From 1992 to 2003 William McDonough served as president of the Federal Reserve Bank of New York, which implements Washington's monetary policies through its open-market trading operations. A close ally of Fed chairman Alan Greenspan, McDonough played a key role in keeping the financial system afloat after the September 11, 2001, attacks and in staving off the 1998 collapse of Long Term Capital Management, a huge hedge fund whose debts threatened global financial stability.

McDonough describes the role of the United States Federal Reserve System, how it dealt with the Long Term Capital Management financial crisis of 1998, and the importance of strengthening the global financial system.

The United States Federal Reserve System

INTERVIEWER: For our viewers who don't really know what the New York Fed is, could you just describe your job and what the role of the New York Fed is?

WILLIAM McDONOUGH: The Federal Reserve Act of 1913, which established the Central Bank of the United States, is a classic American compromise between centralization and regionalization. The centralized aspect is the board of governors of the Federal Reserve System in Washington. It normally has seven members who are appointed by the president of the United States and confirmed by the Senate of the United States. There are also 12 reserve banks which legally are federally chartered private institutions which belong to the banks in our district. Of the 12 Federal Reserve banks, by far the largest is the Federal Reserve Bank of New York—no surprise, since this is the financial capital of the country. The Federal Reserve Bank of New York, in addition to being a major source of advice on monetary policy, actually implements monetary policy. We go in to the markets and take actions necessary to establish the official interest rates which are decided upon by the Federal Open Market Committee. Traditionally, since 1935, when the Federal Reserve Statute had a major change, largely because of the facts of the Great Depression, the chairman of the board of governors, now Alan Greenspan, is the chairman of the Federal Open Market Committee, the decision-making committee, and the president of the Federal Reserve Bank of New York is the vice chairman of the committee. We also are very actively involved in banking supervision here at the New York Fed because, again, this being the financial center of the country, most of the large American banks are located in New York, and most of the very large foreign banks which operate in the

United States have their American headquarters here. So we tend to be where the center of the action is, both in implementing monetary policy and then in problem resolving or accident fighting if anything should come along to disturb the tranquillity of the American capital markets or of the functioning of the American economy.

INTERVIEWER: So you kind of keep your ear to what's happening on Wall Street?

WILLIAM McDONOUGH: Yes, we keep our ear very much to the ground here, because we operate for the Federal Reserve or the Treasury of the United States in financial markets. We work very closely with major financial firms in New York, banks, securities firms, insurance companies, and by this constant interaction with them we are very familiar with what's going on, and we supply that information to the Board of Governors in Washington and to the U.S. Treasury so they, through us, also have a feel for what's really happening in the marketplace.

INTERVIEWER: Who's your boss?

WILLIAM McDONOUGH: My boss is the board of governors of the Central Reserve System, but in a real sense I have two bosses. One, Alan Greenspan, is the chairman of the board of governors and we also have our own board of directors at the Federal Reserve Bank of New York, nine members. The chairman of the board of directors is Peter Peterson, who is a former secretary of commerce of the United States.

The Domino Effect of the Asian Financial Crisis

INTERVIEWER: Let's talk about the events leading up to the Asian financial crisis. In our film we start with Asia—Thailand. From your perspective in New York, what was your sense of what was going on, and how was it impacting on you?

WILLIAM McDONOUGH: In July of 1997, a world that had appeared to be deceptively calm became much less so when Thailand began to be the first pebble in the ongoing stream of problems, which came to be known as the Asian financial crisis. It spread throughout Asia; that had not been anticipated initially. It was thought to be more a problem specifically of Thailand. But it began to spread to its neighbors, and I think we all became especially concerned when it spread to South Korea, a country that had been thought to be very powerful, with a very resilient economy. At the end of 1997—in fact, in this very room on Christmas Eve, December 24, 1997—the major financial institutions of the world gathered at a meeting which I called, and we decided that it was not going to be possible for additional public-sector money from the International Monetary Fund or the World Bank, or certainly from bilateral governments putting taxpayers' money in, to continue to help Korea if the private sector was pulling its money out of Korea. That meeting led to a decision by the private banks that they would reschedule the bank debt of Korea. That took place. The decision was really made on December 24; the actual details were resolved within the next two to three weeks.

