Responding to Turbulence (With Reference to Bob Dylan, Alan Brooke, Washington Irving, Anna Fisher and Marcus Nadler)

Remarks before the Money Marketeers of New York University

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New York City
September 25, 2008

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Thank you, John [Partlan].

I haven't been in these rooms for some 30 years. The Downtown Association used to be a haunt of some of the partners of the firm where I started my career—the venerable, now 190-year-old and still-thriving private bank, Brown Brothers Harriman & Co. I went to work there for the legendary Robert Roosa after graduating from Stanford Business School in 1975. He and the partners of Brown Brothers taught me money and banking and provided me the analytical training and insights that made for whatever successes I have had, including the investment performance record cited by John in his kind introduction.

Most important, it was Mr. Roosa, God rest his magnanimous soul, who set me on the path that led to the Federal Reserve. He had played a signal role in the development of the New York Fed's operations and later served with great distinction as President Kennedy's undersecretary of the Treasury before joining Brown Brothers. During his long career, he mentored many good men—from Paul Volcker, who was his deputy at Treasury, to Mike Long, who became a key general partner at Brown Brothers and whom I am very honored to see here tonight, to a few lesser characters like me. All of us take pride in having been members of a small fraternity that was very much "sub-Roosa."

That was then; this is now. Little about the fraternity I currently belong to—the Federal Reserve System—is sub-rosa, or secretive. Chairman Ben Bernanke has just completed two days of testimony before Congress, and I doubt anything I can say tonight will be any more comprehensive than what you heard from him these past two days. So I will make little effort, neither in this speech nor the Q&A that follows, to review or amplify upon the chairman's testimony. Instead, I am going to focus my comments predominantly on monetary policy, the bedrock mission of the Federal Reserve System. As always, the views I will express this evening are my own and not those of any other participant in the Federal Open Market Committee (FOMC) or the Federal Reserve.

As I was preparing this speech against the background of recent fast-moving events in the financial markets, I couldn't help but think of Bob Dylan's song "It's Alright, Ma (I'm Only Bleeding)."[1] One of my favorite lyrics in that song is: "Money doesn't talk, it swears." Financial institutions have been bleeding, and the markets have been cussing up a blue streak lately. So I thought I would share with you tonight some perspectives on where we have been, what we have done, where we are now and where this might lead us.

Let me begin by reviewing where we have been on monetary policy by dispatching the excessive attention that has been given to my dissenting votes this year on the Federal Open Market

[1] "It's Alright, Ma (I'm Only Bleeding)," by Bob Dylan, *Bringing It All Back Home*, 1965.

Committee. The morning after our meeting on Sept. 16, the headline in the business section of the world's most important daily … *The Dallas Morning News* … read as follows: "Bernanke, Fed Colleagues Decide to Keep Rates Steady; Even Dallas' Fisher Concurs."[2]

The less parochial among you may have read Hong Kong's *Asia Times* on Sept. 18, which had this gem of an analysis on the meeting: "Like an old-time cowboy, [Ben Bernanke]'s got all his 'little doggies' back into the pen. Dallas Federal Reserve [Bank] president Richard Fisher, the leader of an anti-Bernanke insurgency calling for higher interest rates to fight inflation since spring, fell in line this time with the rate hold [at 2 percent], making the statement unanimous." To which the writer appended: "… if the choice was between the health of the economy and the restoration of Bernanke's authority, it seems that the economy got the nasty end of the stick."[3]

I am not sure what was meant by that last clause about the end of the stick. But I can tell you this: Ben Bernanke, whose authority as chairman has never been in question, is no cowboy. And I am no "doggie" (though our family does own a handsome herd of Longhorns and a fine breeding bull named, incidentally, Irrational Exuberance; I consider these noble animals, so the term in itself is hardly insulting). Nor am I a member of, yet alone a leader within, what some cynical writer imagines is an "anti-Bernanke insurgency." I am a member of a group of earnest policymakers, which includes the chairman, that places the health of the economy and the proper conduct of monetary policy above any personal interests or intrigue.

