By your own account, the financial crisis has reached a critical point. How did this happen?
What we are seeing is the culmination of economic imbalances, a succession of financial bubbles and crises that have been building for years. This was all complicated by undue faith in ‘financial engineering’, which attempted to rely on mathematical models to measure and control risks in markets that respond to human and not physical phenomena. As a result, confidence in financial management has been badly eroded.

On the bright side, there is good reason to believe that the means are available to turn the tide. There is clear recognition that the problem is international, and global coordination and cooperation is both necessary and underway. The days of finger pointing are over, and the groundwork can be laid for reconstructing our financial and regulatory systems from the bottom up. Recent U.S. legislation has provided authority for large-scale direct intervention by the Treasury in the markets. None of this is easy; some of it poses risks for the taxpayer, and all of it is decidedly unattractive in the sense of official intervention in what should be private markets that can stand on their own feet. Unattractive or not, the point is that the tools required to restore and maintain functioning markets are at hand.

To that end, the immediate need is determined, forceful and persistent leadership. Both the public and private sectors must be involved, and in my view, the recent extraordinary interventions by the government (and taxpayers) should be ended as soon as possible. Think of it: we are now in a government-dependent financial system. I never thought I would live to see the day.

Which key economic imbalances were ignored leading up to this crisis?
The big imbalance that led to the crisis, I believe, is reflected quite directly in the U.S./China relationship, although I could extend this further than those two countries. We’ve had a strongly consumer-driven economy in the U.S., and with things seeming to go well, consumption and spending have exceeded our production capacity. At the same time, that consumption was satisfied by borrowing from abroad, because the productive capacity of China exceeded what its people wanted to spend internally. Basically, China lent us the money to ‘hang ourselves’ with. It was all very comfortable while it was happening, but it couldn’t go on forever, and it led to some extremely weak credit-extension policies, symbolized by so-called ‘subprime mortgages’.

You are widely regarded as a Wall Street skeptic. What are its key problem areas?
I think it’s fair to say that modern Wall Street – over the last 20 years or so – completely lost any sense of ‘reasonable restraint’. The advantages of risk-taking and high-compensation practices seem to have overwhelmed any natural instincts toward prudence, and what we are now seeing is the result of that.

There has been public outcry concerning the bonuses being paid to employees of bailed-out institutions. What is your take on this situation?
Compensation practices had clearly become excessive, and in turn were undermining a prudential sense of restraint in the
markets. When some of the big financial firms got into trouble and had to rely upon government assistance, it was both inevitable and appropriate that their compensation practices would be looked at. Having said that, it is a very difficult area to come to grips with, and one would hope that the market, institutions and directors will finally reach the conclusion that compensation practices have to be reined in.

You have said that “both the market and the political system will always try to game the Federal Reserve and find ways of getting around restraint.” What are the implications for the Fed’s role going forward?

I could extend that comment to the tendency of the market to try to get around any regulations, whether they come from the Federal Reserve or not, and to do what’s called ‘regulatory arbitrage’ – moving from a tough regulator to a lighter regulator (or no regulator) if they can. Nobody likes restraint, so when the central bank tries to restrain, the natural instinct is to find a way around it, to find substitutes that are less directly under central bank influence. This raises questions for an overhaul of the entire regulatory system, and there will be implications for the Federal Reserve’s role. The Fed has been undertaking a lot of unorthodox policies in an effort to stabilize the current situation, and this raises questions, particularly with its huge commitment of public money. It may be inevitable that the independence that has been so sacred to that institution might be reviewed or modified, and their regulatory responsibilities placed elsewhere.

None of these concerns are new, by the way. Back when I was Fed chairman, I can remember tossing and turning at night thinking ‘whatever we do, the banks will try to game us’. At the end of the day, could they use the same reserves to satisfy our requirements and the reserve requirements in Asia and England? Would the result be an inability to control the effective money supply through U.S. reserve policy? Now the regulatory responsibility is at issue, with respect to how globalization affects policy transmission.

Your strong stand against inflation in the 1970s under President Jimmy Carter laid the groundwork for 20 years of growth. Will inflation play a role in the current scenario?

It is not the worry immediately, given the decline in the economy, the distortions in credit markets and the lack of free-flowing credit. But plainly, as the economy recovers – and it will recover, although I can’t predict the time period or the strength of the recovery– the Fed is going to have a great challenge in restraining the flow of money and credit to what is appropriate to maintain stability. So we’re talking about another potential problem maybe two or three years out.

