

# **Back from the Abyss: Now What?**

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*Remarks before the 125th Annual Convention of the Texas Bankers Association*



**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.*

## Back from the Abyss: Now What?

Richard W. Fisher

“Every age has its peculiar folly—some scheme, project or phantasy [sic] into which it plunges, spurred on either by the love of gain, the necessity of excitement, or the mere force of imitation.”

“Men, it has been well said, think in herds; it will be seen that they go mad in herds....”

Charles Mackay

*Memoirs of Extraordinary Popular Delusions* (1841)

“[a]t particular times ... people have a great deal of ... money.... At intervals ... the money of these people ... is particularly large and craving: it seeks for some one to devour it, and there is (a) ‘plethora’; it finds some one, and there is ‘speculation’; it is devoured, and there is ‘panic.’”

Walter Bagehot

“Edward Gibbon,” *National Review* (1856)

“I maintain that the Great Depression was not some act of God or the result of some deep-rooted contradictions of capitalism but the direct result of a series of misjudgments by economic policymakers....”

Liaquat Ahamed

*Lords of Finance: The Bankers Who Broke the World* (2009)

“The Federal Reserve has no way of offsetting the financial market pressure associated with excessive deficits.... Pushing more money into the system to finance the Treasury would only serve to heighten fears about inflation and the future course of interest rates.”

Paul Volcker (1982)

as quoted in William R. Neikirk’s  
*Volcker: Portrait of the Money Man* (1987)

I have just read to you four passages from financial scripture. In this morning's sermon, I plan to make reference to each of those passages as we explore where we have been and where we might be headed.

But first, I want to thank the Texas Bankers Association for having me here this morning and Victor Pierson, the honorable mayor of Jamaica Beach and president of Moody National Bank, for that kind introduction. Besides being pivotal in the organization of the TBA some 125 years ago, the Moody family has played a rich role in the life of Texas since well before that time (a fulsome history I heard often—always accompanied with a wry sense of humor—from old Dan Oppenheimer back in the 1980s). The lineal and business and banking descendents of Col. William L. Moody have navigated hurricanes, wars, depressions and banking crises—all of epic proportions—and have always remained standing. They are a monument to Texas resilience. It is an honor to be introduced by anybody associated with the Moody legacy.

Now to the sermon.

I once managed Dan Oppenheimer's personal portfolio. One afternoon in 1982, I was visiting Dan at the Oppenheimer Bank here in San Antonio. A Baptist preacher came in to ask him for a "loan."<sup>1</sup> He wanted to buy some cattle. Dan was teasing him about the prosperity he had achieved while preaching from the pulpit and warned him not to count on its permanence. "Your congregation might become as prominent as you," he said, "and then migrate to a nicer church." To illustrate the point, he invented a story about a Baptist preacher who visited a shelter where he found a man who looked particularly downtrodden. The generous preacher took pity upon the man. He took him to a barber for a shave and a haircut and to a store for a pair of shoes, a shirt, a tie and a new suit. The preacher then dropped the man back at the shelter, handed him \$20 and told him, "Son, you have been saved. The Baptist church is just one block away from here. I want you to come to my church on Sunday and praise the Lord."

Sunday came but the man did not. So immediately after the service, the preacher went to the shelter. There was the man, sitting in a rocking chair, all dressed up and beautifully groomed, reading a newspaper. "Son, I had asked you to come to the Baptist church this morning to give testimony to having been saved. Where were you?" asked the preacher.

"Pastor," the man replied, "I surely did go to church. I woke up this morning, shaved my whiskers, combed my hair, put on this beautiful shirt and tie you bought me and dressed in this new suit. I put on these fancy new shoes. When I looked in the mirror, I felt like a millionaire. So I spent the \$20 and took a cab to the Episcopal church."

I certainly don't need to tell a room full of Texas bankers what got the nation into its current economic situation. A sudden new set of circumstances, easy money seemingly heaven-sent and the short-sighted suspension of time-tested, prudent financial practice led us on the road, not to salvation, but to economic perdition.

