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A couple of decades have passed since I first addressed a membership meeting of the Institute of International Finance. The setting was certainly less grand; the challenges less complex.

As I recall it, there were serious banking difficulties, but the United States was benefiting from greater price stability and strong growth. China was still in the ranks of emerging countries, not yet considered a major economic force. A decade of strong growth for the United States lay ahead, buoyed by the broad application of electronic and seeming financial miracles. For some there were enormous – truly unprecedented – financial rewards.

Our perspective today is quite different. Powerful compensation practices and complex financial engineering have been introduced into our markets and institutions. Now it is evident that those changes have not protected us from a succession of bubbles and busts; rather they appear to have contributed to them. Years of growing economic imbalances within and between nations have given way to the worst recession in living memory. Once proud banks and investment banks have disappeared or found themselves reliant on government support. We look hopefully to the new China, now economically powerful, as one of the few countries of growth in this year of 2009.

So the questions multiply. What about the outlook for the American and the world economy? Are there not implications for the management of both the domestic and international monetary systems? Can there be any question that the broken financial system needs extensive repair?

I want to discuss each of those areas in turn: briefly for the first two, then a little more fully about some basic approaches toward reform of our financial institutions and markets. Those are matters that are particularly relevant in terms of the Conference program.

The legendary American baseball player and homespun philosopher Yogi Berra, once stated a seven word aphorism that we all (and particularly the economists among us) can appreciate: "Forecasting," he said, "is difficult, particularly about the future." I warn you that my personal view is close to what I perceive as mainstream opinion in the United States. That doesn't assure its accuracy.

The sudden and unsettling drop in economic activity beginning last fall is slowing, most clearly in the United States and the U.K., perhaps with a short lag in Euroland, and still less clearly in Japan. A healing process in financial markets seems to be underway. Large banks, well-rated companies, and even some weaker organizations are finding funds available in the market. With inventories sharply lower, housing construction close to rock bottom, and the various stimulus programs approaching full force, an expectation of some growth late this year and next in the United States seems reasonable.

Prospects for a really strong recovery, typical of most recessions, seem unlikely; a long slog, with continuing high levels of unemployment, seems to be in store. For most of the developed world, sources of strong spontaneous growth are hard to envisage. In the United States, as elsewhere, even modest growth remains dependent on strong fiscal and monetary stimulus. Large loan losses still need to be fully recognized. The financial system, even if out of the emergency room, remains in intensive care.

You are all well aware that, in the best of circumstances, years of deficit spending far beyond past peacetime experience lie ahead in the United States, as in some other countries. The Federal Reserve has certainly been active, using unprecedented emergency powers.

For the time being, government spending, debt financing and the volume of credit support may be a reasonable response to the sudden rise in personal savings in the United States and the needed deleveraging process. Both the renewed savings and private debt reductions are necessary and desirable structural adjustments for the longer term. However, depressing implications in the short-term have been unavoidable. This is not an environment in which inflationary pressures are at all likely for some time to come.

All in all, the needed adjustment toward a better, more sustainable balance in domestic savings and investment, in international trade, and in capital flows will take time. Nowhere are those adjustments more necessary than in China and the United States. The two countries have been locked into widely divergent patterns of consumption and savings for too long, with the result of persistent and ultimately unsustainable imbalances in international payments.

Now the brute force of recession and financial crisis is forcing the needed adjustments. But surely we need to ask ourselves whether all the unemployment, all the economic dislocations, and all the risks of protectionist pressures could not have been prevented, or at least been moderated, by more effective domestic and international systems and policies.

There is an active and useful debate in the United States and elsewhere about how and when the monetary authorities should respond to potentially destabilizing “bubbles” in financial or commercial markets. The challenge of restoring fiscal and monetary restraint will need to be front and center as the economy recovers. There is also growing discomfort whether the financial crisis and the spreading sense of “too big to fail” may be leading to a degree of government intervention inconsistent with effective, competitive private markets. Put simply, the old concern about moral hazard looms even larger.

