

# **The Egocentricity of the Present (Prefaced by the Tale of Ruth and Emma)**

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*The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System or the Federal Open Market Committee.*

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Thank you, Dick. I admire Dick Evans for many reasons. He is a smart banker. He is a devoted San Antonian. He is a superb member of the Federal Reserve Bank of Dallas' board of directors. And he is married to Jimmie Ruth, who is living proof that men, even Dick Evans, can always be improved upon.

The name Ruth evokes memories of my godmother, Ruth Walgren, who had a vivid sense of humor. She lived to a very ripe old age and used to tell a story that went something like this: Two women, Ruth and Emma, lived well into their 90s, surviving their husbands and practically all their friends in their little town. They had been best friends all their lives, growing up just a few doors from each other and living just a few blocks apart since childhood. Age finally caught up with Ruth. In her final hours she told Emma: "You know what I remember most fondly? Softball. My favorite thing in my long life was playing softball when we were girls. We were carefree and happy and everything was just so perfect. Oh, Emma, I pray there is a softball team in heaven."

"My dear and oldest friend," Emma said, "I loved playing softball too. If there is softball in heaven, will you send me a signal and let me know?"

"I will, I promise," said Ruth, and with that she smiled, closed her eyes and passed on.

Several weeks later, on a Sunday night, Emma was peacefully lying in her bed. Suddenly a flash of intense light hovered above her bed. Ruth appeared as an angel. "Emma," she said, "I have good news and I have bad news."

"Oh, Ruthie," Emma said, "tell me the good news."

"The good news, Emma, is that there is a softball team in heaven! All of our friends from girlhood are here and so are our old teammates. We are all carefree girls again. We play all day in perfect weather. We never get tired. And we are happy, happy, happy and will be for eternity. It is truly heavenly."

"Oh, Ruth, that is so wonderful," Emma replied. "What better news could I have received on this fine Sunday night? What could possibly be the bad news?"

"Well," said Ruth, "the bad news is you are pitching on Tuesday."

So often, just when all seems so good and just right, we receive an abrupt warning that things are about to change, that we are going to be yanked from our comfortable existence and into the unknown. At that moment, we realize we have been enjoying a false sense of comfort. The outlook suddenly becomes less certain, even bleak, and we panic, wondering just how to deal with our new predicament. This is especially true in economics.

Last Thursday, the *Financial Times* published a pithy little letter by Alex Pollock, a resident fellow of the American Enterprise Institute, questioning the assertion of a column written some days earlier about the financial markets that had stated “we are in unknown territory facing situations that have never arisen before.” Pollock’s response was that the current bursting of the housing bubble exhibits time-honored boom–bust traditions. And then he penned this zinger: “In booms it is proclaimed that we are in a ‘new era’—in busts that we have ‘unprecedented problems.’ This is merely the egocentricity of the present.”

I would like to talk today about the “egocentricity of the present” as it relates to the economy. What is the nature of the bubble we have experienced and what are the dynamics of the bust? How is it affecting Texas? What is the proper role of the Federal Reserve in dealing with the situation? And what might Texans do about it?

To begin, we need to spend a moment pondering the nature of risk. Perceptions of risk lie in the eye of the beholder. Some see risk as a powerful force vital to capitalism; others consider it a four-letter word. The latter view may be gaining currency these days, as risks taken in housing finance have led to considerable stress in financial markets and weakness in the overall economy.

We must not forget that prudent risk taking is the lifeblood of capitalism, especially in the American form of capitalism where we are constantly replacing the old with the new, and the familiar with the new and the innovative. If we had not taken risks, we would never have created from scratch the \$14 trillion U.S. economy.

Every one of us takes risks to advance our interests. A young person who goes to college, for example, risks the certain income from today’s job, believing in the probability of a better paying one after graduation. As we accumulate excess savings, we place them at risk by investing in stocks and bonds to secure our retirement. We take risks by borrowing to build our businesses, with the expectation that a brighter future will enable us to repay our debts and then some.

Of course, we also strive to manage risk. Once we are in the workforce, life insurance, for example, hedges the risk that we might die before we have socked away enough money to provide for our families. A prudent banker like Dick Evans drills down into the businesses he is lending to and knows them like the back of his hand in order to minimize risks to his short-term depositors from providing businesses with long-term financing. And so on.