The FOMC met on Sept. 16, the day after the Lehman announcement and as the New York Fed was wrestling with AIG. As we prepared to meet, fed funds were trading at up to 5 and 6 percent, triple the targeted level, even as the open market desk was injecting prodigious amounts of liquidity into the system. And we met on the eve of some $89 billion in one day's withdrawals from money market funds. The problem was clearly not the fed funds rate target. A rate cut was not, and is not, the cure for an economy where many banks cannot expand their balance sheets, or must shrink their balance sheets, because of capital constraints. The case for a rate rise seemed both less urgent and potentially disruptive given the clear and present danger of an imploding financial system and the considerable downside risks to the economy should that implosion occur. This "little doggie" entered the pen not because Ben Bernanke or anybody else had herded me there. Rather, I did so because I felt, as others at the table did, that holding the fed funds rate steady at 2 percent was the right thing to do while our colleagues at the New York Fed and at the Treasury turned to dealing with the risk of AIG and other choke points in the markets.

This does not mean that I or anybody else at the table have abandoned our primary job as central bankers to deliver upon our mandate to provide the monetary conditions for maximum sustainable noninflationary employment growth. We do our duty when we vote with that mandate in mind, even if it means not satisfying the pundits or market operators who wish for us to accommodate their more immediate needs.

I take this charge very seriously, as does every other member of the committee. If the author of that *Asia Times* article, or any of you, wishes to place in perspective my votes—or those of Charlie Plosser of the Philadelphia Fed or Bill Poole of St. Louis, or those last year of the Boston

[2] "Holding the Line: Bernanke, Fed Colleagues Decide to Keep Rates Steady; Even Dallas' Fisher Concurs," *The Dallas Morning News*, Sept. 17, 2008, p. 1D.
[3] "Ben First, Economy Last," by Julian Delasantellis, *Asia Times*, Sept. 18, 2008.

Fed's Eric Rosengren or the Kansas City Fed's Tom Hoenig or any other member of the FOMC[4]—he might benefit from reading Andrew Roberts' magnificent new book, *Masters and Commanders*. It tells the story of Churchill and Roosevelt and their top aides as they sought to negotiate the Second World War. Sir Alan Brooke was Churchill's equivalent to Roosevelt's Gen. George Marshall. On more than one occasion, Brooke openly refused to fall into line with Churchill, and often articulated arguments that differed from the consensus of the war cabinet meetings. A critic considered him an insurgent and told him so, saying that it would appear that he might not hold the prime minister in highest regard. To which Brooke replied: "I adore him tremendously … but the day that I say I agree with him when I don't is the day he must get rid of me because I am of no use to him anymore."

In a committee such as the FOMC, the best service a member can render is to show his or her affection for the institution, its members and especially for its chairman by calling it as he or she sees it.

In my view, the situation this year has been as follows:

Since the beginning of the year, I have been worried about the efficacy of reducing the fed funds rate given the problems of liquidity and capital constraints afflicting the financial system. As I see it, the seizures and convulsions we have experienced in the debt and equity markets have been the consequences of a sustained orgy of excess and reckless behavior, not a too-tight monetary policy.

There is no nice way to say this, so I will be blunt: Our credit markets had contracted a hideous STD—a securitization transmitted disease—for which lowering the funds rate to negative real levels seemed to me to be not only an ineffective treatment, but a palliative and maybe even a stimulus that would only encourage further mischief.

I was and I remain skeptical that lowering the fed funds rate is the most effective antidote for such a pathology, given that, in my book, rates held too low, too long during the previous Fed regime were an accomplice to that reckless behavior. A fed funds rate of around 3 1/2 percent—that was the level at which I began to stray from "the pen"—did not appear to me to be the principal problem, particularly with commodities prices soaring and incipient inflation coming to our shores from demand-pull pressures and rising labor costs in the countries that we use to source the inputs needed to run our manufacturing base and stock the shelves of our retail stores.

