The Current State of the U.S. Economy and the Fed's Response (With Reference to Irrational Exuberance and Virgil's Aeneid)

Remarks before the Texas Cattle Feeders Association

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I am a little uncomfortable speaking to cattlemen. It is true that we have a family ranch in East Texas—a few thousand acres straddling the Titus and Franklin county lines. We don't run a feed yard, but we did run up to 600 mother cows in our pastures until it finally dawned on us that cows graze on dollar bills. We never made a profit from those animals and now simply lease our grazing land to others. So I admit to knowing slim to none about cattle. We do own a couple dozen Longhorns, however. For the past few years, we have bred them with a pure, red Simmental bull that weighs in at over a ton and have covered our costs by selling the offspring. Our bull's name used to be Mr. T. In honor of Alan Greenspan, I had Mr. T re-registered as Irrational Exuberance.

When Chairman Greenspan retired, we had a farewell dinner for him at the Dallas Fed. We had his picture taken alongside a huge poster of our handsome breeder and gave him a lifetime pass to come visit our ranch at any time to pet him. About a week later, I received a copy of the photo on which Alan had inscribed: "Richard—Irrational Exuberance is truly a lot of bull."

Simmentals are thought to be docile and easy to manage. Yet they are also known for their extreme muscle patterns and leanness. When a 2,000-plus-pound Simmental bull in a pasture full of Longhorn cows becomes … uh … exuberant … he is nearly impossible to tame until his energies are spent. An extremely muscular economy and robust financial system like that of the United States is not all that dissimilar. Academics and armchair pundits may think them easy to manage. Yet, despite all the advances in economic theory and risk management techniques, when the economy and financial markets get too headstrong and frisky, they are hard to rein in.

Economists like to say that one of the purposes of a central bank like the Federal Reserve is to "tame the animal spirits of the economy," employing monetary policy to keep the nation on the path to sustainable, noninflationary growth. One of the greatest of Federal Reserve chairmen, William McChesney Martin, once said that the job of the Fed is "to take away the punch bowl just as the party gets going." As I speak to you today, we are in the midst of experiencing the consequences of the failure to take away the punch bowl and of allowing the exuberant "animal spirits" of our economy to get out of hand. We must never allow this to happen again. But first we must deal with the situation at hand. This is what I wish to speak to you about today: our economic predicament and what the Federal Reserve, the nation's central bank, is doing about it.

First, a little background. Let me read to you what I consider to be the most insightful description of what we have just witnessed.

> "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 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 … 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….
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> "Speculative and dreaming … men … relate their dreams and projects to the ignorant and credulous, dazzle them with [their] golden visions, and set them maddening after shadows. The example of one stimulates another; speculation rises on speculation; bubble rises on bubble.…
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> "Speculation … 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.…
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> "Could this delusion always last, … life … would indeed be a golden dream; but [the delusion] is as short as it is brilliant."

This was not written in a recent issue of the *Wall Street Journal* or the *Dallas Morning News* or the *Amarillo Globe-News*, the *Oklahoman*, or the *Albuquerque Journal*. It was written by Washington Irving in 1719 in his famous "Crayon Papers" about the speculative disaster known as the Mississippi Bubble.

I am pretty confident that Washington Irving had never heard of a subprime mortgage or of Countrywide Financial, of a credit default swap or Lehman Brothers, multisector collateralized debt obligations or AIG, or any of the other modern financial innovations and agents that have proven so vexing to credit markets and financial stability. But he understood booms propelled by greed and tomfoolery and what happens when the "animal spirits" of the markets are allowed to run amok. He did not need a modern-day figure like Warren Buffett to warn that we must "beware of geeks bearing formulas." For common sense told him that eventually, the "short but brilliant" phenomenon of irrational exuberance bursts and is most often replaced by irrational fear. What was a sure thing yields to uncertainty; uncertainty undermines decisionmaking; and the confident decisionmaking that is needed to sustain the economy retreats into a defensive crouch. Counterparties come to be viewed with suspicion. No business appears worthy of financing. Cash is hoarded. The economy, starved of the lifeblood of capital, staggers and begins to weaken.

A fellow interviewed on television the other day was asked what positions he would advise viewers to take to ride out the current period of uncertainty. He replied: "Cash and fetal." It was a clever description of a debilitating pathology. You can't grow an economy when financiers are curled up into a ball, clutching dollars for fear they might lose them. With the credit markets frozen, growth gives way to recession, and confidence is displaced by fear. This Sunday, the

New York Times reminded us that James Madison said, "The circulation of confidence is better than the circulation of money." The global economy has been waylaid by a crisis of confidence.[1]

In late September, the CEO of one of the nation's largest retailers called me and told me of a remarkable conversation his buyers had just had with their biggest supplier, the Chinese. In preparing for the upcoming buying season, this retailer—from whom a hefty portion of American families buys clothes, shoes, accessories and housewares—had been told earlier this year by his Chinese suppliers that their asking price for women's apparel would be 8 to 10 percent higher than last year and shoes would be 15 percent higher, reversing more than a decade of price deflation in those consumer products. The retailer had budgeted corresponding price increases in his stores to begin this winter. Yet at that meeting, the buyers were told that the Chinese suppliers would not only not levy the price increases they had previously insisted upon, but would even discount from 2007's prices as long as the buyers were creditworthy.

