

The Economic Situation of the United States and the Federal Reserve's Response

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Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas

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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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リチャード・フィシャーと申します。銀行に勤めています。¹

I hope I said that better than my son James, who, upon our family's arrival in Tokyo in 1990, promptly spoke his first Japanese words:

私の犬は鼻がとても長いです,

which turned out to mean: "My dog has a very long snout."

Domo. Thank you. I am delighted to be here, together with my colleague Mark Wynne, who is the director of the Federal Reserve Bank of Dallas' Globalization and Monetary Policy Institute.

I first came to Japan with President Carter for the G-7 Summit hosted by Prime Minister Ohira in June of 1979. That experience whetted my appetite for Japanese culture. So after I returned to the private sector and had established an investment management firm in Dallas, I came back with my family to reside in Tokyo under the aegis of the Japan Society for most of 1990—arriving here shortly after the Nikkei Dow reached its all-time peak of 38,915. This gave me an invaluable opportunity to simultaneously learn about your country while providing my colleagues at Fisher Capital Management in Dallas insights into a financial market reversal of epic proportions—insights gleaned from an office kindly provided me by Nomura Research as well as from the bleachers on the various baseball fields where my teenage son played for the Minato Moose team in the Tokyo Senior Boys Spring League.²

Seven years later, I rejoined the government and served President Clinton as deputy U.S. trade representative in numerous bilateral negotiations with your government. I also served as cochair with Deputy Foreign Minister Haraguchi of the multiyear, joint commission set up by Prime Minister Hashimoto and President Clinton on deregulation and competition. In this commission, we wrestled with everything from laws governing retail stores to electricity distribution to bid rigging in construction to financial deregulation and even what I referred to then as "mini-micro" issues—ranging from auditing standards to regulations governing law firms. I consider it a significant accomplishment for both sides that, today, one of the few issues from that agenda that remain unresolved is the matter of providing a level playing field for private insurance

¹ "My name is Richard Fisher. I work for a bank."

² That experience served our firm well. In 1990, we eked out a return of 0.6 percent versus a decline of 3.1 percent for the total return of the S&P 500 and a decline of 34.8 percent in the dollar equivalent of the Nikkei's total return. This set the stage for a 59.7 percent return in 1991 versus 31 percent in the S&P 500 and 3.6 percent in the dollar equivalent of the Nikkei's total return—and anchored a run that, until I sold the firm in 1997, exceeded the return of the S&P 500 by almost 2 to 1. In this sense, I owe my personal financial security to lessons learned in Japan.

companies as they seek to compete with Japan Post Life Insurance, which like the rest of the Postal Savings system is now in a 10-year process of privatization.

Today I have the honor of speaking to you in another capacity—as a representative of the central bank of the United States in my role as president of the Federal Reserve Bank of Dallas, one of the Federal Reserve’s 12 operating banks.

Each of the bank presidents participates in the Federal Open Market Committee (FOMC), the body that sets monetary policy for the United States. The tradition of the Federal Reserve is that each member of the FOMC speaks only for himself or herself. I shall adhere to that tradition today. The observations I will offer today are my own and should be interpreted as a view only from the Federal Reserve Bank of Dallas—nothing more.

I have been fortunate to see both my own country and yours from several perspectives. I have learned enough about Japan from my different experiences here and my amateur study of Japanese history and literature to know that I do not know much. The first Western interpretation of Japan that I remember taking to heart was that of Lafcadio Hearn, who wrote of “the immense difficulty of perceiving and comprehending what underlies the surface of Japanese life.”³ I have worked with your government on trade issues, operated an investment fund from Tokyo, watched innumerable Japanese baseball games (I confess, at great risk in this audience of likely Giants fans, to being a fan of the Yakult Swallows, and even though they haven’t won a championship since 2001, I am hoping this 40th anniversary season for their franchise will be their lucky charm), read and re-read the classic works of Western interpreters like Hearn and [Edwin] Reischauer and [Karel] van Wolferen (and, my favorite as a baseball fan, Robert Whiting!) and studied the works of literary giants like Natsume Soseki and Tanizaki Jun’ichiro.⁴ But I have barely scratched the surface of comprehending your rich and complex culture. These experiences have taught me enough, however, to be humble when addressing a Japanese audience of this distinction. So rather than prescribe policy to you, I will stick to describing the policy predicaments in which my own countrymen and women are immersed.

