

Trying Times Ahead

*An Exclusive TIE Interview:
Richard Shelby, Chairman of
the U.S. Senate Banking
Committee and an increasingly
important policy figure in
Washington, talks about hedge
funds, accounting scandals,
and the Chinese currency.*

Senator Richard Shelby
(R-Alabama)



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TIE: How do you feel about the U.S. banking system today? It looks strong, with a lot of capital, but how do you see it?

Shelby: We have a good banking system in the United States. Of course, one reason that might make me feel very positively about the system is that the economy's good. The United States hasn't had a bank failure to speak of in several years. But that doesn't mean that there aren't danger signals, and we shouldn't ignore them. I'm concerned about the implications of Basel II, the international capital standards for banks. What are its implications, especially for our small- and medium-sized banks? Is Basel II going to lower the capital standards? We were told recently by the nominee to lead the Federal Deposit Insurance Corporation, Sheila Bair, that she was interested in capital

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standards. The members of the Banking Committee are interested, although I don't think that we in Congress should determine what they are. The regulators should know what they should do to keep a sound banking system running.

So overall I think our banking system is in pretty good shape, but you never know what tomorrow's going to bring. We have to be ready. One thing that does bother me is the large number of mortgages being made with no equity, no down payment, and a floating interest rate. That seems like a recipe for problems to visit the banking system, as they generally do in a downturn.

TIE: Today, the banking system is a lot different because loans can be securitized and sold into the market and that's a good thing. This process spreads the risk and adds depth to the marketplace. But banks are becoming more and more like securities firms as a result, and securities firms are getting into banking. We had some financial reforms a few years ago when the Gramm-Leach-Bliley Act replaced the Glass-Steagall Act, and now banks can offer a range of financial services. Today we have this

debate about whether Wal-Mart should be in banking. How do you feel about all of this?

Shelby: You're talking about banking and commerce, essentially the same thing. The Gramm-Leach-Bliley Act cracked the door open and permitted banks to get into insurance specifically along with some other things. If Wal-Mart got a banking charter, it would change our banking system today, and turn it upside down. The first victims would be the small- and medium- sized banks in our country. If Wal-Mart gets a charter and begins banking operations in every state and any community they do business in, then all the other companies would follow and then what's a bank charter worth?

We should be careful there as public policy-makers. I'd have to learn a lot more about it and I'd have to know exactly what the pluses and minuses are.

TIE: Deposit insurance has shrunk in real terms over time but still it basically underwrites these institutions. Is there a risk of spreading it too far?

Shelby: Absolutely. We found that out with GSEs — government-sponsored enterprises — such as Fannie Mae and Freddie Mac.

TIE: A good point. Even an implicit guarantee has gotten the GSEs cheaper funding.

Shelby: The cheapest next to the U.S. Treasury.

TIE: In the last decade derivatives have helped spread the risk. But some argue that the Federal

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Reserve dropping the overnight rate to one percent and central banks around the world joining them introduced a lot of excess liquidity to the international system. Are we vulnerable to some bubble-like shock to that system, particularly one that entails systemic risk?

Shelby: Remember Long-Term Capital Management and the big meltdown because of their derivative failures? The Fed had to get involved. And that system was not supposed to fail. But it did fail. Just about everybody's using derivatives to hedge risk. Some of them probably abuse the system. I've thought maybe the GSEs abused it to a great extent by keeping so much in their portfolio and then hedging that rather than staying within their mission and syndicating, securitizing, and moving.

Part of the risk is, in my judgment, that some regulators might not understand some derivatives because people are thinking up more complicated ones every day. If the regulators that are dealing with banks and other GSEs don't understand those derivatives then we could be asking for trouble. I don't understand all the derivatives. I do understand insurance and hedging — when you trade in currencies for example, you've got to protect yourself where you have big exposure. A lot of the derivatives do that, but a lot of them are probably strictly to make money.

TIE: Isn't there a saying, "You can hedge but you can't hedge the universe." At some point the system itself is potentially vulnerable in the end.

Shelby: But Fed Chairman Alan Greenspan has told us before that derivatives have a place in our economy.

TIE: Derivatives have definitely improved the financial system. They've made it possible for the financial system to be expanded for everybody. They have reduced risks for specific institutions and individuals and they've added liquidity to the system in general. The only problem is the one you mentioned: people are still experimenting with new types of derivatives. In the event of a shock, often there aren't counterparties for a trade and you get



Senator Shelby on Fed Chairman **Ben Bernanke**: “I believe Chairman Bernanke will ultimately right his ship and do well. He understands the game. He understands about price stability. We don’t want inflation in America like there was in the 1970s. We can’t stand it. Chairman Bernanke recognizes that fact.”

Ben Bernanke

a freeze-up followed by potential failures. That’s what the regulators are supposed to be watching.

Shelby: They’d better be alert.

TIE: You have gotten involved some with the international accounting standards issues.