I won't take the time to engage in those debates today, except to make the obvious point that these concerns point to the need for really thoroughgoing reform of our domestic financial systems and institutions. I do want to briefly draw your attention to another area of potential reform that, to my mind, has been too long neglected.

Specifically, there is an obvious question, but one seldom raised, about the international monetary system (or as some would put it the absence of a “system”). The theoretical premise that a system of floating exchange rates would promote swift and efficient adjustment has not been borne out in practice. In particular circumstances, within continental Europe, in many developing countries, in China, freely floating exchange rates have been deemed unworkable or undesirable. Quixotically, the international role of the dollar has increased, not decreased, even as the relative economic strength of the United States has diminished.

To me, the ultimate logic of a globalized financial system is a world currency. That is far from a reality in any formal sense. In its absence, the dollar has provided a workable, pragmatic approach. Its widespread acceptability, the fluidity and breadth of its markets, and its relative stability in its massive domestic markets, has made it a common means of payment, an agreed unit of account for much of world trade and a widely used store of value. Those are the basic characteristics of money.

At the same time, the present state of world affairs has made clear that our international monetary arrangements have not provided a needed element of discipline for either surplus or deficit countries. Deep and ultimately destabilizing imbalances have been prolonged, specifically the growing and seemingly irresistible current account imbalances between China (and much of the rest of Asia) and the United States. These imbalances have for years been covered by flows of foreign official and privately held dollars back to the United States. Indirectly those flows have to some degree helped fuel the mortgage market and the housing bubble that touched off the financial collapse.

Chinese officials have themselves recently raised questions about the implications for China and others that are holding so many dollars. I think it is reasonable to ask whether it is in the long-run interest of the United States itself to provide what is essentially a public good – an international currency – in amounts so large as to raise questions about its ultimate stability. All that points to the need to deal effectively with the imbalances that underlie excessive growth of dollar balances.

The fact is there are no practical alternatives today or for many tomorrows to the United States dollar as an international currency. I think it should be clearly understood that the central responsibility of the United States – in its own interest, in China's interest, and in the world's interest - is to maintain both the purchasing power of the dollar at home and in international markets, and a strong and open financial system.

That brings me to the area of your more immediate concern: the reform of the financial system. The obvious need has already spawned a large number of useful reform proposals. I'd like to give the G-30 Report pride of place. However, the reality is that the earlier work of the Financial Services Forum, the recent Turner Report in the U.K., the efforts of the IIF itself, and others have together provided much of the needed raw material. What is of particular interest now is building on the widespread consensus of views that seems to be developing on some of the principles and particular areas of reform. The forthcoming legislative proposals by American authorities and the work of the newly enlarged and renamed Financial Stability Board should be important steps in that direction.

One thing certain is that key elements of the reformed system must be internally and internationally consistent – for example, capital and leverage requirements, accounting standards, clearance and settlement arrangements for over-the-counter derivatives, and practices with respect to disclosure and the sharing of information. Converting the substantial agreement in principle into the specifics of national legislation and administrative arrangements will be a large challenge. Strong political leadership within the G-20 and otherwise will be required to overcome embedded interests – private or public – already resisting change.

In all of this, there are two broad areas in which private initiative will be particularly useful – to my mind really essential. They are very well suited to the capabilities and purposes of the IIF.

The first of these is the obvious need for more effective risk management practices in banks and other financial institutions. Modern finance has become enormously complex. The new profession of financial engineering has seemed to promise mathematical precision in modeling risks that cannot be so modeled. Experienced judgment has somehow been neglected.

Now it is widely understood that individual institutions from their boards of directors on down need to reconsider their internal administrative arrangements, their procedures, and their personnel practices. Difficult matters of compensation need to be dealt with head on. To put it bluntly, there is ample justification for inflamed public and political opinion about pay practices in some countries and some institutions that seem both wildly excessive and counter-productive in terms of rewarding risk-taking at the expense of institutional stability.

Far better that individual and professional groups come to grips with these matters than heavy-handed and inflexible regulation or legislation.