I would be happy to go into further detail during the Q&A period about my concerns this past year for the risk of inflation "pass through." Again, that was then; this is now. But we certainly were seeing it continue as we entered the third quarter, even as the financial crisis was reaching a crescendo. On Sept. 5, almost at the moment the Treasury announced it had taken Fannie Mae and Freddie Mac into conservatorship and the stock market had once again turned dyspeptic from fears of an economic slowdown, the customers of Georgia-Pacific woke up to find a note dated Sept. 4: "Please be advised that the Georgia-Pacific Consumer Products LP is increasing

[4] President Plosser voted against the majority on March 18 and April 30. President Poole voted against the majority on Jan. 22, 2008. President Rosengren cast a dissenting vote on Dec. 11, 2007. President Hoenig cast a dissenting vote on Oct. 31, 2007. All voting records are publicly available at www.federalreserve.gov/monetarypolicy/fomccalendars.htm.

prices up to 10% with selected items increasing more than 10%, on commercial towel, tissue, napkins, wipers, dispensers, soap, aire [sic], and specialty products due to continued cost increases…. Orders shipped on or after Monday, December 1, 2008, regardless of order date will be invoiced at the new prices."[5]

On the day that notice was mailed to Georgia-Pacific's customers, oil had fallen to $106.23 after peaking at $145.66 on July 11, the dollar had rallied to $1.42 on the euro from $1.60 over the same period, and the benchmark Goldman Sachs commodity index overall had come off a July high of 473.97 to close at 374.55. I single out this interestingly timed notice to illustrate a broader phenomenon of well-managed companies determined to preserve their margins after years of upward-creeping cost pressures, despite the retrenchment of commodity prices. I suspect that this risk, while muted, still lingers. Only days after the FOMC met on the 16th, FedEx, for example, announced that its "U.S. express-delivery unit would raise its shipping rates by an average of 6.9 percent in January."[6]

But I digress. The problem that has been ailing capital markets and, by extension, the economy has not been the fed funds rate. It has been and remains risk aversion and uncertainty about counterparty risk and capital adequacy.

It may be useful to review the emergency initiatives taken by the Federal Reserve as the hemorrhaging patient was being rushed into the ER:

First, there was the administration of various emergency efforts to stabilize the situation. The Federal Reserve created three new facilities: the TAF, or term auction facility; the TSLF, or term securities lending facility; and the PDCF, or primary dealers credit facility. We used these improvised devices to intravenously inject liquidity in amounts and on terms that were unprecedented.

We worked with other "ERs" as we saw the infection spread and take on global dimensions. We established and expanded our swap lines with the Europeans and the British and the Swiss and the Canadians and the Japanese (and just this week with the Norwegians, Swedes, Aussies and Danes). Together, these central banks injected sizable amounts of liquidity to satisfy dollar demand in their respective home markets.

And, working with the Treasury, we cauterized certain blood vessels that seemed to burst almost spontaneously and threaten the system, like Bear Stearns and AIG and debilitated money market funds.

Meanwhile, other responders were at work—from the Federal Housing Administration, to the Federal Home Loan Banks, to the Securities and Exchange Commission, to the Treasury, to the Congress. As they collectively sought to contain the disease, they applied emergency treatments ranging from extending lines of credit, to constricting short selling, to easing capital requirements, to putting the government-sponsored enterprises into conservatorship, to

[5] Letter addressed "Dear Valued Customer," by Dennis B. Shearer, vice president, commercial sales, Georgia-Pacific Consumer Products LP, Sept. 4, 2008.
[6] "FedEx Delivers Plan to Weather Downturn," by Justin Baer, *Financial Times*, Sept. 19, 2008, p. 20.

negotiating the dissolution of iconic financial institutions, to backstopping money market mutual funds, to passing bills to support these various piecemeal efforts.

These various efforts were reactive responses. They were as deliberately and thoughtfully crafted and administered as they could be under the unusual and exigent circumstances. But they were necessarily ad hoc. We were fast reaching a point where a more comprehensive, coordinated solution was needed. Given that you are all New Yorkers, I am sure you read the Sunday *Times*. So I am not divulging any great secrets in saying that Ben Bernanke, a careful student of the Depression of the 1930s and other crises, had long been warning the secretary of the Treasury and others that a more comprehensive solution might be required.[7] He pressed especially hard on this front after the events surrounding our last FOMC meeting. You know the outcome: A proposal by the Treasury was sent to Congress Saturday, and both the secretary and the chairman have been reviewing the merits of the proposed "package" with Congress these past few days.

So now a proposal has been made to isolate and quarantine the principal source of this debacle, the toxic mortgage and mortgage-related bacteria, by placing it under a TARP, or "Troubled Asset Relief Program." All parties have recognized that this proposal entails risk, not least of which is that every lobby will seek to sweep other festering sores—from credit card receivables to auto loans—under the TARP. The president of the United States summed up the sense of urgency last night in no uncertain terms.

