Historical Perspectives on the Current Economic and Financial Crisis (With Reference to Paul Volcker, Washington Irving, Walter Bagehot, Mother Caris, Rube Goldberg and Bismarck)

Remarks before the World Affairs Council of Dallas/Fort Worth and the Dallas Committee on Foreign Relations

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Thank you, Mr. Mayor. I am especially honored that you would take time from leading our great city to introduce me so generously and to suffer through my speech.

We have witnessed the unfolding of historic economic developments during this tumultuous year. I can think of no better groups than the World Affairs Council of Dallas/Fort Worth and the Dallas Committee on Foreign Relations with whom to discuss the year's events and lessons learned.

The most cogent description of this year's economic developments might best be summarized by a woman who, having just commiserated with her accountants, put it this way: "This has been like the divorce from hell: My net worth has been cut in half and I'm still stuck with my husband." The mood and pace of the economy have shifted from near bliss to acrimony and an almost palpable sense of betrayal. Many of our fellow citizens feel trapped in an unsustainable situation.

In the third quarter of 2007, we recorded our 25th consecutive quarter of economic growth. Unemployment hit a low of 4.4 percent in March. And the stock market closed at an all-time high, with the S&P 500 Index finishing the day of Oct. 9, 2007, at 1,565. To be sure, there were some signs of friction developing from the passion of the time—most noticeably a heating up of headline inflation, which reached its peak at a 9.6 percent annualized rate in June of this year. And there were fissures developing in the superstructure of the credit markets—most noticeably in the housing market, but also on the balance sheets and business books of major creditors and various consumers. But to the outside world, all was well. Even for Bernard Madoff, who, according to Bloomberg news, was getting $50 manicures before entertaining friends and clients at the Palm in the Hamptons or on his 55-foot yacht appropriately named "Bull."[1]

In 2008, the gears shifted. You all know the events that have transpired, and I will not belabor them. They are neatly encapsulated in the most recent data. Our gross domestic product is no longer growing, but shrank half of a percent in the third quarter. By my estimate, it is on pace to contract another annualized 4 to 5 percent in the current quarter with further contraction likely through at least the first half of next year. Industrial production is falling sharply; consumption is cascading downhill; demand has evaporated as businesses and consumers alike pull in their horns and de-lever from excess indebtedness that fueled the prior boom. Unemployment has increased to 6.7 percent at the last reading and appears to me to be headed in the direction of, and possibly past, 8 percent.

[1] "Madoff Enjoyed $50 Pedicures, 9.8 Handicap, Boat Called 'Bull,'" by Mark Clothier and Oshrat Carmiel, Dec. 17, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aQv4Kmx.cs78.

Bankers and other creditors, having noted that the horse long ago bolted from the confines of prudence, are now shutting the proverbial barn doors. The credit intermediation process has become dysfunctional. Once ubiquitous, credit has become quite expensive—if you can get it. As for stocks, the S&P 500 Index closed last night at 904, 42 percent off its Oct. 9 peak and has become historically and hysterically volatile.

I will not venture to predict the behavioral future of our manic-depressive friend, Mr. Market. But I do know the consequences of his intemperate disposition. Faced with an unforgiving stock market and creditors that have become tighter than a new pair of shoes, businesses are doing what they can to stay profitable: As demand for their products shrinks, they are slashing every cost factor under their control to preserve their profit margins. They are demanding that suppliers cut their prices. They are addressing their cost of labor by cutting "head count." They are delaying capital expenditures. They are watching their receivables and stretching out their payables. And they are taking every step they can to clean up their balance sheets. (If you know the basics of accounting, you will appreciate the black humor of my dear friend, Janet Yellen, the president of the San Francisco Fed. She recently quipped that when looking at the balance sheets of consumers or banks or many other companies these days, nothing on the left is left and nothing on the right is right.)

And sadly, as we all have read, the only things adorning Mr. Madoff's hands these days are handcuffs, and he dines in less glamorous surroundings.

There are plenty of armchair quarterbacks who now claim to have seen all this coming. Indeed, we must acknowledge that many in the financial community, including at the Federal Reserve, failed to either detect or act upon the telltale signs of financial system excess.