The necessity of risk taking as a pillar of market capitalism has also given rise to agents to service it. Insurers and banks are two such agents, as are investment banks, money managers, hedge funds and other financial intermediaries that provide the means to assess, package and distribute risk. In the old days, their job was fairly straightforward. The agents packaged straight-up risk instruments like letters of credit, bankers’ acceptances, commercial paper, simple loans and stocks, life and property insurance and fixed-rate mortgages. More recently, with the aid of technology and computational power that can assess probabilities at lightning speeds, the menu of risk instruments expanded dramatically. Financial intermediaries began offering exotic products to satisfy almost any risk taker’s needs anywhere in the world at any time. Hunger for the new risk products was stimulated by a lengthy period of abnormally low interest rates and the

normal human instinct to look for ever-higher yields when the returns on orthodox financial instruments, like U.S. Treasuries, municipal bonds or bank CDs, become ho-hum.

Of course, like exotic foods, consumption of new risk products can lead to indigestion, and even allergic reactions. Lately, we have witnessed many allergic reactions—in the form of losses and setbacks—especially among money center banks and other financial institutions whose fiduciary eyes—as old Ruth Walgren would have said—“simply got too big for their stomachs.” What began as isolated pockets of trouble in the U.S. housing market soon spread to global markets in mortgage-backed securities, where many of the exotic home mortgage products were gobbled up. Soon it became obvious that financial market participants were gagging on the many types of “structured” credit products—not just those backed by mortgages—they were being served. As we approached the summer of 2007, this gag reflex reached a pinnacle; the larger banks found it difficult, if not impossible, to sell to others many types of loans; and the interbank lending market experienced intense liquidity pressures as banks became fearful of lending to each other for longer than overnight.

Just when things seemed so comfortable, when we were so happy as an economy, it is as though we settled down for a peaceful night’s sleep on a Sunday night this past August, only to learn we would be called to pitch on Tuesday, but with less pleasant prospects than those of our fictional friend Emma. We’ve seen yet another historical cycle of excess risk-taking—in this case, concentrated in financial innovations in credit and structured finance served up and consumed without regard for the downside—followed by extreme risk aversion.

This round of speculation and financial amnesia seems to have been driven by a combination of factors, including an over-reliance on statistical models and rating agencies, excessive liquidity and perverse incentives compounded by an excess of complacency.

In assessing the situation, don’t let anyone convince you that we’ve entered a “new era.” The details may be different, but we’ve been here before. Allow me to temper the ego of the present by recalling the not-too-distant past and the events that happened right here in Texas.

In the 1980s, the euphoria of oil prices around \$100 a barrel in today’s dollars led to a frenzy of lending activity in Texas. At least I think that’s what any reasonable observer would call the annual growth rate of business loans of over 40 percent at Texas banks and annual growth in commercial real estate lending of almost 50 percent that we saw in the early part of that decade. Booking assets at such a rapid clip has a seductive power. My favorite line from the musical “Evita” is when she belts out, “All I want is a whole lot of excess!” Well, we certainly pursued excess here in the 1980s. In pursuit of a seemingly sure thing, more than 550 new banks were chartered in Texas from 1980 through 1985. This made for a volatile brew, combining dramatic rates of growth in activity with a dramatic expansion of the number of players with limited experience in knowing what to do when things go wrong. The assumption of permanently high, or permanently rising, prices in an asset class—in this case, oil—invariably leads to regrettable decisions.

You recall what ensued. Real oil prices began to fall, contributing to an economic slowdown in the region’s most energy-sensitive areas, such as Houston. The regional economy held its own for a while, propelled by a red-hot commercial real estate sector. The state economy suffered a severe decline, however, when oil collapsed to the current equivalent of around \$22 per barrel by

mid-1986. Bank and thrift failures reached a frightful magnitude. More than 800 financial institutions went out of business in Texas during the 1980s and into the early 1990s. Nine of the 10 largest banking organizations based in Texas didn't make it—the exception being Dick Evans' Cullen Frost.

The energy bust reverberated through Texas, and it was keenly felt in both commercial and residential real estate markets. Office vacancies soared. In Dallas and Houston, they hovered around 30 percent, and they approached 40 percent in Austin. Employment growth flatlined and recession ensued.