As the year progressed, there had been a clear pattern emerging in our economy among our nation's businesses. After a ferocious rush upward of prices—not just of commodities and raw materials, but also of intermediate and finished inputs produced by increasingly expensive Chinese and other foreign labor—producers of goods and services were pursuing a textbook strategy to sustain their top lines and protect their margins: They were clamping down on the costs by cutting personnel, running tighter inventories and supply lines, and cutting every controllable cost. And they were pushing rising input costs into their price structure as much as the market would bear. Thus, we saw a rash of announcements of planned price increases for everything from chemicals to diapers to soft drinks to beer to airline fares to rail shipment prices to cereals to feed. Even purveyors of electronic services, like Bloomberg, raised prices by roughly 6 percent in midsummer. Architects and engineering and other services firms were doing likewise.

This microeconomic behavior was reflected in the macroeconomic numbers. Consumer price indexes rose, and even the "core" indexes that central bankers use to sort out the underlying signal from the background noise about inflation were coursing upward. In June, headlines of major newspapers announced that the month-on-month rate for consumer prices had risen at an annualized 9.6 percent, while the core rate was reported out at 3.4 percent. Less dramatically, but nonetheless ominously, the year-over-year rise in headline consumer price inflation (as measured by the PCE) in July was 4½ percent and the core rate, 2½ percent. This is why I was so cautious about endorsing rate cuts: We were at risk of the worst of economic fates—a slowing economy accompanied by expectations of rising prices, more popularly known as "stagflation." Even as the majority of the Federal Open Market Committee (FOMC) voted to lower the benchmark interest rate, and even as we unanimously undertook measures to counter emerging strains on the credit system, the statements that accompanied our policy initiatives repeatedly stressed the balance of risks between growth and inflation. After our meeting of June 25, the FOMC issued a statement to the effect that "although downside risks to growth remain … the upside risks to inflation and inflation expectations have risen." After our August meeting, we noted that "inflation has been high … and some indications of inflation expectations have been elevated," adding, however, that "the Committee expects inflation to moderate later this year and next year." We repeated that concern in our release on September 16, noting that "inflation has been high" and "the inflation outlook remains highly uncertain."

[1] "When a Nation Suffers from Poor Circulation," by Phyllis Korkki, *New York Times*, Nov. 2, 2008, p. 2.

Cattle feeders appear to have been equally concerned. I note that your press release of August 7 expressed deep concern about the impact of rising corn prices, which had reached $7.65 a bushel on June 27 before their descent to the present level of $4.

As evidenced by the experience of the retailer I cited earlier, the impetus for rising prices came to a grinding halt as the credit crisis took grip and confidence evaporated. As the credit market congealed, inflationary momentum froze in its tracks. As October approached, it became increasingly clear that smart businesswomen and -men no longer had the option of seeking to protect their top and bottom lines by seeking price increases for their goods and services. The only option before them quickly became that of running their businesses by aggressively tightening their head count of employees, more passionately seeking to cut other costs, and more closely scrutinizing and reining in their capital expenditures. Economists recognize this as "procyclical behavior." It forms a toxic brew when combined with a credit crisis. Just as irrational exuberance causes economies to overshoot on the upside, behavioral adaptations driven by uncertainty and fear and credit constriction exacerbate the downside.

So what has the Federal Reserve done to counter this phenomenon? Remember that we have a limited role. We are the central bank of the United States, not the fiscal authority. We have available a limited number of tools. But we have been deploying them aggressively.

Again, some historical context. The basic manual for a central bank's response to a panic was written in the early 19th century by two Englishmen, Walter Bagehot and Henry Thorton. Bagehot's prescription to counter a panic was as follows: "The holders of the cash reserve must be ready not only to keep it for their 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' whenever the security is good." He wrote of how, during the Panic of 1825, the Bank of England "lent by every possible means and in modes … never adopted before." Also bearing in mind the advice of Thorton, who in 1802 wrote that "it is by no means intended to imply that it would become the (Central) Bank to relieve every distress which the rashness of (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 ruinous may be their state."

Central bankers are generally considered the most laconic genus of the human species. Yet, in response to this crisis, the Federal Reserve reacted like Bagehot on steroids. We have not quite lent "to this man and that man." But beginning with the announcement on December 12 of last year of our term auction facility, we have reached deep into our tool kit to "lend by every possible means and in modes … never adopted before." We have been neither "scanty" nor "slow." In rapid order, the Federal Reserve has stretched out the terms with which we lend to bankers; accepted new forms of collateral; broadened access to our lending window to securities dealers and one particular insurance company—AIG—whose failure was deemed by the Federal Reserve Board to present a risk to the financial system; opened a window for financing commercial paper; backstopped money market mutual funds; and, recognizing that we are inextricably interwoven with a global economy, established swap lines to help meet the dollar-funding needs of 14 central banks, ranging from the European Central Bank and the Bank of England to the Banco de México and the Singapore Monetary Authority, the total of which now aggregates to hundreds of billions of dollars. And our staff and policymakers have provided substantial intellectual input into activities of other regulators, such as the FDIC and the Treasury, as they develop innovative means and modes of recapitalizing the banking system, dealing with the mortgage crisis and restoring economic growth .