Shelby: I’ve spent a lot of time on it, all over the world.

TIE: The Financial Accounting Standards Board here in the United States and the International Accounting Standards Board in London are talking about converging accounting standards to improve the universality of the financial system and corporate accounting. Are you worried about the speed of convergence or some of the difficult issues such as pension accounting?

Shelby: Pension accounting probably is a misnomer, or has been in the past. So many people are finding out that their pensions are kind of an illusion. That’s not a good thing for America, or for our workers, or for people who invest. Take General Motors and Ford, for example, and factor in their health care and pension costs and basically they’re insolvent. If I were an investor buying stock in those companies I’d want to know all these future costs.

I was involved in the issue of expensing stock options. I thought options ought to be expensed rather than hidden because they either had a value or they didn’t.

Accounting’s about the truth. They’ve always argued that it’s not a true science because of the issue of interpretation. But you can manipulate accounting and a lot of big companies and individuals have done so. If you’re buying stocks and bonds in the marketplace, then

accounting’s important because the integrity of the market drives it.

As far as the standards are concerned, we have rule-based accounting. Elsewhere in the world, they use principle-based accounting. Can we get convergence of the two systems? Can we get equivalence there? That’s what we’ve been talking about. I know Sir David Tweedie, chairman of the IASB. He comes here and I go to London, and we keep talking. The Public Company Accounting Oversight Board is giving

them some time to try to work through this. Will we ever be the same system? I doubt it.

TIE: If you get very close to convergence, then you can always iron out minor differences. But if you’re not close and you allow foreign companies to register on the U.S. stock exchanges and they’re not quite meeting the same standards as U.S. firms, then it seems unfair.

Shelby: How are we treating our companies? Corporations are citizens. Are we treating them right? We should first of all in my judgment treat our own people fairly. We should also try to treat the rest of the world fairly as well, but surely treat our people fairly and not let outsiders have a distinct advantage over our own companies.

TIE: Is one of the reasons the United States attracts so much of the world’s capital the reliability of its system?

Shelby: We are more transparent and we have more integrity. We’ll always have some corporate frauds.

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We'll have some accounting problems, because where there's money, some people are going to abuse the rules. But overall, I believe our markets are viewed by our own people and the world as pretty clean, and we want to keep them that way. The integrity of the marketplace is the most important thing. Strong accounting standards are the backbone of that system.

TIE: That's why during an international crisis there is a flight into the dollar. It's more comfortable.

Shelby: And we want to keep it that way.

TIE: We do. But is there a sense after Enron that the United States has tied itself into knots trying to raise accounting integrity from a system that was maybe 97 percent pure to one that is close to 100 percent? Are we going a little overboard?

Shelby: Perhaps. When we pass sweeping legislation such as the Sarbanes-Oxley Act, overreaction in certain areas because of fraud or lack of confidence in our accounting system is possible. That's why I continue to hold oversight hearings. I'm not blind to the fact that Sarbanes-Oxley like any piece of legislation is not perfect. But the intent was good, and it's got some good things in it. The problem is the heavy costs,

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especially for small businesses. I'd be interested in working with the SEC and FASB and others to see if there are ways that we can streamline it or tweak it,

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but I wouldn't want to say just out of the clear blue that we're going to change this or modify that.

TIE: A lot of people in the markets worry today what is driving U.S. corporations that have so much liquidity. They're flush with cash, and CEOs have to make a decision. Do they invest in new plant and equipment, or do they buy back stock?

Shelby: Some of both.

TIE: To what extent has Sarbanes-Oxley influenced that sort of decision away from productive investment in new plant and equipment and new jobs?

Shelby: I don't know. That might be a good question to ask at an oversight hearing. I will continue to look at Sarbanes-Oxley from an oversight perspective because I don't think any legislation should be implemented and then forgotten. Sarbanes-Oxley doesn't have a sunset. I think most legislation ought to have a sunset. So we're going to scrutinize Sarbanes-Oxley closely, and see what the pros and the cons are. There're always some of both.

TIE: Let's discuss China, which has recently tried to take over some U.S. companies. Some concerns arise over both accounting and security. Has China now become the elephant in the closet for the industrialized countries?

A lot of people are happy to see China becoming part of the global economy. Be that as it may, complaints are piling up that the Chinese have set up this huge export machine, have developed enormous dollar reserves, are manipulating their currency, and will dump stockpiled commodities into the global market at the sign of the next downturn. The Chinese

leadership privately admits they can't control many developments. So how do we deal with China?

Shelby: That's going to be a central question for now and for the next hundred years. How do we deal with China, and also India coming down the track? I don't really know. I traveled to China in 1981. They had a few vegetable markets. On each subsequent visit, I saw China changing tremendously, its economic activity increasing rapidly. The Chinese people are very smart and diligent—there are probably 100,000 Chinese students in the United States, Western Europe, and Japan even as we speak, studying engineering, hard science, and business. Many return to China after finishing their studies. China will have the technical expertise and relatively cheap labor to fuel rapid gains, assuming commodity costs don't rise.