One of my favorite books in Japanese literature is Natsume Soseki’s *Kokoro*, a gorgeous novel written in 1914, two years after the death of the Emperor Meiji and two years before the author’s own death. Lafcadio Hearn offered what seems to me to be the best translation of the word *kokoro*—he defined it as “the heart of things.” In this lecture, I shall try to quickly get to the heart of things occurring in the U.S. economy. I will then summarize the consequences for U.S. monetary policy. And then, if you permit me, I will endeavor to answer any questions you might have. Throughout, I will do my best to achieve the stylistic simplicity that Soseki-san achieved in *Kokoro*, though undoubtedly without the beauty that is implicit in that novel, for there is little of apparent beauty in our current economic and financial situation.

The data from the United States are grim. Our economy contracted at an annual rate of 6.3 percent in the fourth quarter of last year. I expect that when the numbers are properly tallied, we will have contracted at a very similar rate in the quarter just ended. Unemployment is rising. We currently have roughly 13.2 million people without jobs, which equates to an unemployment rate

³ *Japan: An Attempt at Interpretation*, by Lafcadio Hearn, Charles E. Tuttle & Co., 1959, p.1.

⁴ Two exemplary works by Tanizaki Jun’ichiro are *Naomi*, Alfred A. Knopf Inc., 1985, and *In Praise of Shadows*, Leete’s Island Books Inc., 1977.

of 8.5 percent. I expect the unemployment rate to continue rising to a level that could surpass 10 percent by year-end. Among other things, this has compounded the problem of the much-watched housing market, where many of the problems we have encountered in our financial markets germinated: The most recent release of the Case-Shiller index reveals that home price declines accelerated in the 20 metropolitan districts tracked, falling 19 percent on a year-over-year basis for the three-month period ended in January. But the problem with our economy is more pervasive. The men and women who operate our businesses and create and sustain employment have assumed a defensive crouch. Confronted by dyspeptic financial markets, they are doing the best they can to preserve their margins by cutting costs (most significantly, the cost of labor), and running tight inventories, rationalizing supply lines, deferring all but the most necessary capital expenditures and, in general, avoiding risk. The result is an American economy in stasis. Nothing is being ventured, and nothing is being gained.

Of course, not helping matters is the implosion of our export markets, which are vital to the growth of an economy positioned to sell high-value-added goods and services—as well as agricultural and other basic goods—to others. The World Bank is predicting that the global economy will contract by 1.7 percent this year, and global trade by 6.1 percent.⁵ This will be the first time since the 1940s that we have witnessed such a deep and synchronized retrenchment of global economic activity, and this makes tougher the task of growing the U.S. economy.

One of our founding fathers, James Madison, a coauthor of the *Federalist Papers* and considered by many to be the father of the (American) Constitution, wrote that “the circulation of confidence is better than the circulation of money.”⁶ There is presently a palpable lack of circulating confidence in the business community in America.

In light of this, the Federal Reserve has assumed a dramatically proactive and highly innovative role in seeking to restore vibrancy in the credit markets while stemming economic decline. This is an unaccustomed thing for our central bank. Ordinarily, the men and women of the Federal Reserve are the most shy and modest of economic agents. We prefer to move incrementally rather than exponentially, and we have historically treasured conducting our deliberations quietly and away from the public limelight. But confronted with a dysfunctional financial market and an implosion in our economy, in rapid order we have undertaken a series of very visible and widely broadcast initiatives. Over a period of a little more than a year, we:

—Established a lending facility for primary securities dealers, taking in new forms of collateral to secure those loans;