Then a very, very strange thing happened. From about the first of February 1998 until August, when Russia defaulted on its debt, there was a period in which financial markets essentially decided that risk didn't exist anywhere, so the spread, the additional amount of interest that emerging-market countries had to pay or that junk-bond issuers had to pay to sell their debt in relation to the ultimate benchmark, the U.S. Treasury, the riskless security became so small that it became very clear that investors everywhere had decided risk had disappeared. Now, obviously that couldn't endure, and so when I look at the August default by Russia, essentially you were looking at an accident waiting to happen, and the only question is, where would the accident take place [and] at which street corner would cars collide with a bang? It happened to be Russia, and I think the reason that the Russian default was taken so seriously and just convulsed financial markets is that investors had decided Russia is an ex-superpower, and it has lots of missiles and lots of atomic warheads for them; certainly you could not have a financial accident in Russia, because the rest of the world, the rich countries, would bail Russia out. Well, it turned out that that was wrong. The international community had tried to help Russia through an International Monetary Fund program. It didn't work, wasn't working, and so Russia defaulted on its debt, and then there was a massive devaluation of its currency. All these people who in the previous seven months had decided there was no risk anywhere literally panicked and decided there's got to be massive risk everywhere. Behind each fence and barnyard wall there must be a risk that we hadn't though of, you know, like the redcoats retreating from Lexington. And that, I believe, led to the circumstance of the near collapse of Long Term Capital Management [LTCM]. The situation could well have happened in any event, but it required a triggering event, and the triggering event was the Russian devaluation and default.

INTERVIEWER: We'll come to that in a second. I'm just intrigued by this period, this lull that you talked about. You're here on Wall Street; were you telling people, "You're a bit too complacent here"?

WILLIAM McDONOUGH: Well, we do a lot of Socratic questioning, and you have to remember what happened to Socrates from this approach of asking difficult questions. Why do you think that you should be lending at this small a spread? Well, markets are clearing, you know; there's the theory that all information is available to financial markets, and therefore they are setting the right price through the interaction of supply and demand in the market. This was a classic example that markets sometimes get it wrong, seriously wrong. And that period when there was just an absurd view of how much risk had disappeared—risk doesn't disappear.

INTERVIEWER: Historically, why had there been such a movement in funds going out to emerging markets throughout the '90s?

WILLIAM McDONOUGH: It was partially a search for diversification and partially a search for higher reward. Perhaps overlooking that higher reward always goes with higher risk. Now, if you have investors, whether they be individuals, sophisticated investors, or most of us operating through mutual funds of some sort, you reach a point of thinking that you've invested enough in your home-country market. By all logic, Americans ought to invest [abroad]. ... Actually we invest much, much more [in our own country] because we're comfortable with our own country; we think it's the right place to invest. European investors are very much the same way, as are Japanese investors. [There is a] tendency to invest at home in the market you know best. But after a while, you begin to think, "I really ought to diversify," so you begin to diversify into other developed countries. So an American investor will buy some European securities, perhaps some Japanese securities. But after a while there's that tendency to say, "I can have a manageable amount of risk with quite a lot higher reward if I start investing in Thailand or Korea or Argentina or Brazil or Mexico." There's a tendency to put all of those markets in one basket and call them the emerging-market basket, and therefore, when something starts to go wrong in one of the pieces of that basket, Thailand, in '97 or dramatically, Russia in '98, rather than just pulling your investments out of the country that's having the problem, you begin pulling them out of emerging markets in general, and obviously then you create problems by your dramatic pulling out of your investments in countries that probably could have withstood any storm quite well if international participants had not behaved in what for each participant is a rational thing: "I think I'd like to get my money out," but since everybody has the same idea at the same time it's the classic example of everybody rushing to the door when there's a fire and lots of people getting killed in the stampede rather than by the fire.

The Fed and the Imminent Collapse of LTCM

INTERVIEWER: Russia devalues. When did you first get a sense that there was a problem with LTCM, and more broadly, why did you care?

WILLIAM McDONOUGH: We've discussed earlier that we follow financial markets very closely. The so-called hedge funds—which we've since relabeled "highly leveraged institutions," because the problem in a hedge fund is not that it's a hedge fund by definition. A hedge fund is supposed to be eliminating risk; that's what "hedge" means. But in the case of some of them and some of the other institutions not called hedge funds, what they did is decide: "Here's a good idea; we'll invest in these things. It's such a good idea we'll start borrowing lots of money and up the ante, up the ante, up the ante." And it's great as long as it works, but if you have all that leverage, all that borrowed money, if it starts going the wrong way, it gets very bad very quickly. We were looking at hedge funds, highly leveraged institutions in general. Long Term Capital Management was the biggest of the hedge funds and the one that was most highly leveraged, so it was the one that we and other observers of the financial market were keeping a particularly good eye on.

