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U.S. DEPARTMENT OF THE TREASURY

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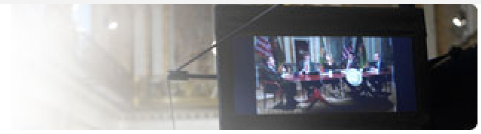

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New York City- Good afternoon. Secretaries of the Treasury, from Alexander Hamilton to Henry Paulson, have acknowledged the value of liquid, efficient capital markets. Hamilton understood that the United States' Revolutionary War debt was "the price of liberty" and to lay the groundwork for functioning, vibrant capital markets, our young nation must establish a globally respected sovereign debt market. Over 200 years later, that vision continues to deliver economic benefits. Similarly, Secretary Paulson has stated that capital markets are "the lifeblood" of the economy. Today's conference on liquidity focuses on one of the vital signs of that lifeblood, and I appreciate the opportunity to share my thoughts with you.

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Elements of Liquidity

In assessing liquidity, we must begin by recognizing the dramatic changes that have occurred in capital markets in recent years. Financial market innovation and broadening investment horizons – both from a geographic and asset class perspective – have led to an ever increasing expansion of investment strategies and instruments. Cash and spot markets have been seamlessly integrated with derivatives markets. With innovation and interrelated markets have come immense pools of capital ready to be deployed – and at times, withdrawn - which reflect the vastly fluid nature of our global financial markets.

Today, I would like to focus my remarks not just on the benefits and challenges resulting from the incoming or receding tides of liquidity, but also their distinct properties and transmission mechanisms. While the traditional characteristics of liquidity are often assumed to be fairly well understood, the dynamic nature of its underlying properties warrants further evaluation.

Furthermore, the channels of accessing or deploying liquidity - be it via the financial marketplace through credit markets, derivatives or structured vehicles - are evolving rapidly. The same can be said about the breadth of alternative sources of liquidity which includes hedge funds, pension funds, and sovereign wealth funds. Such developments have important consequences for all market participants.

Broadly defining and understanding liquidity is therefore critically important. There are real economic returns associated with enhancing liquidity as it vitalizes capital markets. At the same time, market participants can not be myopic and focus just on returns. Market participants must also focus on risks. By better understanding the nature of liquidity, participants are also better positioned to address the difficult challenge of managing one element of risk: liquidity risk. So, how best to proceed?

Water as an Analogy

A healthy functioning financial market implies an efficient flow of liquidity. As we seek to improve the evaluation of liquidity flows, we can expand our knowledge by reviewing the science of liquids as it serves as an interesting analogy. Natural science offers us a perspective on liquidity – through the lens of the chemistry and the physics of liquids.

Liquids possess numerous properties with which we are familiar. Take for example the most familiar liquid: water. Hydrologists can describe the importance and presence of water, its properties and various states, and how it transitions as it moves through the water cycle.

Water is essential for survival. We often hear of the absence of water leading to drought and death. Alternatively, an abundance of water may not be a panacea. Liquidity managers can relate, as no trader wants to be long excess funds at the end of days when there's no bid or short funds when there are no offers.

Understanding the underlying physical properties of water requires consideration of various external forces, be it temperature, pressure or interactions with other liquids. The same can be said for market liquidity as it is affected by multiple exogenous factors such as regulatory limitations or investment constraints.

Water also exists in different states. A glacier may harbor an abundance of fresh water yet tapping the resource requires ingenuity and special mechanisms to penetrate the solid state. Similarly, additional liquidity is brought to borrowers outside the traditional lending channels via securitization.

Science also teaches us to appreciate the implications of transitions between states. Often, such transformations are not uniformly even. For example, when water transitions from its liquid state to a solid as ice is formed, the process is extremely abrupt from a molecular standpoint. We have certainly witnessed the corresponding precipitous changes in market liquidity recently.

The Fluid Properties of Financial Markets

Just as scientists and engineers must understand and evaluate the nature of liquids, the same is true for financial market participants with respect to liquidity. It too, is found in varying amounts and different states. It too, possesses dynamic properties and transitions. While our textbooks may have described this as a virtuous cycle, it can also be experienced as a vicious circle.

In capital markets, liquidity is often defined as the degree to which an asset or security can be bought or sold without significantly affecting the asset's price. It may also be perceived as the ability to convert an asset to cash quickly.

