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Henry Kaufman
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Webinar

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Henry A. Kissinger Center for Global Affairs
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Hello, this is Barbara Van Allen, President of the Club, and thank you for joining us today. We're going to get started in about one minute, 20 seconds. Just to mention that we have a little bit of technical difficulty for Henry's line, but he is here on the phone with us, so you will not be disappointed. Thank you.

Introduction

Chairman John C. Williams

Well, good afternoon and welcome to the 612th meeting of The Economic Club of New York, and this is our 114th year. I'm John Williams. I'm the Chair of the Club and President and CEO of the Federal Reserve Bank of New York. As many of you know, The Economic Club of New York is the nation's leading nonpartisan forum for discussions of economic, social and political issues, and our mission is as important today as ever as we continue to bring people together as a catalyst for conversation and innovation. A special welcome to members of The Economic Club of New York 2021 Class of Fellows – a select group of very diverse, rising next-gen business thought leaders and welcome to the graduate students from Rutgers University.

Now it's a pleasure for me to welcome our special guest today, Henry Kaufman. Henry is President of Henry Kaufman & Company, a firm established back in 1988, specializing in economic and financial consulting. For the previous 26 years, he was with Salomon Brothers, where he was Managing Director, Member of the Executive Committee, and in charge of the firm's four research departments, also Vice Chairman of the parent company, Salomon, Inc. Before joining Salomon Brothers, Henry was in commercial banking and served as an economist at the Federal Reserve Bank of New York.

Now the format today will be a conversation, and we're very fortunate to have Club member, Peter G. Peterson Distinguished Scholar at the Henry A. Kissinger Center for Global Affairs, and Senior Fellow at the Foreign Policy Institute, John Lipsky, doing the honors of moderating. We'll end promptly at 2:45 and, as a reminder, this conversation is on the record, and we do have media on the line. So without further ado, I'll hand the mike to you, John.

Conversation with Henry Kaufman

JOHN LIPSKY: Thank you, John. Thank you very much, and thanks, Barbara, for organizing another wonderful event for The Economic Club of New York. As you are probably well aware, the occasion we're celebrating is the publication of Henry's fifth book entitled, *The Day the Markets Roared*, which centers around a remarkable day in the history of financial markets, specifically August 17,1982.

Let me set the stage. U.S. GDP in 1982 fell by 1.8%. The previous year it had grown by 2.5% and the subsequent year, '83, it grew by 4.6%. CPI, consumer price inflation, in 1982 was 6.2% but the year before had been 10.3% on its way in '83 to 3.2%. The fed funds rate was 11 3/4% but as recently as early '81, it had been as high as 20%. And in August 1982, the ten-year Treasury yield was 12.8%.

That was the day that Henry published something that might be called the memo that was heard around the world, in which he changed views, noted that he was changing views on the outlook for interest rates and had become much more constructive, even bullish. This from the Chief Economist at Salomon Brothers, who had earned in earlier years the nickname Dr. Doom. Well, after the publication of this memo on August 17, equities rose by 5% on the day and on the subsequent month rose 15%, bonds rally, and this was repeated around the world.

So, Henry, congratulations on the book. Welcome to the Economic Club that you know well and have served, including as a trustee. But let me start by asking a few questions around that memo. How had we gotten ourselves in such a pickle, both economically and financially? Why were your views so unique on the run-up to that pickle? Why did you change your views? And were you surprised at the response around the world to your memo? Henry, the floor is yours.

HENRY KAUFMAN: Well, John, you asked a number of questions, and let me see whether I can answer them more or less. It was well known for a long period of time that I had been negative on the economy, on the financial markets, on interest rates, and so forth.

PRESIDENT BARBARA VAN ALLEN: Henry, could we ask you to get a little closer to the microphone please.

HENRY KAUFMAN: Is it better now?

PRESIDENT BARBARA VAN ALLEN: A little bit, as loud as you can please. Thank you.

HENRY KAUFMAN: Okay. It was known that for some time leading up to that moment of August 17, 1982, I had been very bearish for nearly a decade, pertaining to the interest rates, pertaining to the American economy. I was concerned about the inflation rate. And my views were well known through the public speeches, through the various memorandums that we published at Salomon Brothers.