Now, Long Term Capital Management, as you know, had an extraordinarily high degree of success for a number of years. In fact, at the end of 1997, it was rather concerned about whether it had too much capital and, therefore would have trouble investing it, especially with the big leverage factor, and actually returned a fair amount of capital to its investors who were very unhappy in general about the capital being returned. By the fall of 1998 they were pretty happy that they got it back, but at the time they were really quite, quite unhappy about it. As the Russian default took place and you saw financial markets begin not to function very well, then our focus became even greater on institutions with a lot of leverage, and particularly LTCM. The following of it, I think, was not unusual in that it was not the only institution we were looking at, but we were sufficiently aware of what was going on there through some direct contact with the senior people at Long Term Capital Management and the Federal Reserve Bank of New York as an institution and with me personally that we became daily ever more aware of the size to which their problem was growing.

INTERVIEWER: So you got a call from them saying what?

WILLIAM McDONOUGH: Well, I received a series of calls from several people at Long Term Capital Management. In congressional testimony, I've mentioned them: John Merryweather who was the head of the firm, and David Mullins, one of the senior colleagues. And they told us that their positions were becoming more damaged, that their ability to move out of their positions was becoming more difficult, and therefore, as they marched their positions to market that they were getting closer and closer to wiping out their capital.

INTERVIEWER: Why was that important?

WILLIAM McDONOUGH: It was important only because of the background of the world financial market not working very well, so why don't we talk about that, because that understanding is key to why we were involved in Long Term Capital Management at all, however obliquely. The best way to see if a financial market is functioning badly is to look at the relationships of the highest credits, because if, for some reason the U.S. Treasury market, the single highest quality credit there is, is becoming disturbed, then you can be very sure that the market, the broader market is very disturbed indeed. The U.S. Treasury issues securities every three months. The last security they've issued in any series is called the on-the-run bond. The reason it's called on-the-run is when security dealers deal back and forth, they like to deal the with most recently issued security, therefore calling it on-the-run, because it's the most liquid, a lot of people have it, it hasn't reached final hands yet, so there's just more availability in that particular security. The security in the same series, you know, sticking to our example, the 30-year bond that was issued months earlier, is called the first-off-the-run, and the one three months before that is called the second-off-the-run. Normally there is a little bit of difference in yield in the spread between the on-the-run security and the first-off-the-run and the second-off-the-run. Typically between the on-the-run and the first-off-the-run, there would be two one-hundredths of 1 percent, which in the trade is called two basis points. Between the on-the-run and the second-off-the-run, so six months' difference in maturity, there would be about five basis points. At that particular time, after the Russian debacle, that spread moved down to about 25 basis points.

Now, think of the complete lack of common sense of this, that says that investors were demanding one-quarter of a percentage point higher for 29 and a half years to buy the second-off-the-run security as compared with the one that matured six months later. Since it doesn't make any sense, it tells you that financial markets were simply beginning to fail to function. If that should take place, if financial markets really started freezing up, the ability of that to move over to the real economy where the real people of the United States of America live and work was extremely high.

We at the Fed were particularly concerned about that, and the Federal Reserve Bank of New York, the operating center of the Federal Reserve, had to be the main place where that focus was taking place. We have the historical accident where most of my career was in the private sector and in the financial management end. I was for 22 years a commercial banker and vice chairman of a large bank in Chicago, so I had a great deal of experience, both as a central banker and as a former commercial banker with the functioning of markets. None of us had ever seen anything like this freezing up of markets, and therefore it was very clear that everything that could be done to remedy that situation should be. One of the things the Federal Reserve did, you may recall, is we had a rather dramatic easing of monetary policy in a series of three moves in the fall of 1998 in which we reduced at a meeting of Federal Open Market Committee the official rate by 25 basis points a quarter of 1 percent. Between meetings, about three weeks later, we dropped it again, and at the following meeting, about three to four weeks later, we dropped it again. Essentially what we were doing was providing confidence to financial markets so that the Central Bank of the United States was aware of the problem and doing something about it.