The nation's current difficulties took root not in the oil market, but in the U.S. housing market. After several years of startling increases in home prices and financing activity, things began to unravel several quarters ago. But the roots of the current crisis were like those of earlier bubbles. They originated in the seductive power of price escalation—of a “whole lot of excess”—and the egocentricity of the present, which led some to believe we had entered a “new era.” We either didn't notice this elaborate conceit or failed to deal with it. But it was there. Many coastal areas of the U.S. were beginning to see 20 to 30 percent year-over-year increases in house prices, some even as high as 30 to 40 percent. Subprime mortgage borrowing, or lending to less creditworthy individuals by lenders who were eager to finance a “sure thing,” exploded. The good news is that levels of homeownership among the U.S. population reached unprecedented heights, extending the American dream to more people than ever before. The bad news is that the methods used to do so were not sustainable.

Let me give you some numbers to focus the mind. In 1999, before home prices started to defy gravity, 55 percent of homes sold in the New York metro area were considered affordable to the median-income family by one industry gauge. When home prices peaked at the end of 2006, that percentage had fallen to just 5 percent. In Los Angeles in 1999, 43 percent of homes were affordable to the median-income family, but only 2 percent were by the end of 2006. Two percent! Compare that to Texas. In Dallas in 1999, 64 percent of homes were affordable, by 2006 that percentage had barely slipped to 62 percent. In Austin, home prices actually became more affordable over this period, in contrast to the U.S. as a whole.

The chairman of Presidents Nixon and Ford's Council of Economic Advisers, Herb Stein, was fond of saying that, “if something cannot go on forever, it will stop.” Eventually the conceit of a “new era” in housing could not go on forever, and it stopped. The bubble popped, and a harsh correction has ensued.

With that abridged historical background, let's turn back to the financial markets. We saw a wave of innovative mortgage products during the housing boom. Indeed, there would have been no other way for many borrowers to have procured financing without these new mortgage products.

These innovations in financing took two forms. First, credit-scoring models enabled lenders to better sort and price mortgages made to nonprime borrowers. The second set of innovations allowed these loans to be funded and sold to a new class of investors. While traditional mortgages had long been securitized and sold through government-sponsored enterprises such as Fannie Mae and Freddie Mac, the securitization market ushered in new players from the private

sector who would hold nonprime mortgages that could not meet the standards of Fannie and Freddie and that banks would generally not hold in portfolios.

These so-called structured credit products became all the rage with investors. These new and complex securities sliced and diced risk into different tranches. It was thought that the collateralized debt obligations and collateralized loan obligations could be hedged with credit default swaps to make them seem almost risk free. And, if you could do so with mortgage loans, why not credit card loans, auto loans and other types of debt?

Things began to unravel once it became apparent that the housing bubble could not expand forever. Losses began to be recorded on traditional mortgage-backed securities, with the newer types of structured finance products used to securitize the newer types of mortgage lending being especially hard hit. It didn't stop there. Banks in other countries that had invested in the too-good-to-be-true U.S. housing market through these products began to record large losses. Even some that weren't directly involved in the U.S. housing sector or these products still felt the repercussions; who could have imagined that house price declines in the U.S. would contribute to a bank run in England?

All types of structured credit products soon came under suspicion. Issuance of asset-backed commercial paper declined sharply beginning last summer. Although some of that paper was backed by mortgages, not all of it was. But that didn't seem to matter. The market for auction rate municipal bonds was also hit, as doubts spread regarding the financial health of the misnamed "monoline" insurers. Investment banks also experienced abnormal difficulties in the usually routine task of syndicating their leveraged loans in the private equity sphere, which is fairly remote from the mortgage industry, to say the least.

The banking industry was smack in the middle of this maelstrom. This sector is of obvious importance to the Federal Reserve. Not surprisingly, large losses have been recorded at some of the largest banks. Their capital ratios are also under pressure from the fallout in the securitization markets. The difficulty in selling loans and the increase in lending to borrowers who were shut out of the securitization markets have increased banks' exposure. In addition, some banks that offered off-balance-sheet commitments to their structured investment vehicles, or SIVs, have found themselves having to move these assets onto their balance sheets. All this asset onboarding has pressured capital ratios. Combine these pressures with the difficulty of establishing values for structured credit products in seized-up markets and it is no surprise that term interbank lending thinned out considerably.