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<sup>1</sup> Oppenheimer Bank was the largest of the then five surviving private unregulated banks in Texas. Typically, a loan from Oppenheimer consisted of writing a check and asking Dan to cover it with some rate of interest charged. Loans were, in essence, overdrafts. Oppenheimer knew every virtue and vice of his clientele; the bank was privately owned and as principal, Dan viewed loans as essentially lending his own money. The bank reportedly never lost a dime. It closed one year after Dan's death in 1987.

Allow me to address each of these individually.

The new set of circumstances included the economic and financial windfalls that came from at least two major structural changes. The first was the end of the Cold War and the commercial reorientation of China, Vietnam, India and Eastern Europe, which unleashed enormous new capacity for the increased production of goods and services, held down costs and restructured the global economic map. The second was the explosion of computational power and communication ease that came from technological advancement and the Internet, facilitating globalization and leapfrogging frontiers that formerly separated the economic landscape. The world was our oyster. It simultaneously gave us new consumers and suppliers. It provided new sources of funds as well as new places to invest.

The easy money may well have been encouraged by central banks that held interest rates too low for too long. But it was exacerbated by lenders, investors and consumers who—keen on enhancing returns that seemed pedestrian with a flat yield curve anchored by low, risk-free rates—“craved” and “devoured” new risk instruments. As a result, they came up with new “schemes” and “projects” and “phantasies” made more enticing by expanded markets and financial innovation.

The short-sightedness was manifest in the abandonment of prudential practices. For the banker and lender, the time-tested principle of “know your customer” took a back seat to the mad rush to package and sell exposure to others. For the consumer, living within your means became a less compelling discipline in a world where a house was not just a home but a means to financial gain. For the investor, prudence took on another dimension with the presumed ability to mathematize judgment and hedge away the risk of default.

And yet, while the world had indeed changed, the behavioral pathology documented by Mackay and Bagehot in the 19th century—a pathology based on their studies of countless debacles through history—prevailed. A “plethora” of commercial and financial opportunity begat “speculative” excess that inevitably begat a “panic.” The thundering “herd,” spurred on by “the love of gain, the necessity of excitement or mere force of imitation” and “mad” with irrational exuberance for the upside, suddenly realized in 2008 it had “devoured” more risk than it could stomach and panicked. The financial system seized up and the economy descended into recession.

Who is to blame? Well, if you had been listening to the radio on Feb. 26, 1933, you would know the answer. You would have heard a crazed Father Charles Coughlin, pastor of the Shrine of the Little Flower in Royal Oak, Mich., rail against “the Morgans, the Kuhn-Loebs, the Rothschilds, the Dillon-Reads, the Federal Reserve banksters, the Mitchells<sup>2</sup> and the rest of the undeserving group, who without ... the blood of patriotism ... flowing in their veins have shackled the lives of men and of nations with the ponderous links of their golden chain.”

Advance the tape 76 years. If you substitute Goldman Sachs for the Rothschilds, Lehman Brothers for Kuhn-Loeb, AIG for Dillon Read, Ken Lewis, Sandy Weill or John Thain for “Sunshine Charlie” Mitchell and keep the text about Federal Reserve “banksters,” you will have captured the liturgy of invective heard from Father Coughlin’s contemporary secular cousins. On

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<sup>2</sup> “Sunshine Charlie” Mitchell was the head of National City Bank, the forerunner to Citigroup.

airwaves and in the blogosphere, on editorial pages and even in the halls of Congress and foreign parliaments, critics have been casting about for whom to blame for “shackl(ing) the lives of men” and women from Bastrop to Beijing with the “ponderous links” that took us to the very edge of the abyss of global economic collapse.

I will let you draw your own conclusions about who is to blame. In my time at the Federal Reserve, starting in 2005 and working predominantly under the chairmanship of Ben Bernanke, my colleagues and I have been focused primarily on finding a way to undo past errors and mend the system.

I believe that the initiatives taken by my fellow “banksters” at the Federal Reserve prevented us from falling into the chasm of an economic depression. Beginning in August of 2007, we confronted a total breakdown of the financial system. In rapid order, we undertook a series of steps. We:

- 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 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 between March and September to help improve conditions in private credit markets.

