Interview with Federal Reserve Bank of New York President William C. Dudley and CNN's Ali Velshi[1]

Interviewer:
Thanks for joining us.

William Dudley:
Great to be here.

Interviewer:
One of the things we've looked at a lot through companies that have done well, through housing, ancillary suppliers of the housing industries, housing seems to be the gold lining around the cloud, the economic cloud. Why -- what are you seeing and why do you think so?

William Dudley:
Well, housing is gradually doing better. I think it's doing better because the overhang of inventories has worked off. And it's doing better because mortgage rates are very low, home prices have come down, and that's made houses a lot more affordable. So we're definitely seeing the beginnings of a recovery in housing. Now, with that said, housing's still at a very depressed level of activity, so there's a long way to go until we can get back to anything that resembles normal.

Interviewer:
A lot of the support of the housing industry has obviously come from keeping interest rates as low as they've been. And there are people who complain that we're building up asset prices on the backs of an unclear economy because of all the assistance coming from central banks. What's your view of that? I mean, what's your view of the argument that perhaps the Fed should just pull out of this business and let interest rates go to where they otherwise would be and let the housing market figure itself out?

William Dudley:
Well, there's no sign of housing becoming overly exuberant yet. I mean, we're way far away from that. We're just on the very -- you know, the patient has left the hospital and is now convalescing at home. So there's a long way to go before we have to get worried about housing overheating.

Look - the Federal Reserve, basically, is responsible for setting interest rates in the economy, so this idea that somehow the Fed can sort of remove itself and let interest rates be whatever they're going to be, that's just not a credible thought.

Interviewer:
What is the -- what is the exit strategy from the degree of involvement that the Fed has got in the economy at the moment? In other words, if things were -- what does normal look like?

[1] This transcript has been edited for grammar

William Dudley:
Well, I think that we said -- we published a statement last January that explained how we would exit when the time comes. If we actually do see sustainable improvement in the economy -- you know, substantial improvement in the labor market outlook, then we will gradually start to step back. But we've said very clearly that we expect to be accommodative for quite some time. And the reason for that is we're hitting our inflation target pretty close, but we're missing substantially on the unemployment rate [side] of our objective.

How will we withdraw? Well, obviously, first, the asset purchases will come to an end. Then after some period of time, -- we will stop reinvesting maturing assets. Short-term rates will rise. And then eventually, after that, we probably would start to sell assets and return the Fed's portfolio to an all-Treasury portfolio again. But this would stretch over a considerable period of time.

Interviewer:
When you say short-term rates will start to rise, obviously the fear of critics of the degree of involvement that the Fed has had is that short-term interest rates will rise too fast and too much. What's -- what do you -- what do you see -- how do you see the world unfolding in terms of interest rates?

William Dudley:
Well, it's really going to depend on the macro economy, so to say today how we're going to exit, the speed at which short-term rates are going to go up, it very [much] depends on the economic outlook. Obviously, we're going to do it in a way consistent with achieving our dual mandate. What's our dual mandate? Maximum sustainable employment consistent with price stability. So we have two objectives: get the unemployment rate down as low as we can, but not in a way that generates inflation.

Interviewer:
When you measure maximum sustainable unemployment, are you taking into account recent pretty good, you know, valid criticisms of whether or not we should be tying any decisions to the unemployment rate? I know, at the Fed, you look at a whole lot of measures of employment, of hours worked, and wages, and income, in addition to the unemployment rate. How dependent are you on the unemployment rate?

William Dudley:
Well, the [unemployment] rate is just one indicator, and the rate can be misleading at times because people get discouraged from looking for employment; and if they stop looking for work, they're not counted as unemployed in terms of the unemployment rate. So we would look at a broad set of measures. The unemployment rate would be one, but how many people are actually in the workforce actively looking for work would be another.

Interviewer:

Let's talk about quantitative easing. You've been supportive of Chairman Bernanke, even in the face of dissent from other Fed governors and presidents. What's your -- what convinces you that this methodology is working in the face of a lot of, again, a lot of criticism that maybe this isn't where the Fed should be?