As you heard Chairman Bernanke testify, the key strategy in the Treasury proposal is that by gathering these distressed assets under the TARP and auctioning them off in a prudent manner, something closer to a "hold to maturity" price, rather than a panic-based "fire sale" price, can be determined. This process would give banks a basis for marking their portfolios to a more realistic level, allowing them to clear the air and stabilize their capital base. By removing diseased mortgages and curing the credit market patient, creditors can begin getting back to the business of funding commerce and economic growth.

One could make the argument that isolating the infected assets that were the most active sources of contagion is a necessary but still insufficient condition for restoring a healthy credit system. That argument would suggest that once the TARP, or whatever comes of it, passes through the political process and debilitating toxic assets are removed from balance sheets, we must next go about buttressing the equity side of the balance sheets of the system's key agents. I believe that after something along the lines of the Treasury proposal is enacted, that is the next task. The Street and the authorities must put their shoulders to the wheel, and I will be interested in hearing your ideas about how this might be accomplished.

Even before tackling the task of cementing capital adequacy, we need to bear in mind that the TARP places one more straw on the back of the frightfully encumbered camel that is the federal government ledger. Other off-balance-sheet liabilities were already in place before Washington took on additional burdens from the reorganization of Fannie Mae and Freddie Mac and whatever we realize—which may, after all is said and done, be a positive return—from the liquidation of collateralized loans made through the Fed to Bear Stearns and AIG, and now the Treasury's discharging of "x" dollars of mortgage-related securities for which there is presently

[7] "A Professor and a Banker Bury Old Dogma on Markets," by Peter Baker, *New York Times*, Sept. 21, 2008, www.nytimes.com/2008/09/21/business/21paulson.html.

no palpable market. (I say "x" because under the proposal made, the taxpayers' outlay is not $700 billion; it is the difference between $700 billion and the return earned on that $700 billion investment.)

Foremost among the existing liabilities are some $13 trillion in unfunded Social Security benefits and Medicare obligations already promised to the people but as yet unfunded, an obligation that the Dallas Fed staff estimates at a present value of over $80 trillion.[8] The former comptroller general of the United States, David Walker, estimates the Medicare deficit to be less, only $34 trillion, so let's work with his less-excitable numbers. With everything including Social Security and Medicare properly accounted for, Mr. Walker estimates that "as of September 30, 2007, the federal government was in a $53 trillion fiscal hole, equal to $455,000 per household and $175,000 per person."[9]

We are deeply submerged in a vast fiscal chasm. Which begs the question: Is it possible, now that so many distinguished senators and congressmen are proclaiming their concerns for the price tag of the Treasury proposal and are ardently defending the interests of the taxpayer, that one of the outcomes of this debate will be that Congress, which alone has the power to tax and spend, will finally face up to the task of squaring the nation's books?

John Plender, writing in the weekend edition of the *Financial Times*, reminded us of economist Hyman Minsky's dictum that fiscal activism and last-resort loans more often than not set the stage for serious inflation.[10]

Whether or not Minsky is right depends in part on those who have the power to tax and spend the people's money. They can use this crisis as a call to arms for coming to grips with our fiscal predicament, or they can punt by asking our children and their children to do what they cannot bring themselves to do. Or, just as awful, they can turn to the Fed to print their way out of their dilemma and encumber future generations of Americans with the debilitating burden of debased money.

Two weeks ago, I was blessed with the birth of a grandchild. Her name is Anna. For Anna's sake, I pray that those with the power of the purse will take the high road and come to grips with our nation's fiscal predicament either through deft management or enlightened fiscal initiatives. And I pray that Congress will resist the temptation to hinder the Federal Reserve's independence and instead allow us to implement policy unencumbered by political exigency. For if they don't and the people who deliberate monetary policy in the Fed's hallowed halls are no longer able to do their Alan Brooke-ian best to tell it like it is and act accordingly to provide the monetary conditions for sustainable noninflationary growth, I will fear for Anna's future.

Very serious matters are before us, and they require the most thoughtful responses from all parties concerned—from the Fed, to the administration, to the ultimate representatives of the people, the Congress. Mind you, this is not the first time that the capital markets have forgotten

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[8] "Storms on the Horizon," by Richard W. Fisher, remarks before the Commonwealth Club of California, San Francisco, May 28, 2008.