Then, on that day, preceding it, I had been to Europe and I started to realize things were changing. The Federal Reserve had already lowered interest rates, the discount rate. And I came back from Europe and I wrote this memorandum over the weekend and then published it on Tuesday morning. It surprised the market for the very simple reason my views had been negative for so long and they were very well known. And it was to my surprise that the markets then rallied with such broad magnitude.

JOHN LIPSKY: So the response was surprising even to you.

HENRY KAUFMAN: Exactly, John. My views were well known. As you know, I wrote many speeches, distributed them publicly. We published a weekly *Comments on Credit*, where I expressed my views at least on the front page. And I was known after a while as Dr. Gloom or Dr. Doom, alternating with Al Wojnilower, who was considered Dr. Death. And so this negative view had been in the markets, well known, and I then changed my mind for reasons that the economy was slowing, that the Federal Reserve was lowering interest rates. And it ought to be recognized that the change of view occurred well after long-term interest rates peaked, which was in October 1981, when long government bonds reached the lofty heights of 15 1/4%.

JOHN LIPSKY: But you, of course, became famous for your bearishness in the runup to that date. What had you seen that others had missed in terms of the inflationary risks? And what did you see that others didn't see about the change in the economy?

HENRY KAUFMAN: Well, I think there were several events moving along. As you know, the inflation rate was moving up to the double-digit levels, but as you also know, Paul Volcker came in a year or two before as Chairman of the Federal Reserve and he became briefly a monetarist. He said in order to deal with the inflation rate, we're going to have to let interest rates go to whatever level is necessary.

And as a result, we had a big runup in short-term interest rates and long-term interest rates. And he did something that is really a prerequisite for central bankers to recognize if they want to deal with market conditions. You have to shock the market. It was a big surprise when on that Saturday night, which was called the Saturday Night Massacre, he pulled the plug on interest rates and let short-term rates go way up.

Also, there was another development in ___. In the 1970s, we still had Regulation Q ceiling, which is interest rate ceilings on time and savings deposits. Now, what was happening, as those ceilings were reached, it disintermediated the commercial banks and the banks that had time and savings deposits, and it put pressure on the banking system. If you really want to put pressure, the lesson from that is if you want to put pressure on the banking system to resist to what they're doing, create a vehicle that prevents them from doing it. In other words, higher interest rates doesn't prevent banks from making loans, but it is the tourniquet that prevents them from making loans that really helps achieve false purpose.

JOHN LIPSKY: So, in your book you point out one of the admonitions for success, both in research and in general on Wall Street and elsewhere is to focus on what others had overlooked. You didn't overlook the inflationary risks in the economy. As the Volcker Fed, through its actions – as you point out – in fact, conquered inflation and brought it down to levels that became more typical. But in the book you also noted that this ushered in what you call an era of financialization. Perhaps you can tell us a bit about what constituted that financialization? What of it was good and what of it was not so good?

HENRY KAUFMAN: Well, that is really a critical issue, that is the freeing of financial markets from constraints, so to speak, and the Federal Reserve removed the regulation through ceilings on time deposits, the financial markets innovated many new credit instruments. The financial markets became more globalized over time. That raises the issue how do you constrain a financial system? Can you really constrain financial entrepreneurs by raising interest rates and raising interest rates and so on?

And I will tell you a short story about this. I had been invited, the first, Citicorp, who had a very prominent Chief Executive Officer, who said you're blaming the banks here. And he said to me, Henry, you've got to understand that we know how to make loans and we know how to make credit judgments. And if interest rates go up higher and higher, we know how to pick the good ones from the bad ones. Well, the answer is he didn't know that and interest rates went higher and higher and the constraints didn't come on the banking system very quickly.