William Dudley:
Well, the first thing I would say is the degree of dissent, I think, is overstated. You saw at the last Federal Open Market Committee meeting, we met September, and the vote was 11 to 1; so there was only one dissent among voters at the meeting. So I think there's a lot of support for what we're doing. I think, you know, quantitative easing, we're doing it because we're at the zero lower bound. In other words, we can't push the federal funds rate that we control much lower. And so we have to look at other policy tools that we can use to stimulate the economy. We've come up with a series of tools. One tool is talking about how long short-term interest rates are going to be low. Another tool is actually buying longer-term duration instruments in the market to try to push longer-term interest rates down, and thereby provide support to the housing market, provide support to the stock market, provide support to the corporate debt markets. And all those things ease financial conditions and they help support economic activity.

Interviewer:
Let's talk about the fiscal cliff. There are some who say that the fear of the fiscal cliff is overstated; that they're not going to do it, they're all get together, that Congress will make the right decision. And, you know, in the past, sometimes at the 11th hour, they have done that. But it's worrisome. How much damage could it do if this isn't fixed properly?

William Dudley:
Well, I would say it's worrisome even today because I think people's uncertainty about how the fiscal cliff is going to be resolved is actually having its effect today on hiring and investment. So it's hurting the economy as we speak. Now obviously, we don't know exactly what's going to happen post-election. I mean, we don't even know what the results of the election are going to be. And one would think that prudent policymakers would avoid just sort of plunging off the fiscal cliff on the other side.

Interviewer:
One would think and one would hope.

William Dudley:
But there is uncertainty created by that, and that uncertainty -- I think the important thing is that uncertainty's hurting the economy today.

Interviewer:
Play that out. Play that out in terms of where you think psychologically that affects investment and it affects purchasing decisions.

William Dudley:

We talk to a lot of businessmen, small and large, and we hear this over and over again: "I'm just sitting on the sidelines waiting to see what happens in terms of how the fiscal cliff is going to be resolved." Now, if you talk to people, I think the vast majority of people don't think we're just going to plunge over the fiscal cliff with an incredible tightening of fiscal policy, which would probably push the U.S. economy right back into recession. Most people don't think that we're going to have that outcome. But the risk is there, and people want to wait to see how that risk is resolved.

Interviewer:
Let's talk about supervision of banks. We're not where we were, thankfully, four years ago. We don't have a lot of the dangers, and we probably can't get ourselves into a situation as bad as we were in four years ago. What needs to change in terms of supervision of banks and the responsibility that banks need to take? We've seen regulations introduced, there have been criticisms of those regulations, there have been difficulties in implementing them. What's your sense of the best thing we can do right now to make sure that this banking system is safe, regardless of what happens globally?

William Dudley:
Well, I think the thing we've already done is very substantive -- we've raised the capital requirements for the large banks substantively, and both in terms of the amount of capital and the quality of capital. So they have much bigger buffers to take shocks than they did back in 2006, 2007, 2008. The second thing we've obviously worked on a lot is risk management. We want to make sure that they have robust risk management practices, robust governance practices. We've forced a lot of the institutions to raise their liquidity buffers substantially. And we're also working on the other end: resolution. What happens if a big bank gets in trouble? We want to be in a situation where a big bank gets in trouble, it can be allowed to fail. We really want to end "too big to fail."

Interviewer:
When you talk about reserve requirements, are you satisfied that there's enough of a sense of an adequate standard for how banks determine their reserves?

William Dudley:
I think the standard is pretty well-defined. The question is, is it forward-looking enough? In other words, is it too much based on where we are today, as opposed to what the risk for the outlook are going forward? One thing we've done to address these issues is do stress tests. So we basically give the banks a very inauspicious economic environment, and sort of say, well, what does this mean for the bank in terms of the kinds of things that this would do to their revenue and in terms of credit losses? And then make sure that they have an adequate capital to actually handle a very difficult stress test.

Interviewer:
And yet there was criticism of that, saying the situation -- the inauspicious environment that you presented was too dire, that that's not going to happen.

William Dudley:

Well, we want to have a stress environment that's sufficiently severe so you're highly confident that banks can get through that environment.

Interviewer:
So for all that you've done, all that the New York Fed has done, the Federal Reserve has done, that everybody's tried to do to make sure we never repeat the fall of 2008, what -- where are we now? Because there's so much criticism that we're still unsafe. Why are we still, four years later, still unsure?