And the Chinese have been manipulating their currency. They probably learned that from watching the Japanese—they are very good at it. I was in China about two years ago and met with them about currency manipulation, but got nowhere. We had a hearing recently on the issue with [former] U.S. Treasury Secretary John Snow. We're disappointed that Treasury has again failed to make a currency manipulation determination with respect to China

They ought to have made the call a long time ago. By now there's a great deal of political and trade ramifications involved. But China's eating our lunch on trade. Look at our deficit with them. The situation will continue because they're export driven. They're determined to build their industry by exports. And that's pretty smart on their part.

TIE: Americans worry about a housing bubble bursting. Is there a problem with a China bubble bursting? The Chinese are stockpiling commodities. Their

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economy seems to be overheating. The central authorities are trying to slow things down but the regional players just refuse.

Shelby: Their economy will continue to expand and contract. Remember seven or eight years ago when many of the currencies in Southeast Asia went bad? China held steady, with a lot of reserves, and a lot of discipline. I don't think their banking system's up to par yet. They've got to have a private banking system, although that would mean the leadership giving up power and they're not ready yet.

TIE: Do you feel like you know who's in charge there in China? Who's behind the curtain?

Shelby: I don't think anybody's totally in charge in the whole economy. It's not a centrally planned economy any more, whatever they might say about it. And I'm not sure they can control it anymore.

TIE: When you look around the world, with the exception of the Europeans, everybody else is tied to the dollar. So we don't really have an exchange rate system that allows for adjustments that we had ten or twenty years ago. Does this worry you?

Shelby: I like a strong dollar. I like a strong dollar being used by others. But I do worry about our current account deficit. I know we've got a lot of dollars in the world. I hope we know how many.

TIE: Well, it's not clear we do. But it is a confidence game, and as long as—you said it yourself—we treat capital correctly and fairly and provide a safe place for people to invest, the dollar should remain relatively stable.

Shelby: Our economy's great. You know this is a great country. My caveat would be the budget deficit, although it has gone down a lot. Because the revenues rose, the projected deficit could be under \$300 billion. I'd like to be down way below that just for the sake of confidence. But our current account deficit is going up. This doesn't worry some people. I probably worry about our budget deficit first and our current account second. A lot of economists say that it will right itself, but at what price?

TIE: Senators Schumer and Graham proposed a 27 percent tariff on China. Is this proposal going to go anywhere?

Shelby: I wouldn't think so. Not at the moment. I saw where both those senators went over there and met with the Chinese.

TIE: Both seem to have backed off a bit.

Shelby: A punitive tariff is a tough thing. You're damned if you do and you could be damned if you don't. But I was taught that the best of all worlds was free trade. We're probably one of the biggest open trading countries in the world. But I don't think ultimately we can drive the whole world, though we can influence the world.

TIE: Are you optimistic about the U.S. economy and the world economy today compared to ten years ago?

A. We had a good economy ten years ago. We've just become more interdependent each day. I don't think we're going back—you never go backwards. I feel pretty confident about our economy today. The world as a whole has some soft spots. I worry about the European Union especially, with their stratified labor markets, and the failure of a nation like Germany to produce no new net jobs. I worry about the aging of Japan, and I worry about the price of energy. We're becoming more dependent on foreign oil each day. We have not developed nuclear power. We have not been able to even drill in Alaska and offshore, because of political reasons.

TIE: Are you surprised that rising oil prices haven't had a bigger negative impact on the American consumer?

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Shelby: It has surprised me. Our economy's been so good people have basically factored that in. But there's a cost there. You give up one thing for the other. And basically Americans will never get used to paying \$3 or \$4 per gallon for gas. We're not like Europe. We're used to cheaper energy.

TIE: Do you worry about the combination of interest rates being ratcheted up to deal with rising inflationary potential plus higher energy prices?

Shelby: Could that cool this economy? I worry about high inflation too. Maybe I'm worried about too many things.

TIE: How do you feel about the Fed and its leadership?

Shelby: The Fed has new leadership, and new members in the Board of Governors. I believe Chairman Bernanke will ultimately right his ship and do well. He understands the game. He understands about price stability. We don't want inflation in America like there was in the 1970s. We can't stand it. Chairman Bernanke recognizes that fact.

TIE: He's been an advocate of inflation targeting as an approach to monetary policy, although it's kind of a soft, flexible version. He seems to be quite prudent about his approach. Do you think that's a good approach?

Shelby: That's where he differs some from Greenspan. We asked at his hearing about inflation targeting. I can see where a target could work, but not if it's a hard-and-fast target. You need to have flexibility. If the target's not broadcast then the Fed has a little room.

TIE: Thank you very much. ◆