity has been incorporated. There are no real partnerships active anymore. But I do think we can put restraints on the senior management that will make them far more responsible, including their compensation, including their holdings of shares and options and so on that would be quite effective. We haven't done that, but we ought to do that. And I do think that those who serve on the board of financial institutions should be active. They shouldn't serve on many boards. They should be much more involved in what's going on in the organization. I haven't seen that.

QUESTION: Dr. Kaufman, as you indicated, the role of the Fed Chair has changed quite a lot over the years. Most people didn't know who William McChesney Martin was and certainly beginning with Paul Volcker and continuing with Alan Greenspan and Ben Bernanke, the Fed Chair has become not only a household name, but, you know, a 24/7 cable news cycle. It appears that we're on the verge of yet another change in the head of the Fed Chair. We've heard names such as John Taylor, Jerome Powell, Kevin Warsh. I'm wondering if you could comment on who you think would be the best person to lead the Fed going forward.

HENRY KAUFMAN: Let me make a general comment on this. As you go, in the post-war period, and look at the chairs of the Fed, they haven't all been that successful. Bill Martin, who was the first prominent chair served the longest, for about 18 years or so, at the Fed, until the late 1960s. He turned in quite a good performance considering that he served at a period when the

Fed first got its independence after the Accord of 1951. He didn't have a PhD in economics, but he had a lot of background in financial markets and the Treasury and the New York Stock Exchange, export-import banks, and so on. Arthur Burns, who came afterwards, was an expert on business cycles, Chairman of the Council of Economic Advisors. History will not rank him high – an academic, well-trained, government experience. We had Bill Miller, the only real businessman that ever served. He was the head of Textron. He had a very checkered career. He served a little bit more than a year and they had to bring in Paul Volcker, who served eight years and did yeoman work. Yeoman work, well, he's a friend of mine, but I would rank him as the most significant chairman in the post-war period. Then you had Paul Volcker, Greenspan, Alan Greenspan came in. I think he had a checkered performance. He admitted before Congress that he had the wrong model that he was working with. Can you imagine? Admitted that he had the wrong model. Ben Bernanke, I would say he did not sense the crisis that was coming, but once it came, he acted with considerable force, with considerable amount of innovation. And today, of course, we still have Janet Yellen. There'll be a big debate about Janet Yellen, but I somehow, I'm very sympathetic to her. Not because she was the first woman ever to have that job, but because she held the board together. There were very few contrary votes while she has been chair. And so we can debate whether she should have tightened earlier than she has tightened and so on, but it was against a backdrop that was very, very difficult. So, who should be chair? Well, I've just tried to indicate to you, just because you have an academically-trained individual, it doesn't make necessarily the best chair. And the Fed itself has had a checkered record of performance, at least according to my analysis. Who should be chair? I don't know. I would even go along with Janet Yellen for another four years, but that won't, I doubt that that will occur. And it's not clear that an academically-trained economist is necessarily the best one. And it's also very questionable whether a businessman would be the right individual. It depends on the temperament and the knowledge and the understanding and the fundamental views underlying that individual and the conviction with which he'll move, he or she, into that job. Oh, here comes Mickey Levy.

QUESTION: Henry, thanks for your remarks. Thanks for all the leadership you've provided. In your remarks, you talked about some of your concerns about financial markets, the institutions. You also talked about the increasing concentration in banking. And so let's say, let's say you became head of the Fed, okay, and I want to get back to what Bill Rhodes was getting into. If you were head of the Fed, what would be your top, say three, priorities on the regulatory front, in terms of capital adequacy or what would be your priorities in establishing the type of regulatory environment that you'd want to last for the next ten or twenty years?

HENRY KAUFMAN: Well, if I could have my druthers and be able to legislate what I'm about to say, I would be all in favor of it. I would go to Congress and say we have to reduce the size of institutions that are deemed too big to fail. If you're too big to fail, you've got to be small enough to fail. And I would prefer a structure in which the system is run along specific functional lines. If you're an insurance company, you're an insurance company. If you are in the business of making consumer loans, make consumer loans. If you are in the business of investment management, do investment management. I think that kind of a breakup of institutions to these kinds of functions, the regulators can know much more as to what's going on than in a conglomerate enterprise. We are trying to preserve conglomeration. The world is trying to preserve conglomeration. What we're doing is evident in Europe is evident elsewhere and so on. So we are moving more to continue to have institutions that are going to be under tight surveillance because of less conglomeration – institutions that are going to have conflicts of interest, institutions that are going to be too big to fail. And I think this is an institutional arrangement that puts the government into the business of finance and banking, unavoidably. And you can't say let's get the government out of rules and regulations, not when institutions are so large. And I think we're not moving in that direction and we're going to move towards large institutions, continue to have them, and large institutions now pride themselves of having recovered, having good profits, and so on. Well, why not, when you're living in an environment of low interest rates and all kinds of growth of financial assets. That's not the way to judge the performance of an institution. I think when you can segment them more, you better control them, and you better understand what's going on. That will not occur. So just forget what I said, but you asked me and I'm telling you.