Paul Volcker told me recently that in his day, he knew that a bank was headed for trouble when it grew too fast, moved into a fancy new building, placed the chairman of the board as the head of the art committee and hired McKinsey & Co. to do an incentive compensation study for the senior officers.

Paul Volcker is the wisest of men. Yet, I believe the following provides a more fulsome and insightful description of what we recently experienced. This is a long quote, so bear with me, as it perfectly captures the circumstances that led up to our current predicament:

"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."[2]

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 Lee Cullum in the *Dallas Morning News*. 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 a credit default swap or any of the 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—when what was a sure thing yields to uncertainty. Uncertainty is the ultimate enemy of decisionmaking, forcing an otherwise robust credit system into a defensive crouch. (A fellow being interviewed on television not long ago was asked what positions he would advise his clients to take to ride out the current storm. 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?

Well, we could have let nature run its course. P. G. Wodehouse, my favorite comedic author, used to say that "there is only one cure for gray hair. It was invented by a Frenchman. It is called the guillotine." Or we could just ignore it and mandate that it simply not be discussed, as the Latvian government has done recently by decreeing that the Security Police arrest any economists who question the security of its banks or the value of its currency (the lat).

My colleagues at the Federal Reserve and I are red-blooded Americans. We refuse to be fatalistic. (Besides, those of us who have hair have seen it turn gray this past year.) We believe in the power of ideas and listen carefully to our critics. And though in normal times, central bankers appear to be the most laconic genus of the human species, in times of distress, we believe in the monetary equivalent of the Powell Doctrine. We believe that good ideas, properly vetted and appropriately directed with an exit strategy in mind, can and should be brought to bear with overwhelming force to defeat threats to economic stability.

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

Let me go back in history once more. The basic playbook for how a central bank, as the economy's lender of last resort, deals with a financial crisis was written in the early 19th century by two men named Henry Thornton and Walter Bagehot.

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...."[3]

All the while bearing in mind the advice rendered by Thornton, 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."[4]

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' whenever 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 Thornton.

Of course, the panics of the 18th and 19th centuries were different in size and shape than those of recent times. The nature of financial crises changes with time, reacting to the dynamic contours of the economy and financial evolution. Thus we must learn from experience, augmenting the theories and models that come from the study of past remedies.

I have just finished reading Ken Follett's magnificent book *World Without End.*[5] It is a massive tome that runs for 1,014 pages. (I was tempted to rename it *Book Without End.*) It deals with the Black Plague that crippled England and Europe in the 14th century. In those days, the monks were the intelligentsia, and those who practiced medicine were sent to Oxford to learn from the theorists of ancient Greece. The nuns were the nurses. In the middle ages, women were not allowed to attend Oxford, so they learned from doing.[6] While the monks adhered to the Oxford-taught, old orthodoxy of studying the "humors," of bleeding, and of invoking the dictum of *fiat*

[3] *Lombard Street*, by Walter Bagehot, 1825.
[4] *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain*, by Henry Thornton, 1802.
[5] *World Without End*, by Ken Follett, New York: Penguin, 2007.
[6] When I arrived at Oxford 650 years later, there were women studying there, but they were kept in separate colleges and were small in number. The joke among women then was "Come to Oxford where the odds are good but the goods are odd."

voluntas tua ("Thy will be done"), the nuns adapted their techniques according to what actually worked. The punch line of *World Without End* is that the community where the story takes place is spared the worst effects of the Plague by a savvy nun named Mother Caris, who applies experience and adapts established methods and theories to address the needs of the time.

We at the Federal Reserve have dusted off our Thornton and Bagehot and then some. We have been neither "scanty nor slow" in addressing the pathology of our economy and financial system. We have "lent by every possible means and in modes … consistent with the safety of the bank." And just two days ago, we made clear that despite having reduced the target range for the federal funds rate to between zero and 0.25 percent—the old orthodoxy—we will not shy from pursuing every practicable means of supporting the functioning of financial markets and stimulating the economy back to a steady state by employing new techniques that fit the current circumstance.