And, in a series of steps, the Federal Open Market Committee (FOMC) reduced the fed funds rate to between zero and one-quarter of 1 percent, a process 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.

In summary, the Federal Reserve did everything in its power to avoid making the modern equivalent of the “misjudgments” that Liaquat Ahamed argues were made by our predecessors in

the 1930s (and, I should add parenthetically, that everyone and their sister feel Japan made in the 1990s).

There is evidence that our actions have succeeded in pulling the financial markets and the economy from the edge of the abyss. There are, as many have noted, some “green shoots” that have begun to sprout that will help end the contraction in output and set the stage for a recovery. In the world of finance, interest rates in key areas such as mortgages and the London interbank market have declined dramatically, enlivening the housing markets and reviving interbank lending; private bond market issuance has resumed and, indeed as you will see in this week and next week’s issuance calendar, at robust levels for both high-grade and junk issuers; and the stock market has rallied from its lows, bringing with it a surge in the volume of new stock issuance. While it takes some time for these improved financial conditions to start helping the broad economy, I am happy to see that some green shoots are also starting to emerge on Main Street: The most recent reports indicate that job losses may be slowing; trucking companies—a group often looked to as a leading indicator—report a slight pickup in sales; purchasing managers are reporting that the pace of decline in new orders has abated; and retail sales are getting slightly less worse.

These are encouraging signs. But we are not out of the woods. We have miles to go before we sleep.

First quarter results for the nation’s largest banks are encouraging, but challenges remain. Confidence among business women and men—the creators of lasting, productive jobs and prosperity—has shown signs of revival but remains elusive. Consumers at home remain cautious, for fear of losing their homes or their jobs. The markets we sell into abroad—Mexico and Europe, for example—remain weak, while others such as China are perhaps more robust but are insufficiently sized to fill the hole left by consumers at home and in our larger export markets.<sup>3</sup>

Under these conditions, I envision a slow recovery. Not a V-shaped snapback—nor even a U-shaped one—but a very slow slog as we find a more sensible and sustainable mix between consumption and savings and investment.

You know the numbers that have been reported for the nation for the first quarter: Even after upcoming revisions, I venture we’ll find we contracted at somewhere between 5 and 6 percent at an annual rate. The pace of decline will moderate in the current quarter, and then we’re likely to bounce along the bottom for a while, perhaps punching through to positive growth as 2010 dawns. I would be delighted, but surprised, if meaningful sustained growth gets under way any earlier. Regardless, increases in unemployment, while mitigated by the expansion of government (particularly the need for census takers) will likely take us to a 10 percent jobless rate before we reverse course. And global excess capacity is likely to remain excessive for some time to come.

As to price stability—the touchstone of central banking—given the vast amount of slack worldwide, the near-term outlook for inflation is meek. Indeed, the recent pressures have been to the deflationary side, though we seem to have beaten that back.

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<sup>3</sup> Through April, China’s overall imports from the rest of the world dropped 23 percent from last year’s level to \$78.8 billion. The U.S. is presently exporting \$5.6 billion a month in goods to China.

Neither deflation nor inflation engenders confidence. Both distort decisionmaking of households as well as businesses. Both inhibit sustainable employment growth. If you want to know the outlook for inflation over the next quarter or next year, look at current domestic and global slack: It is doubtful that inflation will raise its ugly head until employment and capacity utilization tighten. Looking further out, however, Milton Friedman—whom many consider the Moses of monetary policy—reminds us that inflation, defined as “a steady and sustained rise in prices,” is “always and everywhere a monetary phenomenon.”<sup>4</sup> Bearing this in mind, we must be careful with the deployment of our monetary initiatives.

As the nation’s central bank, the Fed performs two major roles. One is the standard conduct of monetary policy—a blunt instrument of adjusting interest rates and the money supply to achieve our long-term objectives of price stability and sustainable employment. In performing that role, the Fed has lowered short-term interest rates to help cushion the economic downturn.