[9] "Washington Must Heed Fiscal Alarm Bell," by David Walker, Peter G. Peterson Foundation, Sept. 22, 2008, www.pgpf.org/newsroom/oped/ft/.

[10] "Capitalism in Convulsion: Toxic Assets Head Towards the Public Balance Sheet," by John Plender, *Financial Times*, Sept. 19, 2008, www.ft.com/cms/s/0/b210deec-8675-11dd-959e-0000779fd18c.html.

that there are consequences to indiscriminate behavior. Consider this description of what we have experienced:

> "Every now and then the world is visited by one of these delusive seasons, when 'the credit system' … expands to full luxuriance: everybody trusts everybody; a bad debt is a thing unheard of; the broad way to certain and sudden wealth lies plain and open; and men are tempted to dash forward boldly from the facility of borrowing.
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> "Promissory notes, interchanged between scheming individuals, are liberally discounted at the banks…. Every one now talks in [bodacious amounts]; nothing is heard but gigantic operations in trade; great purchases and sales of real property, and immense sums [are] made at every transfer. All, to be sure, as yet exists in promise; but the believer in promises calculates the aggregate as solid capital.…
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> "Now is the time for speculative and dreaming or designing men. They relate their dreams and projects to the ignorant and credulous, dazzle them with golden visions, and set them maddening after shadows. The example of one stimulates another; speculation rises on speculation; bubble rises on bubble; every one helps … to swell the windy superstructure.…
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> "Speculation is the romance of trade, and casts contempt upon all its sober realities. It renders the [financier] a magician, and the Exchange a region of enchantment.… No 'operation' is thought worthy of attention that does not double or treble the investment. No business is worth following that does not promise an immediate fortune.… The subterranean garden of Aladdin is nothing to the realms of wealth that break upon [the] imagination.
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> "Could this delusion always last, … life … would indeed be a golden dream; but it is as short as it is brilliant."[11]

That was not recently written by Martin Wolf of the *Financial Times* or David Brooks of the *New York Times* or Paul Gigot of the *Wall Street Journal*. It was written by Washington Irving in his famous *Crayon Papers* about John Law's "Mississippi Bubble" fiasco of 1719. Irving had never heard of a subprime mortgage or an Alt-A loan, an SIV, a CDS, a CLO or a CMO. But he understood booms propelled by greed and tomfoolery and busts born of fear, and that these underlying forces are deeply rooted in human DNA.

If this is a DNA issue, perhaps no financial system—no matter how enlightened its central bank or sophisticated its regulatory architecture or wise its Congress or executive—can prevent nature from running its course. Still, our country is the most advanced in the world. We have been at the forefront of innovation and structural advancement in biology and science and technology, in

[11] "A Time of Unexampled Prosperity," by Washington Irving, in *The Crayon Papers*, 1890.

culture and management and commerce and countless other fields. We must continually strive to be at the forefront of figuring out how to corral the "little doggies" that are the financial markets' animal spirits in a way that encourages them to work their magic of underwriting prosperity and yet discourages their straying from the pasture. This is not an easy thing to do. But if we want to preserve our way of life, and do what is right for Anna and future generations of Americans, we must get it done.

Let me wrap up this long monologue by going back to the origins of this club. At times like this, it is easy to become melancholy and bitter and cynical. This club, the Money Marketeers, was founded by Marcus Nadler, one of John's and my predecessors at the Federal Reserve who was there "at the creation." You will remember that Nadler put forth four simple propositions to counter the intellectual paralysis and down-in-the-mouth pessimism that gripped the financial industry after the Crash of '29:

> "You're right if you bet that the United States economy will continue to expand;
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> "You're wrong if you bet that it is going to stand still or collapse;
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> "You're wrong if you bet that any one element in our society is going to ruin or wreck the country;
>
> "You're right if you bet that men in business, labor, and government are sane, reasonably well informed and decent people who can be counted on to find common ground among all their conflicting interests and work out a compromise solution to the big issues that confront them."

This became known as "Old Doc Nadler's Remedy," and for my part, it is spot on. Every red-blooded American should keep it in mind.

Thank you.