Like Mother Caris, we have learned from the experience of crises more recent than the ancient debacles of the Mississippi Bubble or the Panic of 1825. We have studied the mistakes made by other lenders of last resort who failed to properly deploy their forces in times of distress, such as the Federal Reserve in the 1930s and the Bank of Japan in the 1990s. And we have reviewed the actions taken by others more successful, such as those of the Swedish Riksbank in response to their banking crisis of the early 1990s. Thus, starting on Dec. 12 of last year, when the base interest rate was 4.25 percent, we began expanding our balance sheet by providing access to credit for longer terms to eligible depository institutions to alleviate funding pressures in the system.

In rapid order, over the course of a year, we took at least eight major initiatives: (1) We established a lending facility for primary securities dealers, taking in new forms of collateral to secure those loans; (2) we initiated so-called swap lines with the central banks of 14 of our major trading partners, ranging from the European Central Bank to the Bank of Canada and the Banco de México to the Monetary Authority of Singapore, to alleviate dollar funding problems in those markets; (3) we created facilities to backstop money market mutual funds; (4) working with the U.S. Treasury and the FDIC, we initiated new measures to strengthen the security of certain banks; (5) we undertook a major program to purchase commercial paper, a critical component of the financial system; (6) we began to pay interest on reserves of banks; (7) we announced a new facility to support the issuance of asset-backed securities collateralized by student loans, auto loans, credit card loans and loans guaranteed by the Small Business Administration; and (8) at the end of November, we announced we stood ready to purchase up to $100 billion of the direct obligations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks, as well as $500 billion in mortgage-backed securities backed by Fannie, Freddie and Ginnie Mae.

And, as you all know, in a series of steps, the Federal Open Market Committee (FOMC) reduced the fed funds rate, a process that I fully supported once it became clear that the inflationary tide was ebbing. Simultaneously, and again in a series of steps, the Board of Governors lowered the rate it charges banks to borrow from our "discount window" so as to lower their cost of credit. That rate now rests at 0.5 percent.

All of this has meant expanding our balance sheet. When I finished Ken Follett's book last Friday night, the total footings of the Federal Reserve had expanded to $2.254 trillion—an almost three-fold increase from when we started the year. And I believe we made it quite clear in our press release after Monday and Tuesday's meeting of the FOMC that we stand ready to grow

our balance sheet even more should conditions warrant. For example, we will expand purchases of mortgage-backed securities, should we feel such purchases would be productive.

You will note that the emphasis of our activities has been on expanding the asset side of our balance sheet—the left side, which registers the securities we hold, the loans we make, the value of our swap lines and the credit facilities we have created. We feel this is the correct side to emphasize. The right side of our balance sheet records our holdings of banks' balances, Federal Reserve Bank notes or cash (currently over $830 billion) and U.S. Treasury balances.

When the Japanese economy went into the doldrums, the Bank of Japan emphasized the right side of its balance sheet by building up excess reserves and cash, only to find that accumulation did too little to rejuvenate the system.

As I said earlier, in times of crisis many feel that the best position to take is somewhere between cash and fetal. But it does the economy no good when creditors curl up in a ball and clutch their money. This only reinforces the widening of spreads between risk-free holdings and all-important private sector yields, further braking commercial activity whose lifeblood is access to affordable credit. We believe that emphasizing the asset side of the balance sheet will do more to improve the functioning of credit markets and restore the flow of finance to the private sector. In the parlance of central banking finance, I consider this a more qualitative approach to "quantitative easing." It is bred of having learned from the experience of our Japanese counterparts, much as Mother Caris learned from watching others' unsuccessful attempts at curing the Black Plague in her community of Kingsbridge.

I realize that by straying from our usual business of holding plain vanilla Treasuries as assets and by shifting policy away from simple titrations of the fed funds rate, we have raised a few eyebrows. One observer has posited that we have migrated from the patron saint of Milton Friedman to enshrining Rube Goldberg.