So we had an enormous change in regulation, in supervision, in new financial instruments coming to the fore and the internationalization of financial markets started to take off. New credit instruments such as securitized mortgages, which Salomon Brothers really introduced to the market. We were the innovators at the time for this. And so we moved money or credit instruments from the non-marketable side to become more marketable. And as a result, more pricing of obligations and the feeling that you would always trade the obligations regardless of whether interest rates went up or down. Of course, that isn't necessarily so, but that is the attitude that was created in the marketplace.

JOHN LIPSKY: Now, as you noted, in many areas that period of the 80s was when Salomon Brothers rose to a leading role, perhaps the dominant fixed income trading firm in the world and was noted for its innovations. On balance, were those innovations positive or did they create more risks than they should have?

HENRY KAUFMAN: Well, by making credit instruments more marketable, the perception was created that the risk was reduced because the presumption was you could sell out at some price. That was the assumption and that was the general belief.

The assumption was you could sell off at a price modestly lower than the last price if you wanted to get rid of it. Now that isn't really true. We can talk about marketability but there are many shortcomings to the concept of marketability.

But in any event, there were more credit instruments created, more credit instruments were deemed marketable and therefore were considered tradable and therefore were considered therefore more liquid than heretofore. And there were new credit instruments introduced to enhance that perception of marketability and increasing leverage. Now I would say that Salomon Brothers participated in the process, to say the least. We were a leading, if not the leading, fixed income house in Wall Street at the time and we participated in that process, some of which I opposed, but that's another matter. Give me the next question.

JOHN LIPSKY: Okay. One of the, of course, as you just alluded to, one of your concerns from that time was the confusion, as you always called it, the confusion between marketability and liquidity as you just described. You also suggested that the period that you called financialization involved concentration. Has that become a problem, concentration, in very large financial firms? Or is that an inevitable result of innovation?

HENRY KAUFMAN: It is a problem for the system. When you have a high degree of financial concentration, how can anybody really move a lot of securities? Let's assume there are only six or seven big financial institutions left. Now, if you would have one financial institution of the six or seven wanting to liquidate a quarter, 25% or 30% of its portfolio, the ___ going to ___ all of that without the assistance of the central bank. The higher the concentration of financial assets by that event, you reduce the marketability or transferability of securities in significant amounts.

So, in that sense, large institutions are being concentrated having a substantial portion of the total portfolio of a ____. They are really the victims of all this marketability. The assets are perceived to be marketable, but when it comes to sell a significant portion of that portfolio, to whom are they going to sell? To the remaining six or seven large institutions? Well, from my viewpoint, marketability declines with financial concentration and places an added burden on the central bank.

JOHN LIPSKY: So is it reasonable to say that one of the responses to the crisis of the late 70s, early 80s, the inflation crisis, was financialization leading to concentration? We then fast-forward to the global financial crisis and once again the result was new concentration. Is that going to happen yet again in the wake of this unprecedented...

HENRY KAUFMAN: I think that it's supported by the central banks because, from the perception viewpoint, it's easier to deal with a few financial institutions than with many institutions from a supervisory viewpoint. However, when it comes to a financial crisis, the problem in concentration adds a significant burden to the central bank. The market isn't allowed to function. The market, the central bank won't allow the failure of a large financial institution.

So what is happening is large financial institutions have become large financial public utilities. Now, from the viewpoint of the large financial institution, that's not too bad. It's not too bad because in good times large financial institutions can garner very significant profits. Take a look at the profitability report of the large banks over the last year or so. But when it comes to a deterioration in the situation of financial markets economy, the central bank won't allow any big institution to fail. That is a mismatch that's not good for a financial system. It's not good for an economy and really means that the central bank helps to support financial concentration.

By the way, you know the history, the central bank's current history as well as I do. I have never, never heard or seen a study by the central bank that discusses financial concentration. It would be the right thing to do because the central bank is the guardian of our financial system. So why not focus on it and let's hear what they have to say as central bankers in dealing with concentration?

JOHN LIPSKY: One of the hallmarks of your research from the start was paying attention to credit flows and issues of credit quality, especially with regards to American corporations and the development of the U.S. capital markets. One thing you have noted repeatedly is a tendency towards increased leverage and reduced concern of credit quality. As you point out, corporations today take profits and use them for dividends or buybacks, stock buybacks, rather than boosting ratings. Is that still a fair characterization? Is that likely to continue and is that a concern? And, if so, is there anything that should be done about it?