The Fed’s other role is to act as a lender of last resort—to stabilize financial markets when confidence breaks down and markets become unduly segmented and dysfunctional. This entails targeted injections of liquidity to keep markets functioning under dire circumstances. Reflecting the larger role of securities markets in funding loans, the Federal Reserve has extended its lender of last resort role beyond banks. Since the fall of 2007, the Federal Reserve has been aggressive in putting programs in place to revive the functioning of key credit markets and pull the economy away from the brink. These actions are not permanent injections of money that may later fuel inflation, but rather are temporary injections of liquidity to stabilize malfunctioning markets. As such, they are intended to promote financial stability, sustainable growth and price stability.

The Congress, spurred on by the new president, has been aggressive with fiscal policy. The good news is that *if* fiscal policy has been properly designed—and time will tell if it has been—it should propel the economy farther away from the edge and put it on its way to a new cycle of economic growth, somewhat tentatively at first but hopefully gathering momentum as time passes.

People are understandably nervous about the combination of a dramatic expansion of the Fed’s balance sheet *and* a ballooning of federal budget deficits. I return to the Book of Ahamed and the Book of Volcker. Ahamed speaks of the miscalculations of policymakers. Volcker warns that the Fed cannot monetize deficits without heightening fears of inflation and negatively impacting the future course of interest rates.

Those of us responsible for developing monetary policy must constantly bear both observations in mind. We have been very careful to calibrate our actions so as to accommodate the needs of credit markets and the economy, not political imperatives. We are well aware that some of our balance sheet additions, designed to pull markets and the economy from the edge, have raised a few eyebrows (like the \$1.25 trillion in mortgage-backed securities we have pledged to purchase if necessary—although it has unquestionably driven mortgage rates to historic lows). And while it is not unusual for the System Open Market Account to buy Treasuries along the yield curve,

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<sup>4</sup> The quotes are taken from Milton Friedman’s “Inflation: Causes and Consequences” in his book *Dollars and Deficits*, published by Friedman in 1968. Friedman clearly recognized that any of a wide variety of shocks can give rise to short-term changes in the price level. Too often, those who quote his inflation dictum fail to distinguish between temporary and sustained price movements.

the FOMC's decision to purchase \$300 billion in U.S. Treasuries—a decision made to improve the tone in the private credit markets—has been viewed by some as skating a little too close to the edge of political accommodation.

I can tell you that the FOMC is well aware of the doubts being voiced about its intentions. I can also tell you that nobody I know on the committee wants to maintain our current posture for any longer and to any greater degree than is minimally necessary to restore the efficacy of the credit markets and buttress economic recovery without inflationary consequences. Indeed, as I speak, we are studying ways to unwind our balance sheet in a timely way. Chairman Bernanke spoke of this just this past Monday in Georgia.

In the meantime, looming before us is the prospect of a heavy calendar of debt issuance by the Treasury. Between now and the end of the current fiscal year in October, the Treasury will issue just over \$1 trillion in net new debt, with at least that much to follow in fiscal 2010. As the Book of Volcker warns, the Federal Open Market Committee can ill afford to be perceived as monetizing that debt, lest we come to be viewed as an agent of, rather than an independent guardian against, future inflation.

Already, there are concerns that the Federal Reserve will be politicized. For example, some have called for increased congressional involvement in the selection of Federal Reserve policymakers and a reduced role for member banks. I trust that the Congress will resist this initiative and not upset the careful federation that has for so long balanced the interests of Main Street with those of Washington, just as we at the Federal Reserve must resist the urgings of some to accommodate the short-term financing needs of the Treasury.

Your central bank has worked hard to pull the economy back from the abyss. To be sure, the FOMC has taken risks to do so. We have no doubt erred on occasion, but for the most part, I think we have gotten it right—primarily because each of us has an abiding faith in the time-tested virtues of conducting responsible monetary policy. We will work hard to remain virtuous, always bearing in mind that our job is to conduct monetary policy with the simple, yet profound, mission of underpinning sustainable economic growth without sacrificing price stability.

So much for the Gospel according to the Dallas Fed! Thank you for letting me be here. Thank you for letting me serve you. And thank you for letting me tell one of my favorite stories about old Dan Oppenheimer, God rest his witty old banker's soul.

In true central banking fashion, I will now do my utmost to avoid answering any questions you have.