You have discussed one possible vision for the future, which involves a two-tiered financial system. Please describe it.

I believe that the basic commercial banking business, not very narrowly defined, is and should be at the heart of the system. It’s been protected; it will continue to be protected, not just by regulation but by access to Federal Reserve facilities, by deposit insurance. The banks carry responsibilities beyond that of ordinary market participants. They control the payment system, they are a custodian for money; they provide credit for businesses, households and governments, and they also provide credit for other financial institutions. Recent developments aptly reflect the fact that commercial banking is the heart of the system. So my thought is that their activities may be somewhat restricted to concentrating on all the things they do for customers – households, businesses or otherwise – whereas more speculative, capital market-driven activity ought to be largely the province of outside the banking system, which needs to be less-closely regulated.

The current crisis has implications for the future of market infrastructure, accounting and credit rating agencies, amongst other things. Within which area do you foresee the most transformational changes coming?

I think there will be a lot of changes, including the ones you mention. Certainly, credit rating agencies need a review; accounting is getting a review; and the world of derivatives and particularly credit default swaps needs a review. But more generally, I think the role of banks and who supervises them is going to be at the heart of the reform.

Is more regulation part of the answer?

Stronger regulations are definitely needed to protect the world economy from such future shocks. I am concerned about the amount of power central banks, treasuries and regulatory agencies have acquired while trying to contain the meltdown. The central bank – not just in the U.S. – out of perceived necessity is taking on a role that is way beyond what it should normally be. Looking ahead, major banks should be more tightly controlled and less able to make the sort of risky bets that led to the current debacle. There should also be more oversight of some kind for hedge funds, equity funds and the remaining investment banks. People argue that this will stifle innovation, but ‘innovations’ like asset-backed securities and credit-default swaps have brought few benefits. Most would agree that this ‘bright new financial system’ has failed the test of the marketplace. Let’s face it, the most important innovation in banking for most people in the last 20 years is the automatic teller machine.

You have discussed the possibility of a world currency. How far off is it?

I think the long-term logical result of a globalized financial system – extending far beyond my lifetime, but perhaps not yours – is a world currency. With a world currency, we would not have a lot of independent central banks. I haven’t figured out what the one remaining central bank would do, what instrument it would use or how it would be controlled, but I think that is the direction in which economic and financial logic guides us. However, I suspect there will be a lot of way stations along the road. For example, I’m pretty sure we are going to move to some regional currencies, and we will almost certainly have many fewer national currencies. Will we have a few large central banks centered in big countries and monetary centres, each with some influence, but with their inter-relationships guided, influenced and affected by the exchange rate
between them? Such a structure leaves open a lot of questions about the organization of the world economy in ways unrelated to central banking. Nevertheless, if the net result of that scenario would be widely-fluctuating exchange rates between major centres, that would not be conducive to the kind of multilateral open trading system and political harmony that we like to associate with the benign leadership of the U.S. and its partners during the post-war period.

Going forward, what is your advice for consumers?
I can’t speak for Canadians, but Americans have been living above their means for far too long. Bringing consumption back into line with income will not only put a crimp (but a tolerable crimp) on individuals and families, it will also require major readjustments in the global economy, which has relied on the U.S. as a ‘consumer of last resort’. We have a tough period ahead of us. But when we dealt with inflation in the 70s, it laid the groundwork for 20 years of growth. I’d like to see that happen again, as a result of a different kind of adjustment.

Any advice for market participants?
There is, and must be, recognition of the essential role that free and competitive financial markets play in a vigorous, innovative economic system. There needs to be understanding, in that context, that financial ups and downs – and crises – will be inevitable, even with responsible economic policies and sensible regulation. But never again should so much damage be risked by a financial structure so fragile, so overextended and so opaque as that of recent years.

What are you most proud of when you look back on your career?
I actually take great pride in working for the government. I always thought it was important to view my government as a ‘client’, to which I owed a high degree of responsibility. After 40 years in public service, I still think that. What has been discouraging is that over the years, the basic idea of the value of public service has been, to some degree, diluted and lost. I do believe the current crisis is going to reverse that a bit. I don’t know how true it is in Canada, but certainly in the U.S., young people are becoming more interested in government and are less ‘starry-eyed’ about making a living on Wall Street.

Paul Volcker is chairman of the Economic Recovery Advisory Board under U.S. President Barack Obama. He served as chairman of the Federal Reserve under Presidents Jimmy Carter and Ronald Reagan (from August 1979 to August 1987). This interview took place on April 28, 2009.