Now, shifting to Long Term Capital Management, normally the way that financial markets work is that if a private-sector firm gets itself in trouble and collapses, the Federal Reserve says [it's] not a bad thing to happen. Market discipline is very important, and market discipline doesn't exist unless there are some casualties from time to time. But the size of Long Term Capital was so great because of the leverage involved that, had it collapsed, which it certainly was very close to doing, there would have been a dumping on financial markets of about $80 billion in securities, Danish bonds, Swedish bonds, American Treasury securities. Almost anything you can name would have been dumped on the market. The ability of Long Term Capital Management to hedge its risks, to reduce its risk, depended on the so-called derivatives markets. That's where financial firms go in order to try to reduce the risk. If you're along a certain security, you'll offset that risk in the derivatives market. Their position in the derivatives market—that's going to sound very dramatic—was the notional amount of their derivatives was between $1.2 and $1.3 trillion. The amount of actual risk in the derivatives book is a very small percent of that dramatic notional amount, but if you have financial markets freezing, the relationship between the real risk and the notional amount gets closer. So what we were concerned about is that if this massive position got dumped on financial markets worldwide, you'd have very many financial institutions that thought their book of risk was balanced, but all of a sudden one part of the trade disappeared because Long Term Capital Management wouldn't be there anymore, and [there would be] a world financial market that was just about ready to stop functioning.

INTERVIEWER: What you just described is actually staggering. What was going through your mind when you saw really what was at stake? And you're sitting here right in the middle of it.

WILLIAM McDONOUGH: What we thought at the Federal Reserve Bank of New York is that the collapse of Long Term Capital Management could be very damaging to the real economy because of its dramatic effect on already very nervous, almost dysfunctional financial markets. It was also very clear that the Federal Reserve Bank of New York has no money, the Federal Reserve system has no money, and the government of the United States has no money and should have no money to rescue Long Term Capital Management, so what could we do other than nothing. What we did, in my view, came very close to nothing, but it was something that I think turned out to be useful. We were invited by Long Term Capital Management's leaders to visit their firm and to find out exactly what their positions were and who were the counter-parties. What we realized from that investigation is that there were 17 counter-parties—that is, firms, banks, securities firms which had big positions which had sold securities to, or bought securities from, or engaged in derivatives contracts with Long Term Capital Management that were very significantly exposed. And so we thought to ourselves, institutions which do in fact have money have an interest in Long Term Capital Management not collapsing, here are the 17 candidates. So we established contact with those 17 firms over a series of meetings that ran from Monday to Wednesday, when we had the final decision-making meeting, here at the Federal Reserve Bank of New York.

The institutions themselves decided to create a leadership group, and the leadership group began to work with the Federal Reserve Bank of New York, but more importantly with Long Term Capital Management to see if there is a way that their interest could be served by avoiding a collapse of Long Term Capital Management, and what they decided to do eventually was to recapitalize Long Term Capital Management. The 17 firms met. Three of them decided not to participate in the recapitalization, so it was done by 14 firms, most of them American but not all—some from outside the United States. These 14 firms in effect bought 90 percent of Long Term Capital Management, leaving 10 percent of it with the management as an inducement for them, since they knew their book better than anybody else did, to stay with the firm and then with an oversight committee from the 14 new investors to work the very large exposure of Long Term Capital Management down, which took about a year, and eventually Long Term Capital Management was just wound down and went out of business.

INTERVIEWER: So when you had these officials and bankers in this room. What was the mood?

WILLIAM McDONOUGH: The mood was very much one which you'd expect of very prominent people in the financial-services field. These people did not get to their positions by getting overly nervous. I mean, there was quite a lot to be nervous about, but the atmosphere of the meeting was very calm. Of the series of meetings, actually the only meeting that I personally was involved in was the final one. I established that there was absolutely no federal money available, that if Long Term Capital Management should not collapse the next day. They all thought that it would collapse the next day unless they announced that they were prepared to do something, that there would be quite a lot of damage to financial markets, and if they thought that it was in their interests to avoid that damage they should do so. They then had some pretty meaningful discussions among themselves, including how much would be involved. They had to do some negotiating with Long Term Capital Managements so that they would be aware that the offer that they would make would be accepted. Some classic horse-trading took place, and by the end of that day they had the makings of a deal. The Federal

Reserve bank of New York, all of its officials then withdrew from the discussions, and the actual final deal with Long Term Capital Management went into the following week, but in the meantime, people were maintaining their positions, keeping the firm alive in order to allow the re-capitalization to take place.

