Remarks Before the Washington Association of Money Managers

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I want to thank the Washington Association of Money Managers for having me here this evening and Fred Boos for that kind introduction. Thank you also for allowing two of my best friends, Evan Thomas and the Reverend Derrick Harkins, to join me tonight.

Neither Evan nor Derrick is a money manager. Evan is editor-at-large of *Newsweek* and is one of the great American nonfiction writers. He wrote *The Wise Men* and one of the great biographies of Bobby Kennedy. Yet, as an Annapolis man, I love him best for his work on John Paul Jones—the father of the American Navy. But that is not why he is here tonight. We are "cousins" through marriage: Both he and my wife, Nancy, descend from the family tree of Norman Thomas, a Presbyterian minister who ran for the presidency six times as a socialist and pacifist. Evan is here because in a most nonpacifist manner, he plans to dispatch with me on the golf course this weekend and wants to make amends *ex ante*.

I shall appeal to Reverend Harkins for some *ex ante* divine intervention in Saturday's match! Derrick leads the Nineteenth Street Baptist Church and has been my pastor for many years, going back to when he led the New Hope Baptist Church in Dallas. He is one of our country's most eloquent preachers, and I am honored that he is here.

With such a distinguished man of the cloth present among this group of people dedicated to the pursuit of mammon, I thought I would give a little sermon-ette this evening.

Here are four quotes from financial scripture:

The first is from Charles Mackay's *Memoirs of Extraordinary Popular Delusions*, written in 1841:

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

The second is taken from the father of central banking—Walter Bagehot—from his essay "Edward Gibbon," in the 1856 edition of *National Review*:

> "[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.'"

From Liaquat Ahamed, who has written a superbly entertaining book, published earlier this year, titled *Lords of Finance: The Bankers Who Broke the World*:

> "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.…"

Finally, Paul Volcker as quoted in Bill Neikirk's *Volcker: Portrait of the Money Man* in 1987:

> "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."

Tonight, I will reference each of those passages as we explore where we have been, where we are today and the fiscal predicament that awaits us further down the road. But first, some context.

Reverend Harkins will no doubt have heard the story of the humble Presbyterian pastor who visited a shelter where he found a man who looked particularly downtrodden. This generous pastor 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 pastor then dropped the man back at the shelter, handed him $20 and told him, "Son, you have been saved. My 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 pastor 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 my church this morning to give testimony to having been saved. Where were you?" asked the pastor.

"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 used the $20 to take a cab to the Episcopal church."

I certainly don't need to tell a room full of Washington money managers 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.

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.

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, to paraphrase Bagehot. As a result, they came up with new "schemes" and "projects" and "phantasies" made more enticing by expanded markets and financial innovation.

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[1] 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 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. Nothing is new under the sun; old prejudices and conspiracy theories never die.[2] On airwaves and in the blogosphere, on editorial pages and even in the halls of Congress and foreign parliaments, critics are casting about for whom to blame for "shackl(ing) the lives of men" and women from Bethesda to

[1] "Sunshine Charlie" Mitchell was the head of National City Bank, the forerunner to Citigroup.

[2] For instance, in a current best-selling book in China, *Currency Wars*, it is asserted that the major central banks—including the Federal Reserve and the Bank of England—are controlled by a small group of private bankers. These bankers make their profits through the control of the nation's money supply.

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 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. Having announced our extension of term lending to banks in December, in rapid order, we then set in motion a series of steps to provide liquidity, strengthen the security of certain banks, become the equivalent of market maker for key financial instruments such as commercial paper and certain asset-backed securities and, in ways appropriate to the times, deliver on our mandate as lender of last resort.

You are all familiar with the efforts taken by the Federal Reserve to these ends. I won't review them program by program this evening. I think it fair to say that with these actions the Federal Reserve has done 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 brother 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" beginning to sprout that will help end the contraction in output and set the stage for a recovery. This is not to be Pollyannaish or imply that these sprouts are spreading like kudzu. But the knock-on effect of the Fed's direct efforts does seem to have reignited animal spirits in markets that had been frozen. The commercial paper market has been revived. Mortgage rates have declined significantly. Issuance of corporate bonds has become robust. The premium over Treasuries that investment-grade corporations pay to borrow in the open market has fallen by more than 35 percent since peaking last December. The same can be said of higher risk bonds as well as jumbo mortgages—all markets considered to be at the far end of the risk spectrum. This round-trip back from last fall's unprecedented flight to quality is also reflected in the stock market, as equity markets have coursed upward and volatility has diminished.

While it takes some time for these improved financial conditions to start helping the broad economy, I am pleased to see a reaction on Main Street: The most recent reports indicate that purchasing managers see an abatement in the pace of decline in new orders; manufacturers surveyed by the Kansas City, Philadelphia, Richmond and Dallas Feds, to varying degrees, report a moderation in their previous rates of decline in activity;[3] retail sales are no longer plunging; and, as all of you heard from the Conference Board on Tuesday, consumers' assessment of the economy over the next six months—driven primarily by slowing job losses—appears to be less pessimistic.

[3] Texas produces more than 8 percent of the total manufactured goods in the United States, ranking second behind California in factory production.

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

Compared with the fourth quarter of last year, first quarter results for the nation's largest banks are encouraging, yet obvious 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 strikingly 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.[4]

Under these conditions, I have been forecasting 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, savings and investment. It is worth recalling that employment did not reach its nadir until 21 months after the end of the 2001 recession, though headwinds then were not nearly as severe as those we face today.