William Dudley:
Look, I think we're in a much better place than we were four year ago; so I wouldn't characterize where we are today as unsafe in any way. I think that obviously, you know, a shock that's big enough, you know, an asteroid hitting the earth, I mean, obviously, there's shocks of such big magnitude that you would be in trouble under any conceivable scenario. But we're in a much better place. Do we still have more things that we need to do? Absolutely. Resolution is something that's still a work in process. Doing it for a large banking institution that spans many multiple jurisdictions, geographic regimes, and legal systems is challenging; so we have a lot more work to do in that matter.

Interviewer:
I'll take the criticism that “unsafe” may be the wrong word. You've used the “car stuck in the mud” analogy for the economy, which is broader than banking obviously and broader than the financial sector. Given -- let me rephrase the question. Given that -- given everything the central bank has done, given everything that the government has done, should we have more traction now than you would have thought?

William Dudley:
I think that the recovery has been slow and it’s been disappointing relative to the expectations. But you have to ask yourself, “What were the reasons for it?” And I think there are lots of different reasons. One, we’ve had a number of shocks to the economy. You know, the euro zone, for example, is a negative shock to the global economy. But I think we've also maybe underestimated some of the structural problems with the economy. For example, the housing sector has been hurt by the fact that it's hard for people who have homes that have fallen in value to refinance their mortgages, and there's some structural things that we could probably do there that could make it easier for them to take advantage of lower interest rates.

Interviewer:
When -- if somebody comes to you and says, “Because we have to take hard looks at everything, let's look at the Federal Reserve. Let's look at the role of the Federal Reserve.” Some have called it an audit. But let's just say, “Let's look at it, and its usefulness, its efficiency, and those things that can be fixed.” What would you tell them?

William Dudley:
I think that the Fed did a very good job through the financial crisis. I think we intervened very forcefully in terms of interventions to save the financial system. Because if the

financial system collapsed it would have wrecked Main Street. Not to save particular institutions, that wasn't [the goal]-- the goal of policy was to save the financial system because that was essential to ensure the flow of credit to businesses and households. I think we've been very aggressive on the policy side, the monetary policy side in trying to provide support for the economy. Now, I think with the benefit of a hindsight maybe we could have done even more. And that’s really why we did more at the last FOMC meeting. We were unhappy with the fact that we weren't growing fast enough to drive down the unemployment rate quickly. But I think, generally, I think we get a reasonable grade. Do we know, you know, are we perfect, are we omniscient? Absolutely not. We learn by doing and as we get more information we try to recalibrate what’s the appropriate policy course.

Interviewer:
And do you -- do you feel there's been some mission creep by Congress not doing everything it could have done or should have done, that now it falls to --

William Dudley:
No, not really.

Interviewer:
-- the Fed to do more?

William Dudley:
Not really. I think we have to take the world as it is. Now, obviously there are things that could be done in Congress and the administration that would make our lives easier. So the example of resolving the fiscal cliff in a way that puts the budget trajectory of the U.S. on a sustainable basis long-term, that gave people confidence about what tax and spending policy was going to be long-term. That would be helpful to us because it would reduce uncertainty. But at the end of the day we have to take the world as it is, not the world that we want it to be.

Interviewer:
How would you -- if the same person were asking you about what we can do to make the Fed better -- in the case of the New York Fed, you're here on Wall Street right amongst everybody you regulate. How do you assure people that you're not unduly influenced by those organizations? You said that we had to take the steps that we had to take in 2008 to save the financial system so that Wall Street -- so that Main Street just got saved? But there are still some who say, “But really, you saved Wall Street first.”

William Dudley:
It wasn't our choice, you know, it wasn't a choice of don't save Wall Street but save Main Street. If we hadn't saved parts of Wall Street, Main Street would have been ruined. So it's very important that people understand why we do what we do. And I think we have to be better about articulating the motivations for our actions. I think historically the Federal Reserve was a little bit, you know, we'll do what we think is the right thing and our actions will speak for themselves. But sometimes I think it's important that we

actually get our own narrative out and explain our actions.

Interviewer:
Let's talk about Europe for a moment. For all that we're talking about, the fiscal cliff here in the United States and general economic outlook, the fact is Europe remains a bit of an unknown out there, what -- the effect that it's going to have on our financial sector and our economy?

William Dudley:
It's definitely a downside risk to the economy if it were to go badly. I think the good news, though, is I think the European leadership is very much committed to European Union. Obviously very difficult politically, 17 different countries -- I mean, we had enough trouble on our own just passing the TARP legislation --

Interviewer:
Right.