HENRY KAUFMAN: Well, that's a very interesting point which you make. As we all know, the credit quality of business corporations has deteriorated over the last couple of decades. The number of Triple A-rated, non-financial corporations, I think, is down to two. Back in the 1980s, there were over 61 non-financial corporations rated Triple A. I'm not talking about the banks, only non-financial corporations. There has been a significant increase in the corporations that are rated Triple B and below.

Now, why does that occur? I think it's partially due to the belief that the financial management of business corporations is recognizing that very few failures are permitted and allowed, that leveraging adds to the bottom line in many instances and it's considered a moderate risk-taking. I haven't heard of any financial officer of a non-financial corporation say my object is to preserve a Triple A, Double A or A rating of my corporation. No.

Leverage is considered one of the great beneficial attributes of modern finance. And it is considered that way because a central bank will not allow the process of failure to move along and so that allows for the consolidation in business corporations. And I think, think about it this way, we are starting presumably another economic expansion now and we're entering that expansion with the credit quality of business corporations lower than it was in the previous economic recovery and at that time, that was lower than the previous economic recovery. There has been a steady deterioration in the quality of corporations and that is not being reversed.

JOHN LIPSKY: So far, investors are rewarding corporations with extremely low rates and very favorable spreads. In the runup to August 17, or really in the 70s, investors had been far too sanguine about inflation risks. Is there a parallel issue here that investors are far too sanguine about credit quality and the vulnerability to higher rates and higher spreads as the economy re-accelerates?

HENRY KAUFMAN: There certainly is. I think we should think about it in these terms. Having gone through this pandemic, I think the Federal Reserve clearly indicated that it would try to prevent significant failures among financial institutions, but then also among business corporations. The central bank even indicated it would support the commercial paper market of business corporations. While it didn't have to take down much of that stuff, but by merely indicating it would support, that was a signal that business corporations could move ahead with the same practice as before.

So we are entering this next economic recovery with corporate balance sheets not as good as they were where we started the previous economic recovery, not as good as they were 20 years ago or 30 years ago. And there is no financial officer that I have talked to or I've read about who said my objective is to improve the credit position of my corporation. Now, the objective tends to be to use maximum leverage because history has shown leverage pays in most instances and interest rates are very low, and why not go ahead and borrow. So we begin in a distorted financial system from earlier periods.

JOHN LIPSKY: And I think you discussed in the book the issue of the relationship between credit quality and Federal Reserve independence in the sense that, I guess I'm putting words in your mouth, what used to be called the Greenspan put is really global central bankers put. Is that a fair characterization? And if so, is that leading us into trouble or is it just a fact of life?

HENRY KAUFMAN: I think, now it's become a perception that central banks will not allow significant failures. In the past, there were failures. There were Chapter 11 settlements and so on. So you began economic expansion, new economic expansion with some cleansing of balance sheets, some cleansing of business balance sheets. In this movement so far and going out now to the end of the year and next year, there hasn't really been any cleansing of business balance sheets. There's been an improvement in profitability perhaps here, but that there's been major movement to recast liabilities, that's not the case. Leveraging is a positive concept when it comes to finance, both in the financial sector as well as in the business sector. And that's a different attitude.

I remember in the early post-war period, liquidity was the kind of assets that you had on the balance sheet, you know, commercial paper, Treasury bills and so on. Liquidity has changed. The attitude now is my liquidity is my capacity to borrow from the banking system and to issue obligations into the market. So it changed from an asset-based attitude to a liability concept, from a conservative position to an aggressive position.

JOHN LIPSKY: So has the associated explosion in the Fed's and other central banks' balance sheets represented doing the right thing in an emergency or is it harbinger of a sense of loss of independence of central banks that will have broader impacts as we move forward?