QUESTION: Henry, I want you to look ahead to the next recession. Traditionally, in the United States, when we get into a recession, inflation is high, interest rates are high, and we get into a recession and the Fed reduces interest rates in order to stimulate capital spending. If that doesn't happen, and sometimes when it does happen, we have fiscal spending as we did in the 1930s to stimulate the economy out of the recession. Now, interest rates are low. If the Federal Reserve reduced interest rates from these levels, I don't think it would have much impact. We have a Republican Congress who is averse to fiscal deficits and unlikely to engage in a vigorous program of public spending. So my view is that we're going to defer the next recession as long as possible and do that by further monetary accommodation. But if we get into a recession next year or the year after, how do we get out of it?

HENRY KAUFMAN: Well, this is one of the reasons why the Fed, I believe, wants to move short-term interest rates higher yet than we have, because it wants to be able to lower those rates when we have a recession. So, if you can get the federal funds rate somewhere close to 3%, you have the opportunity to go back to zero. But if you stay at 1 to 1 ½%, you don't have the same punch. And I do think somewhere along the line, they're thinking about getting that rate up in the event of a, so that they're there to accommodate recession, and to go back to quantitative easing. And the Fed, more or less, indicated that it will go back to quantitative easing and buy securities again for its portfolio if there is a stalling in the economy and a recession occurs. But in the meantime, I think it will want to get the short rate up somewhat so it has the leeway to come down. Now, I don't think monetary policy has the capacity to induce a recession today. That's the strange thing about it. I didn't want to talk about that, but monetary policy hasn't got that capacity because it's leaning on these two variables which I mentioned and those two variables really don't allow it to really push the economy up. I think the next recession, when it comes, will be the result of some malfunctioning in the financial system because of the leveraging, the so-called off-balance sheet society, and so on, things that we don't know. That can happen. I don't know when it will happen, but it will be when you create more and more credit and allow more and more things to go in different directions, you ultimately induce financial risk. And when it will come, but I think it will come through the financial side. One more...

QUESTION: Dr. Kaufman, I'm the Consul General of the Netherlands. Talking about the Eurozone would take another breakfast session, but could you give your, you must have followed what happened in Europe after the Greek crisis. It was the Dutch Chairman of the Euro Group who was sort of coordinating a new set of arrangements and rules, you might be very much aware of, of course, the position of the central bank in Europe is in the discussion. Could you give your view as to the sustainability of the whole set of agreements that we reached in the Eurozone?

HENRY KAUFMAN: Well, I'm not an expert on the Eurozone – to say the least – but it's always puzzled me, the European arrangement is an arrangement without fiscal authority and only monetary authority, and that's a very difficult arrangement to have. Also, Europe right now, as it is constituted, is heavily dependent on Germany because it is the strongest of the countries. And Europe, as I indicated, is even more so. The financial institutions are really public financial utilities. I don't think there's an independent banking system in Europe at all. You have weak sectors in Europe, whether it's Greece or whether, there's the talk about Italy at times. We have weak sectors in the United States, so we have Puerto Rico and some other state has a problem, but it is the United States. It's far different than anything that you have in Europe. I think Europe will continue to muddle along under this arrangement and it will exist as long as Germany is willing to be there and reluctantly – and I say reluctantly – make some adjustment over time. When that problem will surface more so, it could be at the end of the current economic expansion, maybe it's in four, five, six years, I don't know, but I'm not an expert on Europe. Well, thank you very much. (Applause)

CHAIRMAN TERRY J. LUNDGREN: Thank you, thank you, Dr. Kaufman. That was excellent insights for sure. But I'm also particularly proud of our membership for your excellent questions, which I think makes this dialogue so interesting for our Breakfast Series. So, thank you again, Henry Kaufman. (Applause) And Henry will stick around and sign books for anybody who is interested. I just want to briefly run through our fall agenda. We have such a powerful agenda coming forward. Starting on October 16, Chancellor Hammond, the British Chancellor of the Exchequer will be at the New York Stock Exchange. And on the 17th, a breakfast with Larry Merlo, the CEO of CVS Health. Then on the 25th, we have Wilbur Ross, of course, the Secretary of Commerce will be coming on October 25th for a luncheon. We have a breakfast on November 3rd with Jan Smets, the Governor of the National Bank of Belgium. On November 6th, Bill Dudley, our former Club Chair and Chairman, of course, of the New York Fed, will be here. We have a lunch on the 15th of November with Ginni Rometty, who is the Chairman and CEO of IBM. Then on the 21st of November, we have a lunch with Doug McMillon, the CEO of the largest company in the world, called Walmart. And then on the 29th, our guest speaker is Randall

Stephenson, who is the Chairman and CEO of AT&T. And then a dinner on December 5th with Dr. Henry Kissinger. So a great lineup, I hope you'll all attend. In the meantime, again, thank you. Thank you Henry. Stick around if you'd like to have his book autographed. Thanks everyone.