

# Addressing a Credit Crisis

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*Remarks before the International Institute of Finance  
Annual Membership Meeting*



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Washington, D.C.  
October 12, 2008

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

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Richard W. Fisher

Thank you, Bill [Rhodes].

I have been wondering why Charles Dallara asked me to join this distinguished panel of presenters this morning.

Perhaps it was because in the convenient lexicon of the press I am viewed as among the FOMC's most outspoken inflation "hawks" and have of late made clear that the dynamics of price movements have shifted and been overpowered by the implosion of the credit mechanism.

Or perhaps it is because I hail from the strongest economic region within the United States. Texas has an economy that is larger than India's, created roughly 30 percent of all private sector jobs in America last year, expects to have employment growth of around 1.5 percent this year despite the slowing of the national and international economies into which it sells, is the country's second-largest manufacturing center, is the largest exporting state and was singled out by the *Financial Times* on Friday as enjoying "the best" economic situation in the U.S.

So Charles may have wanted to present me as a curiosity. Or he may have wanted to remind those of you who in your trips to the United States never venture outside the narrow Boston–New York–Washington corridor that this vast American economic machine still has pistons that are pumping and entrepreneurs and financiers who refuse to be trapped in the conventions of the past and instead view the current markets' turmoil as an opportunity that occasionally presents itself through the painful but inexorable process of "Schumpeterian creative destruction."

Or, perhaps more likely, it was simply because he may have confused me with my prestigious central banking namesake, Stanley Fischer, a towering intellect and most clever man.

It was Stan Fischer who a couple of years ago at Jackson Hole quipped that there are three kinds of economists: those that can count and those that cannot.

Some would say that Stan Fischer's little quip might best apply today to bankers and regulators who, in the zeal to quantify risk and econometricize decisionmaking, abandoned rudimentary math and forgot the basics that anchor credit and money and banking.

Let me read you a description of fiduciary amnesia, written by one of the shrewdest of financial market observers:

"Every now and then the world is visited by one of these delusive seasons, when 'the credit system' ... expands to full luxuriance: everyone trusts everybody; a bad debt is a thing unheard of; the broad way to certain and sudden wealth lies plain and open; and men ... dash forth boldly from the facility of borrowing.

“Promissory notes, interchanged between scheming individuals, are liberally discounted at the banks.... Everyone talks in [huge 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....

“Speculative and dreaming ... men ... 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....

“Speculation ... casts contempt upon all its sober realities. It renders the [financier] a magician, and the [stock] 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....

“Could this delusion always last, life ... would indeed be a golden dream; but [the delusion] is as short as it is brilliant.”

That was not written by Martin Wolf of the *Financial Times* or Paul Gigot of the *Wall Street Journal* or David Brooks of the *New York Times*, or their counterparts at *LeMonde* or the *Frankfurter Allgemeine Zeitung* or the *Straits Times* or *Reforma* or *O Globo* or the *Daily Mail and Guardian* in Johannesburg (whose headline today was “Without Real Leadership, We Face Financial Disaster”). It was written by Washington Irving in his famous “Crayon Papers” about the Mississippi Bubble fiasco of 1719.

Irving, mind you, had never heard of a subprime mortgage or an SIV or a credit default swap or other modern financial innovations that are proving so vexing to credit markets today. But he understood booms propelled by greed and tomfoolery and what happens when what one old colleague called “irrational exuberance” is replaced by irrational fear: What was a sure thing yields to uncertainty; uncertainty is the ultimate enemy of decisionmaking; and the decisionmaking that ordinarily keeps the credit system robust retreats into a defensive crouch. (A fellow being interviewed on television the other day was asked what position he would advise his clients to take to ride out the current storm, and he replied: “Cash and fetal.”)

With uncertainty in full fever, cash is hoarded, counterparties are viewed with suspicion, and no business appears worthy of financing. The economy, starved of the lifeblood of capital, staggers and begins to weaken.

So what have we done about it?

The Federal Reserve is the central bank of the most powerful and dynamic economy in the world. It is the lender of last resort for that colossal economy. The behavior of the classic lender of last resort in the current circumstance is also etched in the history books, and it is well worth remembering.

Henry Thorton and Walter Bagehot articulated it early in the 19th century.

Bagehot's prescription to counter a panic bears repeating: "The holders of the cash reserve must be ready not only to keep it for its own liabilities, but to advance it most freely for the liabilities of others. They must lend to merchants, to minor bankers, to 'this man and that man' wherever the security is good."

Bagehot describes the response of the Bank of England to the Panic of 1825 by quoting its governor as follows: "We lent by every possible means and in modes we had never adopted before; we took stock on security, we purchased Exchequer bills, we made advances on those bills, we not only discounted outright but we made advances on the deposit of bills of exchange to an immense amount, in short, by every possible means consistent with the safety of the bank...."

All the while bearing in mind the advice rendered by Henry Thorton, writing in 1802: "It is by no means intended to imply that it would become the (Central) Bank to relieve every distress that the rashness of bankers (and financiers) may bring upon themselves.... The relief should neither be so ... liberal as to exempt those who misconduct their business ... nor so scanty and slow as deeply to involve the general interests. These interests, nevertheless, are sure to be pleaded by every distressed person whose affairs are large, however indifferent or even ruinous may be their state."