I rather like Rube Goldberg. I recall fondly the complex devises his protagonist, the felicitously named Professor Lucifer Gorgonzola Butts, would deploy to perform different tasks. If you turn to Wikipedia, you will find one of my favorites: the self-operating napkin. As described therein, it was activated when a soup spoon (Exhibit A) is raised to the mouth, pulling on a string (B), thereby jerking ladle (C), which throws cracker (D) past parrot (E), who jumps after it, tilting perch (F), upsetting seeds (G) into pail (H), whose new extra weight pulls cord (I), which opens and lights automatic cigar lighter (J), setting off skyrocket (K), which causes sickle (L) to cut string (M) and allows pendulum (N) with attached napkin (O) to swing back and forth, thereby wiping face.

I assure you the Federal Reserve has not abandoned the wisdom of Milton Friedman or Walter Bagehot or any of the other patron saints of central banking. But these are complex, trying times. Our economy faces a tough road. We are the nation's central bank and we are duty bound to apply every tool we can to clean up the mess that has soiled the face of our financial system and get back on the track of sustainable economic growth with price stability. The men and women of the Federal Reserve spend every waking hour doing their level best to perform their duty. Even if we have to deploy a little Rube Goldberg engineering to get the task done.

Some of our innovative contraptions have begun to work. For example, the London interbank offered rate, known by its acronym LIBOR, has come down handsomely. This is important as most variable-rate subprime and Alt-A mortgages that will be reset in the immediate future are based on LIBOR. Our purchase of government-sponsored enterprise (GSE) mortgage-backed securities has reduced the interest rate on 30-year, fixed-rate mortgages to 5.19 percent, a record low, according to Freddie Mac data that start in 1971. And our commercial paper and money market fund facilities have improved the tone of the all-important commercial paper market.

You cannot read a great deal into the initial response to an FOMC meeting. The markets need time to digest the signals being sent, especially when we are declaring a new regime change. That said, I found it encouraging that one of my favorite, well-run companies, Disney, was able to issue $1 billion in five-year notes yesterday, priced to yield 4.7 percent—some 30 basis points lower than most mavens on Wall Street had expected. If we are successful, issuers of corporate debt should see the cost of debt reduced over time. According to this morning's *Wall Street Journal*, the credit-default swaps index, which tracks the cost of insuring against the default of high-quality, investment-grade bonds, has fallen 16 percent in the past three days.[7] So, so far, so good.

Yet despite these accomplishments, we have miles to go before we sleep.

Please bear in mind that the Federal Reserve is only one arrow in the quiver that can be deployed to restore the nation's economic vitality. The power to stimulate activity through taxing and spending of federal monies lies with the Congress of the United States, and all eyes are on the fiscal stimulus package that will be worked out by the new president and the legislative branch. As a representative only of the monetary authority, I will refrain from commenting on the business of the fiscal authorities. With one exception: Whatever they decide to do, it is imperative that they withstand demands for protectionism—action that is within their purview as collectors of tariffs and writers of trade legislation. What made the Great Depression regrettably "great" was the Smoot–Hawley Act, with which everyone in this audience is familiar. You may be less familiar with the Long Depression that began when a flowering of new lending institutions that issued mortgages for municipal and residential construction in the capitals of Vienna, Berlin and Paris turned a cropper and began the financial panic of 1873.

If you study that debacle, you will quickly determine that what transformed a severe global downturn into a depression that lasted until 1896 was action taken by Chancellor Otto von Bismarck in 1879 to abandon Germany's free trade policy. His actions were followed in quick succession by France and then by Benjamin Harrison, who won the U.S. presidential election of 1888 by running on a protectionist platform. As world economic growth slows and economic conditions in the United States toughen, our elected representatives and newly elected commander-in-chief must resist with every fiber of their political beings the temptation to compound our travails by embracing protectionism. For if they fail to do so, the economic situation we now are working so hard to overcome will seem like a cakewalk.

With that cautionary note, I think I have said enough, Mr. Mayor. If you wish, I would be happy to take questions from the audience—as long as everybody keeps their shoes on.

[7] "Sentiment Shifts to Corporate Debt," *Wall Street Journal*, Dec. 18, 2008.