That's what happened. There will be lots of theories as to how it happened. Mine is fairly straightforward: however many "quants" from MIT or Cal Tech or UT San Antonio you bring in to build models that theorize away risk, there is no overturning the fundamental law that the price of an asset is determined by what someone is willing to pay for it. Mathematical models complement judgment and experience but are no substitute for them. Judgment and experience, including our own vivid experience here in Texas in the 1980s, teach us that in booms and bubbles, prices overshoot and during busts, they overcorrect.

To a great extent, the bubble in housing was a classic case of the bigger-fool theory and efficient-market theory run amok. The excesses in subprime lending in the United States were fed by an excessive amount of faith in technically sophisticated approaches to risk management and a

misguided belief that mathematical models could price securitized assets, including securities based on mortgages, accurately. These valuation methodologies were so technical and mathematically sophisticated that their utter complexity lulled many people into a false sense of security. In the end, complexity proved hopelessly inadequate as an all-encompassing measure of risk, despite its frequent advertisement as such. The risk models employed turned out to be merely formulaic descriptions of the past and created an illusion of precision. Such approaches could not and cannot replace the forward-looking judgment of a seasoned professional.

Seasoned investors and creditors know that incomplete information—or information asymmetry, in technical jargon—is a fact of life in financial markets. In fact, the presence of information asymmetries goes a long way toward explaining the structure of financial markets and institutions. In our system, we have implemented a process of “delegated monitoring” to address these asymmetries.

Let me explain what I mean by “delegated monitoring.” Because an individual saver would be hard-pressed to monitor the many potential borrowers to whom they could lend, they have delegated that monitoring role to their bank, which then is in charge of keeping tabs on borrowers. In the U.S., where the safety of deposits at most banks is federally guaranteed, regulators are a delegated monitor, loosely speaking, watching over banks on behalf of their collective depositors.

The regulators also are not above delegating some work. Rather than attempting to monitor the entire universe of financial institutions, U.S. regulators rely heavily on a core group of very large money center banks with significant exposures, expecting them to act as delegated monitors, disciplining the remaining players in the financial system through effective controls on counterparty risk by assessing and limiting the risk of other banks, hedge funds and private equity firms. And finally, regulators and investors alike have come to depend on ratings agencies to assess and monitor firms and securities on their behalf.

All these complex monitoring arrangements are motivated, at least in part, by the fact that information is costly. Yet it seems to me that a lot of our recent problems can be attributed to breakdowns in this chain of delegated monitoring. To this end, the secretary of the Treasury has put forward recommendations to modernize and clarify the chain of command of delegated monitoring. We are studying the recommendations he has made—as is the Congress and others—and will contemplate them dispassionately over time.

Meanwhile, the Federal Reserve is doing its level best to facilitate the process of price discovery and adjustment from a period of excess in a manner that restores the efficacy of the financial system.

Here is a simple analogy to help you think about our effort. The Federal Reserve is charged with conducting monetary policy that sustains noninflationary economic growth. We have at our disposal a tool called the federal funds rate, which we set as the base lending rate for the economy. Think of the fed funds rate as a monetary spigot, and the Fed’s goal is keeping the lawn of the economy green and healthy. If we turn the spigot up too forcefully, we will flood and kill the grass with inflation. If we provide too little, the lawn turns brown, starved for money. To get the money from the spigot to the lawn requires a working system of pipes and sprinkler heads. The “shadow banking system,” however, looks like a Rube Goldberg device designed by

a hydrologist on acid, with pipes and conduits that lead every which way and not always toward the goal of sustainable economic growth. Moreover, the system of pipes and outlets is clogged with the muck and residue of a prolonged and frenetic period of unrestrained growth and abuse. Until the confusion and the debris are cleared away, financial intermediaries will be reluctant to book new loans or incur additional risk. This retards the impact of additional monetary accommodation.

Thus, even as we have been cutting the fed funds rate—even as we have been opening the monetary spigot—interest rates for private sector borrowers have not fallen correspondingly, and rates for some borrowers have increased. The grass is turning brown.

To address this problem, we have created some new facilities that should provide a liquidity bridge over the currently dysfunctional system while the marketplace and regulators—ourselves included—go about restoring the system’s plumbing.