If you are looking for a cognitive road map of what the Fed has been up to as we navigate between the need to "advance most freely for the liabilities of others, lend to bankers and merchants, and 'to this man and that man' wherever the security is good" and the equally compelling need to fend off moral hazard of relieving "those who misconduct their business," you might dust off your Bagehot and Thorton.

Central bankers are ordinarily considered the most laconic genus of the human species. Not so in a time of crisis. I would submit to you that the Federal Reserve under the chairmanship of Ben Bernanke has wasted no time and left no stone unturned in addressing the current crisis. We have "lent by every possible means and in modes we have never adopted before" "consistent with the safety of the Bank." We have neither been "scant" nor "slow."

Yesterday, Roger Coles walked you through the rapid-fire steps we have taken at the Federal Reserve. Phillip, throw up that chart of the growth of our balance sheet. This picture says a lot: The assets on the books of the Fed are now close to \$1.6 trillion. In December of last year, they were only \$890 billion.

You will notice the dramatic difference in the composition of the assets held by the System. At the beginning of the year, we were almost 100 percent in Treasury securities; now "other assets" and "term auction credit" represent roughly one-third or some \$500 billion in our total assets. This reflects what I consider one of the most significant strides taken to address perhaps the most debilitating pathology of a credit crunch. I refer to "rollover risk." When counterparties are unwilling to engage one another for fear that regardless of price, a borrower will not be able to roll over a loan to another source of funds, the credit markets cease to operate. Suppose Charles, for example, thinks Richard is creditworthy. But the certainty that Bill might replace that loan to Richard when it comes due to Charles is suspect. Charles becomes reluctant to lend to Richard in

the first place for fear that Richard will be unable to roll over his debt to Charles to Bill. The result is that no one lends to Richard at all, even if he is creditworthy in Charles' eyes. Thus our recent initiatives to provide a backstop for funding banks, primary dealers and commercial paper issuers. By providing a backstop source of funding, the Fed seeks to lower or eliminate rollover risk. Charles no longer worries about what Bill might think of Richard as a borrower because he knows he will be repaid by Richard's going to the Fed for a loan.

The Fed will do whatever it needs to do to be a credible backstop in support of the credit system.

It is traditional for Reserve Bank presidents and governors to proffer only their personal views and never speak for any other member of the Federal Open Market Committee. This morning, I am casting that convention aside. I believe I can safely speak for us all when I tell you that the Federal Reserve will continue to explore every avenue and consider every option to see the credit market through the current crisis, consistent with the safety of the System. We will provide the leadership called for by the *Daily Mail and Guardian* of Johannesburg and others.

Of course, we know that we cannot go it alone. At home, our work must complement the work of the fiscal authorities as they seek to recapitalize the banking system and reconfigure our regulatory system. Thus we are working hand-in-glove with the Treasury, which has facilitated the growth of our balance sheet, enabling us to keep credit flowing in the face of the seizing up of interbank lending and of the commercial paper market.

We live in a globalized world, and as evidenced by the expansion of swap lines with nine of our counterparts and by the recent coordinated rate cut, we will continue to explore appropriate policy responses that can be enacted without detriment to others but instead to the benefit of all.

In the end, there is only so much that the Federal Reserve or any other central bank, even acting in unison with each other and with fiscal authorities, can do. I believe we can and we will restore order to the credit markets and that the fiscal authorities led by Secretary [Henry] Paulson and the Congress will engineer an appropriate recapitalization of the banking system in a manner that does not kill the goose that lays the golden eggs of the practice of capitalism that has made for the powerful economic machine of America. That does not mean that we can undo in short order the damage that has been done to confidence on Main Street—in the real sector of the economy where jobs are created and innovation and progress are realized. Contrition for the misbehavior of the financial sector and the realization that we have lived for too long too high on the ambrosia of money compliantly advanced by overly eager lenders at home and abroad—that, to go back to Washington Irving, our “delusion” could not “always last”—will likely be manifest in a painful period of adjustment and subpar or even negative growth for some time, probably well into 2009. But properly managed, a task to which my colleagues at the Federal Reserve and I will devote every ounce of our collective energy, need not—indeed must not—result in the dire scenarios being bandied about by economics Cassandras.

As we navigate our way through this difficult patch, we would do well to heed the advice of Marcus Nadler, a former chief of the Foreign Division of the Federal Reserve's Board of Governors:

You're right if you bet that the United States economy will continue to expand;

You're wrong if you bet that it is going to stand still or collapse;

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.

These four propositions—what is now known as “Old Doc Nadler’s Remedy”—were not written for some political campaign or for a recent edition of *USA Today*. They were crafted some 70 years ago by one of the world’s foremost economists to counter the down-in-the-mouth pessimism that gripped our financial system in the 1930s. They serve as a gentle reminder that we should never discount the unfailing ability of the American entrepreneur and thoughtful government officials to solve our most complex problems—even those that plague us today.