High levels of trading activity, narrow bid/ask spreads, low transaction costs, and similar, non-discrete price movements characterize a highly liquid market. The clear availability and activity of market makers, the incentive to take on risk, and the presence of effective clearance and settlement systems support efficient capital markets. In addition, complementary derivative instruments can help to lower costs associated with risk transfer and attract additional investors to a market, thus enhancing liquidity.

Securing the benefits of liquid capital markets is challenging as conditions are anything but static. Capital markets – including even U.S. Treasuries - face varying degrees of liquidity. This has been particularly true over the past several months.

Last summer, liquidity conditions reached a critical point. The plentiful flow of liquidity that fueled a boom in borrowing and leverage across asset classes -- from home mortgages to leveraged buyouts to private equity simply vaporized -- like water into steam. Despite market participants' continuous monitoring of the conditions in the financial environment – be it the worsening of mortgage lending standards, the expansion of even more complex instruments and structures, or the application of more leverage – the resulting transition in liquidity states was nonetheless sudden and took most market participants by surprise.

Not unexpectedly, the consequences were dramatic. Certain financial sectors were materially compromised by the inability of participants to access liquidity – even when such liquidity was widely present. This was a result of a decrease in confidence as doubts arose about future financial conditions, which in turn, delivered devastating blows to both users and providers of liquidity.

For example, short term funding markets essentially froze. Inter-bank funding spreads to future expected Fed policy rates rose to unprecedented heights, reflecting the tremendous friction and tenuous ties among counterparties. Mortgage origination and other asset securitization fell dramatically, exacerbating challenges in the housing sector. Given the interconnectedness of our capital markets, other stresses predictably emerged which further impeded liquidity: algorithmic trading ceased, financial institutions grappled with valuing assets, and balance sheets came under pressure.

The lack of liquidity led to unprecedented actions by major central banks and tremendous strains in the financial sector. We continue to see the results of these strains play out. Since last August, we've seen the write off over $153 billion in the financial sector, the downgrading of numerous issuers and structures, loss of over $1 billion to guarantee over $18 billion of assets held in money market funds, and the consolidation of over $136 billion in SIV assets.

Liquidity Sources and Cycles

However, this period of write-downs and recapitalizations is not a permanent state. It is transitory – another phase of the cycle and in the long term, likely to be beneficial. Just as water can be found in aquifers, new pools of liquidity are being formed and tapped, resulting in a gradual reintermediation of capital markets.

Over the past nine weeks, over $95 billion has been raised in the capital markets. We have seen equity raised by the housing Governments Sponsored Entities (GSEs), and capital injections in financial institutions by various sovereign wealth funds. We have also witnessed entries by other investors with strong balance sheets and credits into capital reliant businesses such as banks, and monoline insurance companies.

Recently, we have seen a gradual reduction in key benchmark spreads. Commercial paper markets, even asset back commercial paper markets, have seen greater issuance and lower funding rates. This is certainly not an "all clear" signal, but perhaps the beginning of the transition to an improved state of liquidity. This process will take more time. Confidence returns when investors validate their assumptions - not just on future returns, but equally on risks. It is on the latter dimension where a great deal of reassessment is occurring.

One reason investor confidence is being hit so hard, is that many investors were sanguine over the last few years. This sanguine state – perhaps even over-confidence- was a result of many factors. But recent events underscore the importance of the need for strong market discipline, prudent regulatory policies, and robust risk management. Investors must appreciate risk – in its myriad dimensions and seek to better identify, assess, and manage it. Successfully doing so requires continuous evaluation from multiple perspectives, and humility to know the limitations of any single or even comprehensive assessment of risk.

More transparency, disclosure and independent analysis can increase investor confidence. We have seen some positive developments in recent weeks, particularly in the U.S., but more must follow. As the global capital markets continue through this transition, some revaluations will be gradual, while others may be more dramatic. As a result, we are likely to witness continued volatility.

Importantly, the markets' underlying infrastructures, and processes have remained intact. Trading, clearing and settlement systems have each responded well despite tremendous strains and massive volumes. However, we must not take this for granted. Continued efforts to enhance such systems serve to prepare our markets for future challenges.