—Initiated so-called swap lines with the central banks of 14 of our major trading partners, ranging from the Bank of Japan to the European Central Bank and the Bank of England to the Banco de México to the Monetary Authority of Singapore and the Korean Central Bank, to provide these foreign central banks with the capacity to deliver U.S. dollar funding to financial institutions in their jurisdictions. We also have put in place swap agreements with four of our counterparts—the Bank of Japan, the European Central Bank, the Bank of England and the Swiss National Bank—to enable the Federal Reserve to provide up to 10 trillion yen, 80 billion euro,

⁵ “As Global Economy Deteriorates, World Bank Predicts Sharply Slower Growth in Developing World in 2009; Weak Recovery in 2010,” World Bank Press Release No. 2009/285/DEC, March 31, 2009.

⁶ Speech in the Virginia Ratifying Convention on the Judicial Power, June 20, 1788.

30 billion in sterling and 40 billion in Swiss franc liquidity to U.S. financial institutions as a reciprocal prophylactic measure;

—Created facilities to backstop money market mutual funds;

—Initiated new measures in cooperation with the Treasury and the Federal Deposit Insurance Corp. to strengthen the security of certain banks;

—Undertook a major program to purchase commercial paper, a critical component of the financial system;

—Began to pay interest on bank reserves;

—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, then increased that sum to \$200 billion;

—Announced we would buy \$500 billion in mortgage-backed securities backed by Fannie, Freddie and Ginnie Mae, then increased *that* sum to \$1.25 trillion;

—Announced, and just recently fleshed out, 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, a facility which we have since stated we were prepared to expand significantly to other types of securities and beyond our originally planned \$200 billion to \$1 trillion; and

—Began the process of purchasing up to \$300 billion of longer-term Treasury securities over the next six months to help improve conditions in private credit markets.

And, in a series of steps, the FOMC reduced the fed funds rate to between zero and one-quarter of 1 percent, a process which I supported once it became clear that the immediate 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 we charge banks to borrow from our discount windows, so as to lower the cost of credit to the economy.

All of this has meant expanding the Federal Reserve's balance sheet. As of today, the total footings of the Federal Reserve have expanded to roughly \$2 trillion—more than a twofold increase from when we started in 2008. It is clear that we will grow our balance sheet even more as we complete our programs of purchasing longer-term Treasuries, expanding our holdings of mortgage-backed paper and purchasing larger amounts and different forms of asset-backed paper.

By being so proactive in straying from our usual business of holding plain vanilla, mostly short-term Treasuries as assets and by shifting policy away from simple titrations of the fed funds rate, we have raised a few eyebrows. But these are complex, trying times. Our economy faces a tough road. We are the central bank of the largest economy in the world, and we are duty bound to apply every tool we can to clean up the mess that our financial system has become and get back on the track of sustainable economic growth with price stability.

This expansion of our balance sheet has given rise to concerns that we may be:

- 1) Planting the seeds of future inflation;
- 2) Setting the stage for a demise of the dollar; and
- 3) Placing the cherished independence of the Federal Reserve at risk.

I understand these concerns. And I have actively and loudly argued during deliberations of the FOMC that these risks represent a real and present danger. But I am here to tell you that I am not alone. The committee members—from the regional bankers like me to its chairman, Ben Bernanke, and other governors—are each and every one determined not to violate the basic tenets of Federal Reserve sanctity.

Let me address each of these concerns in order.

First, with regard to the potential inflationary consequences of our actions: Our assignment is to conduct monetary policy so as to engender sustainable, noninflationary job growth. Presently, the risk is deflationary job destruction. We have undertaken measures to counter that risk. And we seek to do so in a way that will not ignite the embers of either a future destructive inflation or a debasement of our currency.

I have a reputation for being the most “hawkish” participant in the deliberations of the Federal Open Market Committee, and I have a record that substantiates that reputation, having voted five times against further accommodation during the commodity-driven price boom of 2008. I consider inflation an evil spirit that rots the core of economic prosperity and must never, ever be countenanced. But it is clear to me that in this environment, inflation is unlikely to present a serious threat given the pervasive bias in the U.S. economy toward wage cuts and freezes, rising unemployment, the widespread loss in wealth that has resulted from both the housing and equity market corrections, continually declining consumption and business investment, and the anemic condition of the banking and credit system, all of which reinforce downside price pressures in a global economy groaning with excess capacity.

