The Fed's Response to the Current Economic Challenge (With References to Gershon Bleichröder and Central Bank Independence)

Remarks before CERAWeek

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Thank you, Dan [Yergin]. It is a pleasure to be here at CERAWeek and especially to be here in Houston, the energy technology capitol of the world.

A week ago tonight, I returned to Texas from Washington, following a two-day meeting of the Federal Open Market Committee (FOMC), some public talks to warn against the dangers of protectionism and finally a weekend of events surrounding the annual Alfalfa dinner.

The Alfalfa Club is an institution peculiar to Washington, D.C. Once a year, it holds a dinner devoted solely to poking fun at the political pretensions of the day. Tongues firmly in cheek, its members nominate a candidate to run for the presidency on the Alfalfa Party ticket. Of course, none of them ever win and nominees are thenceforth known for evermore as members of the Stassen Society, named for Harold Stassen, who ran for president nine times and lost every time, then ran a tenth time on the Alfalfa ticket and lost again. The motto of this distinguished group—which in addition to Stassen has included my fellow Texans Jim Baker, Lloyd Bentsen, Robert Strauss, Jack Valenti, and both George Bush '41 and George Bush '43—is *Veni, Vidi, Defici*—"I came, I saw, I lost."

This year's dinner was the first for President Obama, who at the time had been in office only 11 days. Alfalfans introduced Vernon Jordan as the candidate to head their ticket and challenge the real president. Mr. Jordan appeared on stage in a stovepipe top hat. With a twinkle in his eye, he addressed President Obama and said, "Mr. President, you may have noticed my hat. At the end of my announcement speech, I will pass it on to you. I must merely wear it. You must pull a rabbit out of it."

Certainly concerning the economy, Jordan hit the nail on the head. The only description of recent economic developments I have heard that is as cogent came from 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. Our self-confidence has gone wobbly. Many of our fellow citizens feel trapped in an unsustainable situation. The challenge facing the new president is daunting.

Only yesterday, it would have appeared to the naked eye that the economy was cruising along in the most tranquil of seas. 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 of that year. And the stock market closed at an all-time high on Oct. 9, 2007, with the S&P 500 Index finishing the day at 1,565. To be sure, there were some signs of friction developing—most noticeably a heating up of headline inflation, which reached its peak at a 9.6 percent annualized rate in June of 2008. 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 income statements of major creditors and various consumers. But to the unsuspecting world, all was well.

In 2008, conditions shifted radically. 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 at an annualized pace of 3.8 percent in the final quarter of 2008. By my estimate, it is on pace to contract further throughout this 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 7.6 percent at the last reading and appears to me to be headed in the direction of, and possibly past, 9 percent.

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 today 44.4 percent off its October 2007 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 addressing their cost of labor by cutting "head count." They are delaying capital expenditures. They are demanding that suppliers cut their prices and are tightening inventory management. They are watching their receivables and stretching out their payables. And they are taking every step they can to clean up their balance sheets. (One of my colleagues 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.)

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 those 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 (and I hope, parenthetically, that President Obama makes full use of his wisdom). 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.”[1]

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 Leon Hale in the *Houston Chronicle*. 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. He had never heard of Bernie Madoff. 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 at the Federal Reserve done about it?

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 have just ignored it and mandated that it simply not be discussed, as the Latvian government did 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).

[1] “A Time of Unexampled Prosperity,” by Washington Irving, in *The Crayon Papers*, 1890.

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.) 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.

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...."[2]

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."[3]

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 recently read Ken Follett's magnificent book *World Without End.*[4] 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

[2] *Lombard Street*, by Walter Bagehot, 1825.
[3] *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain*, by Henry Thornton, 1802.
[4] *World Without End*, by Ken Follett, New York: Penguin, 2007.

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.[5] While the monks adhered to the Oxford-taught, old orthodoxy of studying the "humors," of bleeding, and of invoking the dictum of *fiat 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 do not believe in the economic equivalent of "fiat voluntas tua." We believe in using our powers proactively. We 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 we have made abundantly clear that despite having reduced the target range for the federal funds rate to the "zero bound"—the old orthodoxy—we will not shy from pursuing all practicable means available to a central bank in supporting the functioning of financial markets and stimulating the economy back to a steady state.

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, 2007, when the base interest rate—the fed funds 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.

[5] 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."

And, as you all know, in a series of steps, the FOMC reduced the fed funds rate to between zero and one-quarter of one percent, a process which I supported once it became clear that the inflationary tide was ebbing. Simultaneously, at the request of the 12 Federal Reserve banks, 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.

All of this has meant expanding our balance sheet. As of today, the total footings of the Federal Reserve have expanded to $1.9 trillion—an almost twofold increase from when we started in 2008. It is clear that we stand ready to grow our balance sheet even more should conditions warrant. Our options include purchasing longer-term Treasuries, expanding our holdings of mortgage-backed paper and purchasing larger amounts and different forms of asset-backed paper.

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, short-term 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 established 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.