Catalysts for Evolution

In the face of important changes related to global capital market liquidity, market participants and public policies must evolve. As market leaders, we need to possess both judgment and confidence: judgment to recognize when changes are necessary and the confidence to make those changes.

Addressing market challenges must be done thoughtfully. This task is a shared responsibility between the private and public sectors. Consider liquidity risk management. Firms have learned that the properties associated with liquidity may be fleeting – and that additional methodologies to assess and manage liquidity exposures may be warranted to avoid such strains in the future. Both regulators and senior management of financial firms recognize that efforts to enhance comprehensive stress testing, valuation and hedging capabilities, as well as management information and metrics for evaluating and managing liquidity risk are invaluable.

Market participants should continue to appreciate the benefits of diversified sources of liquidity, including the benefits of larger reserves, complementary sources and potential global suppliers. Equally important, participants must appreciate that risks must be assessed to each of these and that these assessments and relationships can change, especially during periods of market stress.

Markets, practices and policies will need to evolve. Institutions, structures, and strategies must do so as well. The good news is that our capital markets have a rich history of adapting.

Both policymakers and market participants must review current practices. Encouraging issuers to enhance disclosure, financial institutions to be well capitalized, and investors to conduct independent due diligence are logical outcomes of such reviews.

The President's Working Group on Financial Markets, which Secretary Paulson chairs and includes the Chairmen of the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, has begun a comprehensive review of such policy issues. We are also working with the G7 and the Financial Stability Forum to review issues related to the recent challenges in the global financial markets.

These complementary reviews are focused on issues that range from enhancing risk management including liquidity and counterparty credit risk, to market infrastructure, to reporting and disclosure, and to ratings and investor practices.

While we address these intermediate term issues, our short term focus is to minimize the spillover effects of the current capital markets challenges to the real economy. In addition, we are also engaged in a strategic endeavor. We are developing a blueprint that outlines a more optimal regulatory framework for our financial sector. Given the current fragmented structure and a global financial marketplace that is constantly evolving, we need to ensure that our financial marketplace is well positioned to compete and deliver future benefits to our economy.

Equilibrium

Economies derive much of their strength from robust and diverse capital markets. As market participants, each of us must contribute to ensure the integrity, openness and competitiveness of our markets. The natural byproduct of such conditions is liquid, efficiently functioning markets. A better understanding of global liquidity, including its capricious properties, its abundance, its hidden reservoirs, its dynamic nature, and its transitional characteristics – enhances economic growth and improves risk management. This in turn, serves to bolster investor confidence.

All stakeholders – be they providers of liquidity, such as investors, or users of liquidity, such as issuers, – have a direct interest in facilitating liquidity in capital markets. But the underlying drivers for such optimal operating conditions may not always be present. As we have seen recently, liquidity can be abundant and encourage imprudent risk taking. Or it can be scarce and create broad based risk aversion.

There is no ideal quantity of liquidity. We live with cycles and must learn to live with a range of market conditions. We need to attempt to understand the underlying drivers of that liquidity. But even with such examination, the ultimate truths may not be readily borne out.

The famed Russian physicist George Gamow once noted that the picture of molecular motion in liquids is "unpleasant and untidy". This is somewhat of a fitting description of liquidity conditions in financial markets over the last six months. Rather than attempt to attain some ideal level of liquidity in markets, we should strive to enhance liquidity, with the full knowledge that markets – like liquids – are fickle in nature and difficult to fully quantify – or even qualify in certain states or periods.

In addition to efforts to enhance market liquidity, we should seek to strengthen market discipline and participants' awareness of risks. Ultimately, albeit at times slowly, market discipline and prudent regulatory policies serve to recalibrate capital markets. Eventually such efforts bring future benefits: greater market depth, more trading volume, larger flows, tighter spreads, lower costs, less volatility, better price discovery, more capital, and an increasingly diverse investor base.

Conclusion

Liquidity is a vital sign of capital markets. Robust capital markets possess efficient flows of liquidity, which in turn, facilitate economic growth. Its fluid nature is in fact beneficial as it enables capital to flow to ever higher and better uses. Its presence stimulates competition and innovation -- enabling not just economic viability, but vitality.

At the U.S. Treasury Department, encouraging open capital markets, addressing both the near term and strategic challenges, and doing all we can to ensure high quality, competitive and orderly capital markets remain our goals. We encourage the private sector to do the same.

Thank you.