For as far ahead as I trust my forecasting ability (that is to say, the next couple of years), the problem with regard to maintaining price stability most certainly is not inflation.

With regard to the fate of the dollar and the willingness of others to continue purchasing dollar-denominated debt, we realize that by purchasing Treasuries in volumes and of durations that are atypical, we are at risk of being perceived as monetizing the fiscal largesse of our Congress. And we are acutely aware that by intervening in the mortgage-backed securities and other markets that we are at risk of being perceived as blurring the lines between fiscal and monetary policy. We realize that this may give rise to some apprehension among large holders of Treasuries and agency paper such as your government and others in the Asian Pacific region.

And yet, let me remind you that over the past year since we began in earnest the process of using the new tools I have just articulated, the dollar has appreciated 17 percent against the euro and 29 percent against the British pound. Among the major currencies, the dollar has depreciated against only one currency, Japan’s, and by 2.4 percent.

Here are some numbers for you to contemplate: If a Japanese investor had purchased a three-month U.S. Treasury bill in March 2008 and rolled it over every three months until the end of this past month, the return would have been slim to none—about -1.4 percent. That is hardly inspiring. But, had that same investor purchased and rolled over a three-month euro-area central government bond, the investment would have resulted in a loss of 16 percent. A Chinese investor investing in euro bonds would have had the same experience. A Korean investor investing in the same manner would have earned a return of 21 percent in euros but would have earned a 42 percent return in won terms had he invested in three-month Treasury bills.

Certainly for the past year to date, fears of debasement of fixed-income portfolios invested in dollar-denominated public debt have proven unfounded. To be sure, an investment in comparable maturities in yen would have earned a modest positive return of 0.47 percent for a Japanese investor. But, adjusted for liquidity, that is hardly sufficient incentive for not having a predominance of the world's most significant currency in a portfolio.

I would add that a foreign investor who moved out on the Treasury yield curve would have enjoyed superior returns to those just cited. In yen terms, 10-year sovereign Japanese paper earned a return of 2 percent from March of 2008 to March of this year. Ten-year euro sovereigns would have earned a return of *negative* 11.5 percent in yen terms. The equivalent return would have been a *positive* 10.4 percent for the Japanese investor in 10-year U.S. Treasuries. If I may paraphrase Andrew Mellon, at least for the period over which the Fed has been applying its new tools, it has been quite true that “gentlemen prefer American bonds.”

But that is in the past. As to the future, the underlying math becomes more complex: The net new supply of Treasury debt is predicted to expand by \$2.5 trillion in the current fiscal year, versus \$788 billion in the last fiscal year and only \$145 billion in fiscal year 2007.⁷ All things being equal, this would result in a move upward in yield and downward in price, providing negative returns absent any foreign exchange factor. But all things are not equal. For starters, the problems facing the largest competitive currency, the euro, are perhaps even more substantial than those confronting the United States. I will point to Spain and Ireland as examples of euro-area economies that led the European pack on the upside and now are cascading rapidly downhill. In the case of Japan, you are as aware as anybody of the economic and fiscal and political predicament you are faced with; I will say no more. My point is that demand for Treasuries and other official paper of U.S. government issuers will be determined by their attractiveness relative to alternatives, and they may well be judged more, rather than less, attractive under most reasonable future scenarios.

Moreover, both the fate of budget imbalances and the potential for total returns earned by investing in U.S. securities depend on the efficacy of the fiscal policies Congress has advanced. These policies are designed to jump-start the economy while laying the groundwork for permanent structural reform. Time will tell if they achieve this multipurpose goal. If they do, they will engender economic growth and concomitant confidence in the fixed-income and equity markets for private securities. In addition, tax flows will be restored and confidence boosted in the path of deficit reduction envisioned by the current administration in its budget projections. If these policies don't jump-start the economy, then I am confident that the reaction within fixed-

⁷ “Fed Home Loan Purchases Fail to Keep Mortgage Rates from Rising,” *Financial Times*, Feb. 9, 2009.

income markets will force those with the power to tax and spend, the Congress, to readjust their fiscal policies.