The World's Recovery from the Financial Crisis of 1997-1998

INTERVIEWER: I talked to Robert Rubin yesterday, and he said although it was serious, he thought LTCM was more indicative of a broader problem, that its failure alone might not have that kind of effect. Why did you think that there was really something at stake there? It's as if it was like a gut feeling.

WILLIAM McDONOUGH: Well, first of all, I think it was a difference of opinion between Bob and me, and that can happen when one guy is right in the middle of something and somebody else isn't. Then Secretary Rubin was being kept informed essentially by me. Mainly what I was concerned about and perhaps the mild difference of opinion is that I thought that we would have a domino effect; that if Long Term Capital Management collapsed, the spread of it would be such that other firms would begin to collapse, and that would bring about the freezing of markets. Now when you say what happens if markets froze, the real answer to that is nobody's sure. If financial transactions cannot take place, I think the big likelihood is that banner headlines are going out, TV stations are announcing it, radio stations are announcing chaos on Wall Street, and the average American citizen who most days doesn't care a whole lot about these things realizes that things are very bad, and what he or she shouldn't do is spend any money. And so you bring the economy, not to a complete stop—people have to buy food and gasoline and so on—but it brings the economic to a very much lower level of activity. That's dangerous, and if a public-sector official can stand in the way of that happening, in my view, he should. Since I was the public-sector official, I decided I should.

INTERVIEWER: It's about psychology, really.

WILLIAM McDONOUGH: That's right. Very much so.

INTERVIEWER: At the beginning of this whole crisis in Thailand, was LTCM a factor? It didn't collapse, in the end.

WILLIAM McDONOUGH: No, the world financial crisis, I think, has been managed, but I would not say that it has been fully resolved. There are, if you look at the spreads in financial markets, with the exception of the ones that didn't make any sense at all, like the ones I described between the on-the-run Treasury and the first- and second-off-the-run, the spreads of financial markets indicating the degree of risk the market participants observed are just about as wide now as they were now in the financial crisis of 1998. That tells you that there is a very large amount of risk-aversion taking place. It means the cost of capital to any but the finest firms in the finest companies is higher than it used to be; therefore, the pace of economic growth will be slowed down. The possibility of world growth got much, much lower. Of some of these emerging-market countries that depend very highly on their export business. The likelihood of their getting into trouble again is disturbingly high. So this is not a situation which has been fully resolved. It is rather one in which we've learned to try to take out all the insurance we can by strengthening payment systems around the world, by making sure that securities clearing systems are more robust or stronger, to have the International Monetary Fund and the World Bank to use their power and prestige, their ability to work with countries to get a better public-policy mix. But we still are living in a world in which the dramatic events of '97 and '98 are not so fully placed behind us that we could revert to a view which says, everything's okay, let's go back to that, I think, unfortunate period of the first half of 1998 when markets simply were evaluating risk very badly by thinking there was much less risk than there turned out to be. I think that's a mistake that we should not make again.

Typically, market participants' memories are not eternal, but they're not that short. So since 1987-98 is not that many years ago, hopefully the people will continue to remember it, and the improvements in financial markets that I've been talking about can continue to take place, so that the likelihood of an Asian financial crisis of a Russian devaluation of default of an LTCM episode are less likely. One would be very unwise to say they're impossible. Because they're never impossible.

INTERVIEWER: We've been talking to Domingo Cavallo, and the rules of the game are crazy. It sounds like you're talking about something like that—trying to strengthen or improve the rules of the game.

WILLIAM McDONOUGH: That is exactly right. Domingo Cavallo, I think, is on the right issue. We have to improve the rules of the game. For a while there was a thought: Could there be a great new financial architecture in which everything would be so brilliantly constructed that there would be no risk? No one knows how to do that, and therefore what we have to do is take the rules of the game as we know them and make them better, make the system more robust, less accident-prone, but recognize that there still is risk in the system. We never can eliminate it completely.

The Increasing Interconnectedness of the World

INTERVIEWER: You've been in the business a long time. In our film, we're looking at the impact that technology's had and the fact that the money can move across borders so rapidly. How has technology impacted the speed at which some of these shocks can be filtered round the globe?