You can see the size and breadth of the Fed's efforts to counter the collapse of the credit mechanism in our balance sheet. At the beginning of this year, the assets on the books of the Fed totaled $960 billion. Today, our assets exceed $1.9 trillion. I would not be surprised to see them aggregate to $3 trillion—roughly 20 percent of GDP—by the time we ring in the New Year. The composition of our holdings has shifted considerably. Previously, almost 100 percent of our holdings were in the form of core holdings of U.S. Treasuries; today, less than a third are. The remainder consists of claims deriving from our new facilities.

This combination of measures, together with an effective fed funds rate of less than 1 percent, is unprecedented. We believe they are a necessary antidote to what ails the economy and a needed impetus for the restoration of confidence.

But we also know that there are limits to what the central bank can do. Our efforts must be complemented by fiscal policy and by initiatives undertaken by other regulators. And we also know that it will take time before confidence is re-established.

I don't know how many of you have read Virgil's Aeneid. It tells the story of the epic voyage in which Aeneas is tested by all kinds of temptation and fury, dispossession and defeat, torment and, eventually, triumph as he crosses stormy seas to seek the city from which Rome will eventually be founded. One of the great tests of Aeneas' will comes when he attempts to cross the Tuscan Sea. Juno, the queen of the gods, asks Aeolus, the god of the winds, to whip up the mother of all storms to stop Aeneas' fleet. Neptune, the god of the sea, comes to the rescue, and as described by Virgil, he saves the day. He: "calms the heaving seas, putting the clouds to rout and bringing back the sun … clearing a channel through the deadly reefs, his chariot skimming over the cresting waves on spinning wheels to set the seas to rest."

And Virgil goes on to declare: "Just as, all too often, some huge crowd is seized by a vast uprising, the rabble runs amok, all slaves to passion, rocks and firebrands flying … but then, if they chance to see a man among them, one whose devotion and public service lend him weight, they stand there, stock-still with their ears alert as he rules their furor with his words and calms their passion. So the crash of the breakers all fell silent once [Neptune], gazing over his realm under clear skies, flicks his horses, giving them free rein, and his eager chariot flies."

If it were only so easy to turn around an economy that is now geared to the downside with a kind of turbulent ferocity that seems to equal, if not better, the powerful tailwinds that drove both the United States economy and the rest of the world on its upward slope of growth. Such growth was the product of exuberant financial markets running "amok, all slaves to passion, rocks and firebrands flying" in the pursuit of the ever greater returns made possible by the end of the Cold War, the death of Mao, the triumph of capitalism, the onset of globalization, and the speed with which the Internet and modern technology have accelerated financial calculation and economic development.

A reader of the Aeneid will recall that after the storm that I just described, “Aeneas puts in with a bare seven warships saved from his whole fleet.”[2] And this is but Book One of Virgil’s epic poem. Aeneas’ ultimate victory does not come until 11 books later.

There is no modern counterpart to a Neptune who will rise from the depths and “chariot spinning … set the seas to rest.” The task of restoring the credit markets, instilling confidence and righting our economy ship will take many hands. I have described to you the initiatives undertaken by your central bank—by the Federal Reserve—to calm the tempest that is upon us. Complementary action must now be undertaken by the fiscal authorities—by the Congress in cooperation with a new president who will be elected by the American people today. It was not to distract you that I spoke of the Aeneid. Despite the efforts of the Fed, the hope that comes with a new presidency, and what will hopefully be responsible and carefully calibrated fiscal initiatives for the Congress, I believe we have an epic challenge ahead of us. We are navigating the mother of all financial storms. We will certainly come out of it with a lesser number of ships than we entered it with, for we cannot and should not “relieve the rashness of distress that financiers” and other imprudent decisionmakers “have brought upon themselves.” And we know that that reduced fleet will face many challenges before it reaches the safe harbor of prosperous economic growth.

But this much I know: We have been here before and we have overcome our problems. We are a nation of risk takers. Often we confront storms of our own making. We falter. We get blown off course. We lose some of our ships. But we never give up. We are a resilient people. We always come roaring back, recovering from our setbacks with an even more extreme muscle pattern and a leanness that would put that hearty bull that roams our pasture in Mount Vernon to shame. You don’t have to be irrationally exuberant to know that that is what makes America unique.

And always will.

Thank you.

[2] The sections quoted are from Book One, lines 167 through 200, of Virgil’s *The Aeneid*, as translated by Robert Fagles, Viking Penguin Press, 2006.