I offer as evidence the revelation that came to the fiercely partisan Democratic operative James Carville during the Clinton administration. He said that were he to be reincarnated and wished to be the most powerful of all, he would come back not as a president or a pope but as the bond market, for “[the bond market] can intimidate anybody.”⁸ I suspect this respect for the power of bond markets remains true for the Obama administration and the current Congress.

As to the independence of the Federal Reserve, let me remind you that in 2013, we will celebrate our 100th anniversary as the central bank of the United States. We are not as established as an ongoing entity as the Bank of England, nor as young as institutions such as the People’s Bank of China. This is not to say we are superior or always exemplary, but we are an elder in this business. We seek to be worthy of the veneration traditionally given to an elder. To this end, we feel it necessary to guard our ongoing independence.

We have recently agreed with the U.S. Treasury to an accord to work together to support the goals of preserving both monetary and financial stability.⁹ In this endeavor, it is the Federal Reserve’s job to maintain monetary stability, while the Treasury will enable the Fed to sterilize the impacts of its lending and securities purchases on its balance sheet—and on the balance sheet of the banking system. In essence, the Federal Reserve will not monetize the growth of the assets on its balance sheet that has been, and will continue to be, necessary to jump-start the credit markets that are so essential to the recovery of the U.S. and global economies. To put it another way, the Federal Reserve is in the process of acquiring the tools to short-circuit any inflationary consequences of its balance sheet growth.

In contemplating the future of the American economy and our ability to overcome our current financial predicament, I take great comfort in knowing that we have faced far tougher tasks and have always accomplished them. It is true that we Americans often confront storms of our making. We occasionally falter and get blown off course. But we never give up. And we always come roaring back stronger, leaner and more efficient than we were before. For 233 years, the people of the United States have demonstrated that they are masters of the process of creative destruction that the economist Joseph Schumpeter articulated as the key to success for any economy. Our recent presidential election demonstrates that we are still possessed of a vibrancy and adaptability that the French social philosopher Alexis de Tocqueville found so inspiring in the early 19th century. As an American, I may be insufficiently humble, but I consider our track record and our adaptability the stuff of an eventual recovery that will take my country to new levels of prosperity. I am confident that the innovative policies being pursued by the Federal Reserve will facilitate and, indeed, expedite the recovery process.

One of the unique cultural artifacts that I found intriguing while I was here in Japan in 1990 was the senninbari. For the Western press that is here, these are the “thousand stitch cloths” that originated during the Sino-Japanese War. By tradition, they consisted of a strip of white cloth embellished with 1,000 French stitches sewn with red thread by a thousand women and given to soldiers to ward off bullets and ensure a safe return. There should be no doubt that we at the

⁸ James Carville, as quoted in the *Wall Street Journal*, Feb. 25, 1993.

⁹ Federal Reserve Board and Department of the Treasury joint press release, March 23, 2009.

Federal Reserve, like central bankers everywhere, are subject to attack by the bullets of a severe global recession and financial turbulence. Perhaps we could use senninbari to protect us. But as symbolically and emotionally meaningful as they might have been, senninbari were no substitute for prudent maneuvering on the battlefield. As part of the team working very hard to successfully maneuver our central bank through the current financial battlefield, my colleagues and I are committed to the utmost to conducting monetary policy not only so as to ward off the bullets and other threats to our economy but to emerge from this stressful period with an American economy that is stronger and better and that plays an important role in renewing the vibrancy of the global economy.

And now, in the tradition that is the hallmark of central bankers everywhere, I will do my best to avoid answering any questions you may have.

Goseichou arigato gozaimashita. Thank you very much.