In approaching reform more generally, I hope national measures will be informed by some broad agreement on some basic points of departure – matters extending beyond particular institutions to their inter-relationships and inter-dependencies. One key point is that a clear point of responsibility should be provided for system-wide oversight and supervision. The point is that there are potential risks extending beyond individual institutions. Some authority should be alert to identify systemic excesses or weaknesses that might impair market performance and institutional stability. Excessive leverage, inadequate margin requirements or collateral practices, lack of strong clearing and settlement arrangements, accounting and credit rating practices that exacerbate cyclicality are all examples of potential systemic concern.

In some countries, central banks, given their broad interest in financial stability, their traditions of professional competence, and their prestige may be the natural choice for a “macro-prudential regulator” or “systemic overseer”. Other arrangements may be better suited for particular countries. In any case, access to full information from supervisors of particular institutions and clear authority to close supervisory gaps and to temper emerging financial excesses will be necessary.

Another important common concern is the “too big to fail” syndrome - the presumption that an institution is so large or so inter-connected with counterparties that its creditors (possibly even shareholders) must be protected. One unfortunate consequence of the massive public assistance provided both banks and non-banks in dealing with the present crisis is that moral hazard may, I am afraid, become more deeply embedded.

We can, and we should, take steps to limit the need and possibility of official “bailouts”. One approach would be to set clear policy limits to access to the “official safety net”. Deposit insurance and central bank liquidity facilities are properly confined to deposit taking institutions. It is, after all, those institutions that remain the backbone of the financial system. They provide basic essential services, meeting the needs of households, businesses, and other institutions for credit, for a safe and liquid repository for their funds, and for both everyday and complex payment services.

Historically, the need for continuity in those functions has provided the rationale for close government supervision and protection. In my view, it is unwarranted that those same institutions, funded in substantial part by tax-payer protected deposits, be engaged in substantial risk-prone proprietary trading and speculative activities that may also raise questions of virtually unmanageable conflicts of interest.

Hedge funds and private equity funds have an entirely legitimate role to play in providing liquidity and innovation in our capital markets. I do not believe they need to be so closely supervised and regulated as depository institutions. A presumption of government protection and support for financial institutions outside the “safety net” should be avoided. Nor by the same token should hedge funds or private equity funds indirectly benefit from official support by sponsorship or ownership by a banking institution.

The possibility that failure of a large hedge fund or trading organization might present a systemic risk can be reduced by way of speeding timely resolution of troubled non-banking institutions. Such authority already exists in the United States for insured banking institutions by means of appointing a “conservator” or “receiver” empowered to maintain continuity of services pending a more lasting resolution of a failing institution.

There is a growing international consensus that hedge funds and equity funds beyond some de minimus size should at least be required to register, with the implication of limited reporting requirements. There may be a few instances in which such funds become so large as to suggest official capital and leverage requirements would be appropriate. Hedge and private equity funds are necessarily dependent on banks for credit and operational needs. Encouraged by supervisory and risk management processes, the vast majority of such funds could be appropriately monitored and controlled through those banking relationships.

One other hotly contested matter deserves mention. There isn't much doubt that attempts to enforce strict application of mark-to-market accounting procedures has contributed to confusion, uncertainty and inconsistencies among financial institutions. There is a strong case for reviewing the application of so-called “fair value” standards to commercial banks, insurance companies and perhaps certain other regulated financial institutions.

The problem is not only the difficulty of measuring value in highly disturbed market conditions. More broadly, strict mark-to-market accounting entirely appropriate for trading operations and investment banks may introduce a degree of volatility in reporting incompatible with the basic and essential business model of banks which inherently intermediate maturity and credit risks.

At the same time, we should demand international consistency and professional judgment in setting accounting standards. Both are today jeopardized. Political bodies in Europe or the United States or any other country are simply not the appropriate venue for reaching well-considered judgments that can be enforced internationally. Instead, we need a bit of patience as the International Accounting Standards Board carefully reviews the application of "fair value" to banks and those other institutions subject to close official scrutiny in reporting.

This has been a heavy talk after a splendid dinner in this Great Hall. My excuse is simple, you have a very long, very technical agenda, and I am delighted to be able to get a few words in first.

I appreciate your attention.