William Dudley:
-- here in the United States. So I think it's going to be a long, complicated process. But they are moving in the right direction. I mean, I think you see that there's a determination to move towards a more, you know, European banking regulation. I think there's, you know, desire to move to greater fiscal integration over time. I think that they're in the process of sort of building out the roadmap of what that will look like.

Interviewer:
Do they have the time?

William Dudley:
Well, I think they have some time. I don't think they have an indefinite amount of time. And I think the, you know, the ECB has been very -- the European Central Bank has been very helpful in making it very clear under what terms that would they intervene. And that's actually provided a backstop to the system which has actually given them a little bit more time.

Interviewer:
You must talk to your colleagues over there. And I mean, do you ever just get up and say, "Guys, what's taking you so long?"

William Dudley:
Well, I --

Interviewer:
"Can't you just do this a little faster?" We all know kind of what the recipe's got to look like in the end.

William Dudley:

Well, I think this is the problem having 17 different countries having to coordinate policy. I mean, you know, sort of the joke is like, "Okay. I got some really good advice for the Europeans. Who should I call?"

Interviewer:
[laughs]

William Dudley:
Who is that one person that can actually get it done? Now, obviously for the European Central Bank, it's Mario Draghi. But if you're talking about how this gets worked out broadly, there's lots of different players.

Interviewer:
Let's talk a little about where the economy is going. Where do you think economic growth is going in the United States; unemployment and economic growth?

William Dudley:
Well right now we're growing at about 2 percent for real GDP at an annualized rate plus or minus a little bit. And I think what's going to happen is as we get into 2013 and beyond, we're going to see a gradual strengthening. And the reason -- this is assuming that the fiscal cliff and the euro zone --

Interviewer:
Right.

William Dudley:
-- get resolved in a good way rather than a bad way. But I think underneath the surface the economy is actually getting healthier. The banks are in much better condition in terms of their capital and their ability to support lending. Household balance sheets have been repaired considerably compared to where we were back in2008, 2009. And I also think, you know, the housing sector which we talked about earlier, the housing sector is on the mend, and so you're actually seeing a rebound not just in housing activity but also in home prices. And that improvement in home prices then also supports household wealth and makes them feel more comfortable that their biggest asset is no longer falling in value.

Interviewer:
How serious do you see impairment to lending right now?

William Dudley:
I think it's mixed. I think if you have a good credit history -- you're a big business or you're a household with good credit history -- , I don't think you have any great problem of obtaining credit. If you're a smaller business or if the deep downturn that we had in 2008, 2009 hurt your credit history, then I think you'll still have some issues.

Interviewer:

Is that a good thing or bad thing?

William Dudley:
No, it's a bad thing. I mean, I think we want the access to credit to be broadly available throughout the economy. So we don't want to have one sector having really good access and another group being very much impaired. But I think this is part of the healing process and this will gradually improve over time.

Interviewer:
I’m entirely sure you don't want to be dragged into an election discussion, so I'll give you one that's very fair. Because both candidates have made the same claim that if you elect them then they'll create 12 million jobs over the next four years. Hard to get to that map given our current state of creating about 8 million over the next four years. What could do it? What could goose job creation in the United States that we're not thinking about? Is it housing, is it infrastructure?

William Dudley:
Well, look, I think we have a pretty easy monetary policy in place, and as the economy heals, that monetary policy will become more effective over time. Two, if we get rid of some of these uncertainties about, for example, the fiscal cliff, that will be helpful as well. The other thing that I think is very important, the U.S. is actually becoming really competitive relative to the rest of the world because of what it's happening in terms of our energy markets. Production of natural gas and oil has increased dramatically. The cost of electricity in the U.S. has been falling --

Interviewer:
Which helps industry in the United States.

William Dudley:
-- relative to other countries. So this is actually a very competitive place to set up manufacturing activity. And I think that's going to be another thing that's going to help us. Also it's important, once you get going in the right direction, it's a virtuous circle. Jobs make people more confident, jobs generate income. That confidence and income supports spending, that spending generates more employment. So get a virtuous circle going and you could actually get an economy that gets pretty strong pretty fast. We saw this back in 2003. We were going nowhere and then all of a sudden, third quarter of 2003, the economy took off. So this could happen again if things go in the right direction.

Interviewer:
Let’s leave on that optimistic note.

William Dudley:
Okay, thank you.

Interviewer:

Great discussion. Thank you so much.

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