The term auction facility—known by its acronym, TAF—was introduced in December as an entirely new approach to funding problems at banks. Those who are eligible for primary credit at the Fed’s traditional discount window can now bid at bimonthly auctions for term funds. So far, the auctions have been well-subscribed and term funding pressures abated after the introduction of the TAF. The term securities lending facility we announced last month expands the Fed’s securities lending program. Securities will now be made available through an auction process with an expanded array of collateral on a weekly basis for a term of 28 days. We also set up a primary dealer credit facility, an overnight lending facility that provides funding to primary dealers in exchange for a range of eligible collateral. And, at the request of the Federal Reserve Bank of New York, the Board of Governors of the Fed approved a loan to J. P. Morgan so that that bank might digest the exposure that many counterparties had to Bear Stearns, without rewarding Bear Stearns shareholders for the imprudent risks assumed by their management.

To repeat, the objective of all this activity is to provide a bridge for the financial system while it transitions from a period of indiscriminate excess and gets back to normalcy. I do not believe the Fed should be, or is, “bailing out” any particular institution. Nor do I personally believe that any institution in and of itself is “too big to fail.” But I do believe that we must have a financial system that is in working order. We must have a system where the chain of delegated monitors operates smoothly and efficiently. We must have a system where the pipes that nourish capitalism sustain the fertile lawn that is the American economy. It is the Fed’s duty as lender of last resort to lead the way to restoring the efficacy of the financial system.

The Fed has made some tough judgment calls lately, and, having been party to making those calls, I can assure you they certainly were not made lightly. In principle, we know that the market should decide the winners and losers, who survives and who fails. I am a big fan of Winston Churchill. “It is always more easy to discover and proclaim general principles than to apply them,” Churchill said. I now know full well what he meant.

Looking to the future, and in summary, the emerging discussion on new regulations and a new supervisory framework should proceed, but regulations by themselves cannot replace good judgment by individual investors or bankers or financiers, and certainly by policymakers. Policymakers need to remain vigilant in seeking the right balance between prudent and indiscriminate risk taking. But the elimination of risk—and the consequences of incurring risk—

can never be the goal of any policymaker in a capitalist system. In building the bridge to restore financial order and efficiency, my primary interest is to do the *minimum necessary* to get the job done. And no more. In so doing, my hope is that we restore the long-term faith of the millions of risk takers who make our economy so mighty.

Having used the term “mighty,” let me turn to Texas. Texas’ housing, as mentioned earlier, is affordable. Our industrial mix creates jobs that are appealing. People continue to move here from the high-priced East and West Coasts and the Midwest, where the job market has been softer. We are a thriving engine of growth in an otherwise anemic economy.

Here are some data to prove the point. Between 2004 and 2007, job growth in the expensive cities on the East and West Coasts was 4 percent or less. In manufacturing-oriented cities of the Midwest, the job market was weaker, with Cleveland and Detroit posting declines. By contrast, between 2004 and 2007 employment in Dallas grew by 8.9 percent. In Houston, by over 12 percent! Last year, almost one-third of all the private sector jobs created across America were created in our state. Let me repeat that: Over 30 percent of all the private sector jobs created in America last year were created right here in the Lone Star State.

As a Texan speaking to a room full of Texans, I would be remiss if I didn’t offer my two cents about what this state ought to be doing in times like these. Before he became president, Jack Kennedy reminded an audience that the Chinese character for the word “crisis” has two brush strokes. One stroke means danger, the other means opportunity. As Kennedy so wisely put it, “In a crisis, be aware of the danger but recognize the opportunity.”

The housing crisis may not yet have run its course, and further danger could lie ahead both for the nation and also for Texas. We may seem isolated from the rest of the nation’s woes, but we are not immune from the dangers they pose. Still, as I survey the Texan economic landscape, I sense we have an opportunity here. Our economy is growing. We’re an affordable and wonderful place to live. And we hunger for workers—as recently as this morning I heard anecdotal reports of labor shortages in parts of Texas.

The U.S. economy will continue to suffer from a bout of anemia while the housing and financial markets settle down. I take comfort, however, in knowing that markets eventually clear if we at the Fed do our job and the other regulators and fiscal authorities do theirs. Even in the egocentric present, when gloomy analysts lament “unprecedented problems,” we must never lose faith in the economic machine that has propelled the U.S. economy to unprecedented prosperity. You need look no further than to what is happening in our own state for proof of our nation’s inherent resiliency. All I ask of you as San Antonians and as Texans is that you continue to serve as the exemplar of what can be accomplished by properly managing risk and turning “unprecedented problems” into unrivaled opportunities, as Americans have done time and time again.

Thank you.