WILLIAM McDONOUGH: Technology is by and large a very good thing. It makes international financial markets work more efficiently, and therefore, other things being equal, the cost of capital would be lower than it would be otherwise. However, it also means that any adverse information is spread immediately, and markets tend to respond very quickly. That other things being equal increases the cost of capital, because the ability to transmit risk is much more rapid. It points again, I think, to the only thing we can do which is improve, in Cavallo's words, the rules of the game. Technology is here. In general it's is a good thing. We can't turn the clock on it even if we didn't think it's a particularly good thing, and therefore we have to learn to cope with it. It does make possible the knowledge of what's going on in financial markets being higher. The likelihood of clearings and settlements system working better is made greater by the existence of technology, and so I think the collective results of the technological advance is positive, but like most things in life, there are two sides to that coin, and we just have to make sure that the negatives, the greater risk coming from technology, are managed well.

INTERVIEWER: The connectedness has just become greater. I think you wrote a piece in January saying that basically, now ... what happens here has a very rapid impact on [the global] economy, [on all] other economies.

WILLIAM McDONOUGH: Well, I think that it's no doubt true that the international community, the international economy is much more interconnected. There are some countries that decide that they just don't want to be part of the world. The price that they pay is very, very low growth, if any growth at all. One of the things that's very clear is that countries that decide to participate in the market economy benefit from it with a higher level of growth, but they also suffer from it because of the quick transmission of problems. One of the conclusions that I think one draws from that, which is brilliantly analyzed by Ernesto Zedillo, the very, very capable and very successful president of Mexico, Ernesto Zedillo's view is that what it says to a country that wants to participate in the market economy is that policies that you might have thought were great ideas 20 or 30 years ago when the world was less connected simply don't work. As he put it rather dramatically, the price of bad policy ... Actually what he said was the price of stupidity is so high that if you do something stupid, the marketplace immediately tells you you'd better stop doing it. So it has reduced four emerging markets which participate in the market economy, the degree of freedom they have. The rewards for it is that their economies grow faster and their citizens are better off. That impresses me as a pretty good trade, but it is a trade, [and] they do lose some independence in the process.

McDonough's Reaction to the 1998 Financial Crisis

INTERVIEWER: Just wondering, your background from Chicago... Presumably you lived through the Continental Illinois Bank failure. Did that experience give you a sort of visceral feeling of what was really at stake during the LTCM crisis?

WILLIAM McDONOUGH: No, I think Continental Illinois was really significantly enough different that it didn't provide any particular background to deal with LTCM.

INTERVIEWER: On a gut level, what were you trusting when you thought, "This is really serious"?

WILLIAM McDONOUGH: There are not a great many advantages in the passage of time as one gets older, but having lived for quite a long while, it does have some limited benefits, and I think one of them is that if you've been at something for a very long time, you start trusting your own instinct. Now I did talk to some other people as well. One of my very close friends, John Whitehead, former head of Goldman Sachs, former deputy secretary of state, and I chatted about the involvement of the bank in Long Term Capital Management. John felt as I did that there simply was no other substitute for the New York Fed. One goes back if one is interested in history to the financial crisis in New York in 1907 which was solved by J.P. Morgan calling the kinds of people that I invited to this boardroom to the library of his magnificent home and they resolved the problem of the 1907 financial crisis. The Federal Reserve didn't exist then. The 1907 financial crisis was one of the reasons that the Fed was created. Now, the likelihood of anybody else being able to get all the people in the room, people who normally spend their lives trying to out-compete each other so that each gets a little bit more of the pie than the others, we do have the capability of the Federal Reserve, to be able to bring them in, have them look at the somewhat bigger picture. A very important part of it, I think, is no public official will ever get the head of a private-sector firm to do something which is not in that private-sector firm's best interests. The head of a securities firm or a bank is not paid to be a patriot; he or she is paid to serve the best interests of the shareholders, so the most that one could do in a position like mine is to say the public interest may well be served by Long Term Capital Management not failing or by Korean debt going into default, but there is no public-sector money to solve the problem; the taxpayer is not going to do this. You folks have to decide whether it's in your interest to do it. Now, if somebody has had many years of experience like me, the people that you're talking to at least think, well, this guy knows what he's talking about; he's been through some of these firefights himself, and so we're not dealing with somebody who doesn't understand how we think or what we can do. I think that's helpful.