HENRY KAUFMAN: Well, I do think there is a loss of independence. And it's always been a question of how independent are central banks really? They're somewhat quasi-independent as such. And usually that independence depends on public support rather than on necessarily the leadership in Washington politically. But the central banks, by doing more and intervening more established their presence in the system, in the economy, in the financial markets, and therefore, it's going to be very difficult for any central bank to move back to a quasi-independent period. I think there is a linkage today that is tighter between central banks and government than it was 10 years ago or 20 years ago.

JOHN LIPSKY: One of your concerns from, I think, early in your career that has been persistent is about the effectiveness, not just of central banking but of financial regulations. You have been a, I think it's safe to say a critic of the extremely complex, multi-layered and overlapping system of regulatory, financial regulatory bodies in the U.S. Has that improved? Has that changed? Has it gotten worse? Or have the circumstances made regulation more important, but no more effective?

HENRY KAUFMAN: Well, let me put it this way. The regulations that were in place have allowed a massive financial concentration, whether it comes through deposit institutions, which become conglomerates, or whether it's other financial institutions, the share of the market that they control has gone up and up. I think that is not good for a free market capitalistic system. It's making it easier for a central supervisor to supervise when there are fewer than when there are many, but that's a different issue.

Now, I do think that when it comes to supervision, as I said before, the central bankers would prefer to deal with fewer institutions rather than with many institutions. I think that is wrong. I also said, or indicated, as before, central banks have never spoken up on financial concentration and what it does to a capitalistic system. The central banks are supposed to be the guardian of the financial systems, whether it's in Europe or here or Japan. Never. Now, I think that is rather shortsighted, and I think it is a significant failure of central banking.

JOHN LIPSKY: The creation post-financial – the global financial crisis – of the Financial Stability Board represented an attempt to promote the creation of a level playing field internationally between financial centers as well as to improve the effectiveness globally of financial regulation. Has there been progress or do we have a long way to go before we get even close to those aims? Or is that really just a pipedream?

HENRY KAUFMAN: My impressionistic feeling is that we have a long way to go. Whatever is done in that area is more supportive of financial concentration than financial diversification. Now, I realize financial diversification is more difficult to oversee, but financial diversification is really part of a competitive, capitalistic system. And the more concentration, the less we have of a capitalistic system, and the more we have of supervision and controls. And we haven't made any real inroads into that.

Central banks, I believe, prefer to deal with large institutions. They don't like to deal with smaller institutions. I know here in the United States we say, politically we say a lot about supporting smaller financial institutions, but I think smaller financial institutions maybe have 15 to 20% of the financial assets of the United States. All the rest is divvied up by a relatively few. And that is not the task of a capitalistic system. It's unfortunate that central banks prefer to deal with the big ones, not with diversity of the institutions.

JOHN LIPSKY: Thanks very much. I suspect that the audience here will feel cheated if I don't ask you about your opinion regarding the Fed's latest changes to its operating procedures and its approach to policymaking, moving to average inflation targeting – whatever that turns out to mean. Is this a positive? Is it inevitable given the uncertainties and uniqueness of the current situation? Or does it represent a challenge?

HENRY KAUFMAN: I think it is, the latest move by the Fed and policy approach tends to give much more weight to the immediate political needs of a society rather than the intermediate and long-term needs of a society. The idea that the central bank will tolerate inflation, even if it goes to 2.5% for a while, when we get to 2.5%, the question is what will the Fed really do at that time?

I don't think setting targets on the inflation rate is the correct way. I think the target should be, the central bank should be much clearer and say we are not going to allow much inflation, period. The sanctity of the financial system depends on financial stability.

Rising inflation creates instability in the system. In a way, it seems to me that the central banks are much more a captive of the central government today than they were years ago. Now that was always the case in Japan, to some extent certainly in Europe, but there was a quasi-independence between the central bank here, the Federal Reserve, and governmental policy. I think that gap has been narrowed and it is very difficult from here on for the Federal Reserve to reestablish its quasi-independence. I think that's unfortunate.

I worked at the Federal Reserve many, many years ago for four or five years and it's a wonderful institution. But one of the problems, I think, in central banking is that there may well be too much agreement within each of those institutions rather than a certain amount of disagreement, which I think would be healthy. The tendency is people who disagree within the central bank leave, but I think there ought to be more air opened up here so that there can be an element more of disagreement.