To be sure, we have to be very careful in deploying our arsenal. For example, we are well aware that the issuance of new Treasuries is expanding at an eye-popping pace: Net new issuance of Treasuries was $145 billion in fiscal year 2007, expanded to $788 billion in fiscal year 2008 and, according to this morning's *Financial Times*, will broach $2 trillion in fiscal year 2009.[6] This "guesstimation" is based on the pace of issuance in the first five months of this fiscal year and an $800 billion price tag for the expected fiscal stimulus package (but before a net cost is assigned to the bank proposals that will be forthcoming from the Treasury). The Federal Reserve must, of course, be very careful to avoid the perception that it is monetizing the explosion of fiscal deficits, as this would undermine confidence in our independence and raise serious doubts about our long-term commitment to price stability. This does not mean, however, that we should refrain from buying Treasuries in this time of crisis. Similarly, we must be very cautious about the dimensions of our program to intervene directly in the market for asset-backed securities, making sure that our actions are, literally, the least we must do and no more. Most important of all, we must continue to make clear that we will unwind our interventions in the market and shrink our balance sheet back to normal proportions once our task is accomplished, for this is, indeed, our unanimous and unflinching intention.

I would suggest to you that some of our innovative, Rube Goldbergian 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 initially 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—though the rate has floated back upward as the yield on longer term Treasuries has risen with the new issuance calendar. And our commercial paper and money market fund facilities have improved the tone of the all-important commercial paper market—not just the A1/P1 paper market, in which we have directly intervened, but also in the A2/P2 market. It has also not escaped my attention that the premium over Treasuries that investment-grade corporations pay to borrow in the open market has declined by 20 percent and by 26 percent for non-investment-grade borrowers.

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 the American people's money lies with the Congress of the United States. All eyes are on the stimulus package being hammered out in the Senate, and, then, in conference with the

[6] "Fed Home Loan Purchases Fail to Keep Mortgage Rates from Rising," *Financial Times*, Feb. 9, 2009.

House of Representatives. This is no easy task. Our senators and congressmen and -women must find a way to give our economic engine an activating short-term jolt without encumbering or disincentivizing the entrepreneurial dynamic that has made for the long-term economic miracle that is America. Simultaneously, they must agree to the funding and structure of a revamped banking system. And, on top of all that, they must begin, now, to dig us out of the very deep hole they themselves have dug in incurring unfunded liabilities of retirement and health care obligations—programs that are already on the books but have not yet been paid for—that Pete Peterson's foundation calculates at $53 trillion and we at the Dallas Fed believe totals over $99 trillion.[7]

We are navigating uncharted, financially treacherous waters. Our fiscal authorities must carefully plot a course between the immediate needs for stimulus and the future needs of our children and grandchildren.

I trust the Congress will get it right. And, I should add, I hope that they—and you—continue to bear in mind the limited powers of the Federal Reserve. I believe it vitally important that the Federal Reserve must be left alone to independently craft policies using those powers, based solely on our best judgment as to what is needed to achieve financial stability and conduct monetary policy aimed at maximizing sustainable job creation without upsetting price stability.

As a central banker, I am genetically programmed to be a worrier. In times of economic duress, there is always a temptation for political authorities to compromise the central bank. I saw this firsthand in the Carter administration with the ill-advised imposition of credit controls. This was but one instance in history.

Liaquat Ahamed, a former World Bank official and CEO of the bond management firm of Fischer, Francis, Trees and Watts, has written an entertaining book, titled *Lords of Finance*. In it, he notes that the founder of the German Reichsbank was Otto von Bismarck. When the Reichsbank was formed in 1871, Ahamed reports, Bismarck's closest confidant, Gershon Bleichröder, is reported to have "warned [Bismarck] that there would be occasions when political considerations would have to override purely economic judgments and at such times too independent a central bank would be a nuisance."[8]

It is no small wonder that the political considerations of the First World War and the impulse to override what might have been the purely economic judgments of Germany's central bank led to the hyper-inflation of the Weimar Republic and the utter destruction of the German economy. I beg to differ with Herr Bleichröder. It is more important than ever that we maintain the independence of our central bank, keeping it free from being overridden by political considerations. As the executive branch and the legislature seek to navigate our economy to safe harbor, we must minimize the impulse to let political exigencies hamper the work of the Federal Reserve. If, in the process of doing what is right and proper by confining its activity to its singular purpose, the Federal Reserve becomes a "nuisance," so be it. It is important that we be left to do our job and no more.

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[7] Figures from the Dallas Fed cited in "Storms on the Horizon," by Richard W. Fisher, remarks before the Commonwealth Club of California, San Francisco, May 28, 2008. Figures from the Peterson Foundation cited in "Washington Must Heed Fiscal Alarm Bell," by David Walker, Peter G. Peterson Foundation, Sept. 22, 2008.

[8] *Lords of Finance*, by Liaquat Ahamed, New York: Penguin, 2009, p. 88.

Having ventured into fiscal matters, let me conclude with another comment on the stimulus package being debated within the legislative branch. Whatever our elected officials decide to do, it is imperative that they withstand demands for protectionism. What made the Great Depression "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 23 years was action taken by our buddy, the aforementioned Iron Chancellor, Otto von Bismarck. In 1879, he decided 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.

I have been quoted as saying that "protectionism is the crack cocaine of economics. It provides a temporary high but is instantly addictive and leads to certain economic death."[9] Were I not a taciturn, cautious central banker, I might have chosen my words with less constraint. As global growth slows and economic conditions in the United States toughen, our elected representatives, newly elected commander-in-chief and his agents must resist with every fiber of their beings the temptation to compound our travails by embracing protectionism. For if they fail to do so, the economic situation we are now all working so hard to overcome will seem like a cakewalk.

Thank you for bearing with me. I think I have said enough, if not too much. In the time-honored tradition of central bankers, I would now be happy to avoid answering any questions you might have.

[9] Interview on C-SPAN's *Washington Journal*, Feb. 2, 2009.