INTERVIEWER: Just tell me: I've heard phrases thrown out that all this must be considered the worst crisis in this half of the century. Was it really that big?

WILLIAM McDONOUGH: I think the financial crisis of the fall of 1998 had the potential to be the worst financial crisis at least since the war. But one never knows if you say that something has the potential to be the worst of whatever it is, and it's avoided, were you just hysterical? Hopefully not. Were you a little bit overly cautious? Maybe. But the important thing is that steps were taken at no expense to the American or any other taxpayer to avoid a crisis which could have been very damaging.

INTERVIEWER: Were there any moments that sort of stick out like the worst moment for you or a time you thought, maybe we're not going to be able to kill this thing, or maybe it's too tough?

WILLIAM McDONOUGH: Well, I should correct something that I've been saying which isn't 100 percent true, and that is that is that there was no taxpayer money involved. We began the meeting on that decisive Wednesday at 1:00. We had some fairly cold coffee and some really terrible sandwiches, and we didn't charge for them, so the Federal Bank of New York paid for those. That was our contribution, so other than the fact that the coffee was kind of cold and not very good to begin with and the sandwiches were barely edible, the rest of the meeting went so smoothly. That's what I remember as being the biggest problem. Mainly I think the advantage is that the private-sector firms involved were well represented by serious people who knew one another well enough that they were able to have a little fight now and then and disagree now and then and raise their voices a bit and use some words that one wouldn't wish to use on this program, but that's a necessary part of human beings reaching a point of consensus in which a deal was done. So I was quite confident from very early on in the meeting that the assembled group was going to reach a positive conclusion. You never really know that until the deal is done but it just had a feel that it was heading in a direction in which resolution would take place.

INTERVIEWER: When you got that resolution, did you feel a sense of relief—"Thank God it's over," I mean?

WILLIAM McDONOUGH: Well, that particular day we'd reached a stage of thinking that the deal was likely, but the details of it still had to be resolved. Between the 14 firms which recapitalized LTCM, the management of LTCM, and it was not necessarily a done deal. In the course of the following week, there was a point at which there was real concern about whether it was coming unstuck. I was asked if I would join the meeting again. I decided that the Federal Reserve had been sufficiently involved, that the private sector was on top of the situation if it was going to be resolved, and that further involvement by the Fed would make it too much a government-dictated solution, and that to me would be anathema. That would mean that the government, even though no government money was involved, had gotten too involved in the solution. Now that's a very fine line to draw, but it was one that I drew, and I said to the caller: "You have to work this out yourselves. If you do that's fine; if you don't, that's life."

Strengthening the World Financial System

INTERVIEWER: You talked about the rules of the game and the need to make them more robust. Without getting into too much detail, how is that possible? Who writes the rules? Who sets them? Who administers them? We're talking about a big global economy now and not the power of any one government.

WILLIAM McDONOUGH: The main part of how the game is managed is in payments systems and settlements systems, settlements of securities and then payments of funds around the world. There is a committee which is created by the Central Bank governors of the group of 10 countries, the main industrialized countries of the world, called the Committee on Payments and Settlement Systems. I used to chair that committee. It's presently chaired by a very fine Italian central banker, Tommaso Padoa-Schioppa. That committee is involved in setting standards for payments and settlement systems to make them ever more robust. When you get into the individual payments and settlements system in various countries, then they come under in the United States, the Securities and Exchange Commission, the Future Trading Commission, The Federal Reserve. Various parts of the U.S. government have regulatory jurisdiction over these mechanisms. Another area where we need to work is to make ever sounder the world's banking system. There is a parallel committee of the G10 Central Bank governors, called the Basel Committee on Banking Supervision. Basel happens to be where the Bank of International Settlements is. I am the current chairman of that committee. We are in the process of making quite a lot stronger the capital requirements for banks around the world, how they are supervised and how market discipline is brought to bear to make sure that the marketplace is disciplining these major financial institutions, all to make the world's financial system, stronger, more robust, more capable of withstanding shock.
You want the financial system essentially to be like the shock absorber in a car. When you hit a pothole the car still bounces, but have you ever been in one that didn't have a shock absorber? If you have a good, strong shock absorber, at least you get through the pothole and you're still driving in the same direction that you thought you were when you hit it.