It's very interesting for me to watch over the last year or two as I read the minutes of the FOMC and I don't see a negative vote there when it's released. At least a number of years ago we had some dissension, but not today. I think that kind of conformity is not good for the system.

JOHN LIPSKY: Now the Fed says it's watching closely inflation expectations. Is what you're advocating a more, let's call it heterogeneous approach, a more rules-based approach or what?

HENRY KAUFMAN: Well, I think an indication to me of the willingness to tolerate somewhat more inflation in the interim. Now the Fed and many others participate from a bulge in the inflation rate because of the pandemic, once we work our way out of the pandemic, the assumption is the inflation rate will subside. I don't know of any historical period where you can really match this up in a very concrete way. I would think once you begin to allow the inflation to feed and be moved to 2.5% and the system is opened up more as we go into next year, I suspect the Fed will be behind the inflation curve.

JOHN LIPSKY: That's a widespread expectation. But let me then jump, as we're running out of time, to a topic I also think the audience will expect me to put to you. Think back, of course, in the runup to the famous August 17 memo, you had put together and subsequently the leading, pioneering and leading and innovative economic financial sector research effort. What are the principles to beat that success today? And are they being implemented like in your day?

HENRY KAUFMAN: Well, you ask a very tough question. You were a member of that team, and I was very fortunate to have been able to attract you to it. In research, it requires independence in research. A research effort in a financial institution, whether it's a commercial bank or whether it's a securities firm requires really that the research is not beholden to trading, it's not beholding to investment banking, it's not beholden to the international department, but that it is independent. And what it wants to say, it is allowed to say. That is a very difficult thing to achieve, at least today. I was very fortunate.

We developed the fixed-income research department. I took over all of research, but I was a member of the senior management at Salomon Brothers. And therefore, there was someone in senior management that spoke to the role of research if any problem came up. Research did not report to somebody who was in charge of sales or in charge of investment banking or in charge of trading.

Research, I was the head of research and I was a member of the senior management. And occasionally, problems came up where the researcher would say something about some investment banking client, but I was able to limit that confrontation. And it is very important that if you're going to have independent research, that independent research has to be represented in the senior management of that firm. If not, it is very difficult to remain there with an independent voice as a researcher.

JOHN LIPSKY: Henry, on that note, thank you. Thank you very much. I can't resist, it's baseball season. The All-Star Break is coming up. Henry, as you know, you're an All

Star among All Stars and the unanimous choice for the Hall of Fame. For those who had the good luck to be on your team, you were our Sandy Koufax or, I guess in current parlance, you were our Jacob deGrom. We relied on your leadership, intellectual honesty, personal integrity, and we can see that all still vibrant today. Thank you very much. John Williams...

CHAIR JOHN C. WILLIAMS: Well, thank you so much, Henry and John, for sharing your valuable time and insights with us today. We truly appreciate it. Now I'm pleased to report that we have many great speakers lined up for the summer, and as always, we encourage you to invite guests to our events.

Next up on June 22, we have Henry Louis Gates, the Alphonse Fletcher University Professor and Director of the Hutchins Center for African and African American Research at Harvard University and Emmy Award winner for his PBS series, Finding Your Roots. And on June 24th, we have Wes Moore, former CEO of Robin Hood. And then on June 28th, we have Charles Tribbett, III, the Vice Chairman and CEO of Board Advisory Partners at Russell Reynolds. And then on June 29th, we have Betsy Cohen, the Chair of FinTech Masala. And then on June 30th, we have a Member Only Conversation on Women in Business. Now that's just June. We're going to have many more speakers for the rest of the year so please keep watching our website and your emails from us about future events. And if you joined as a guest today and you'd like to become a member, please email the Club at the address on the screen.

Now finally I'd like to take a moment and recognize those of our 336 members of the Centennial Society joining us today as their contributions continue to be the financial backbone of support for the Club and help enable us to offer our wonderful, diverse programming, both now and in the future. So thank you again and please stay healthy and safe.