You know the numbers that have been reported for the nation for the first quarter: Even after upcoming revisions, I venture we will find we contracted at somewhere between an annualized 5 and 6 percent. The pace of decline will moderate in the current quarter, and then we are likely to bounce along the bottom for a while. I would be delighted, but surprised, if meaningful sustained growth gets under way before the end of the year. 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. As evidenced in the Dallas Fed's most recent manufacturing survey, firms receiving lower prices for their goods outnumbered those receiving higher prices 11-to-1, although firms do expect deflationary pressures to begin subsiding.[5]

Neither deflation nor inflation engenders confidence. Both distort the 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—who, in keeping with the theme of this evening, I suppose I could safely refer to as 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."[6] Bearing this in mind, we must be careful with the deployment of our monetary initiatives.

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[4] 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.

[5] "Texas Manufacturing Remains Weak But Outlook Continues to Improve," Federal Reserve Bank of Dallas, press release, May 26, 2009.

[6] 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

As the nation's central bank, the Fed performs two major roles, in addition to its regulatory duties. 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.

The Fed's other role is, as mentioned, 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. I point to the term auction (TAF) and commercial paper (CPFF) facilities as examples of initiatives that have worked as planned by the FOMC and are now shrinking in size. 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.

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.

Unfortunately, that momentum faces a real, long-term threat: storm clouds on the horizon in the form of daunting fiscal imbalances.

That deficits will be high over the next few years seems clear, with a $1.8 trillion deficit expected this year and $3.8 trillion in new debt issuance now forecast over the next five years. Perhaps more important, annual deficits exceeding half a trillion dollars are projected for at least 10 years into the future, emphasizing that we as a nation will continue to spend considerably more than we take in long after the current economic crisis.

The country's major newspapers recently reported with great urgency the administration's finding that Social Security would begin spending more than it takes in by 2016—seven short years from now. Left *unreported* was the fact that the discounted present value of entitlement debt, over the infinite horizon, reached $104 trillion.[7] This is almost eight times the annual gross

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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.

[7] Estimates for Social Security are compiled from the official *2009 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*. The $15.1 trillion figure presented here is the amount by which promised benefits exceed expected revenues, primarily from payroll taxes, over the infinite horizon using a long-run discount rate of 2.9 percent.

Estimates for Medicare are compiled from the official *2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*. The $88.9 trillion cumulative figure presented here is the amount by which promised benefits for Medicare Parts A, B and D exceed expected revenues over the infinite horizon using a long-run discount rate of 2.9 percent.

domestic product of the United States—and almost 20 times the size of the debt our government is expected to accumulate between 2009 and 2014.

Most of this entitlement shortfall comes from Medicare rather than Social Security. As you may know, Medicare has three main components: Part A for hospital stays, Part B for doctor visits and Part D for prescription drugs. The fiscal shortfall for Part A alone is $36.4 trillion—about one third of all entitlement debt. Part B's shortfall is just a tad larger, clocking in at $37 trillion. Part D—the latest addition to the Medicare program—registers a shortfall of $15.5 trillion. And Social Security, the program about which various reforms have been so frequently mooted in recent years, registers a deficit of $15.1 trillion—only one seventh of the total unfunded liability from entitlement programs.

This is the fiscal predicament to which I alluded earlier—a looming budgetary threat to our long-term economic prosperity. And while the announcement that the Social Security trust fund will begin its decline one year earlier is an important fiscal event, the swelling of overall entitlement debt to more than one hundred trillion dollars has far more serious implications for economic growth—implications we are poorly positioned to address given the budget deficits we face today.

Our successor generations are coming to grips with this daunting reality. Faced with the prospect of a government that they believe may be unable to deliver on its promise of long-term fiscal balance—particularly with regard to entitlement programs—these individuals might logically begin to alter their consumption patterns, spending less today to save more for tomorrow. There is nothing wrong with increasing savings. But, in an economy driven by consumption, this intertemporal hedging may dampen the pace of future economic growth.

Of course, any student of history knows that throughout time, governments unwilling to face the music and fund their liabilities have turned to monetary authorities to print their way out of their predicament. We all know by heart the pathologies that afflicted Weimar Germany, Argentina and other countries. And we have daily reminders from bond vigilantes like Bill Gross about the prospect of losing our AAA rating. This cannot be allowed to happen in America. Which is why I am pleased to see that the new administration has embraced what was hitherto perceived as the third rail of American politics and brought the issue of unfunded entitlement liabilities to the fore. For the sake of our grandchildren, I hope that the administration and the Congress will take this vexing beast of a problem by the horns and tame it.

Neither estimate incorporates the value of program trust funds, currently estimated at $2.4 trillion for Social Security and $0.3 trillion for Medicare. Because spending down these trust funds will require the use of general revenue, some budget analysts include them when calculating unfunded liabilities. If this is done, then the total figure would rise from $104 trillion to $106.7 trillion.

These figures also do not include current or projected future nonentitlement debt, including the $10.7 trillion national debt as of the end of 2008, the $1.8 trillion deficit for this year, the $3.8 trillion in projected debt between 2010 and 2014, and any future debt that might be compiled after 2014. If projected debt between now and 2014 were added, and no further nonentitlement debt were accumulated in the future, then the total figure would rise from $106.7 trillion to $123.0 trillion.

Against that background, it is important that monetary policymakers be especially sensitive to concerns voiced about the dramatic expansion of the Fed's balance sheet in an era of high 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, the Federal Open Market Committee's (FOMC) decision to purchase $300 billion in U.S. Treasuries—a decision made to improve the tone in 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.

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 debt, lest we come to be viewed as an agent of, rather than an independent guardian against, future inflation and drive real interest rates higher.

You may wish to note that, press and analysts' reports to the contrary, a keen student of the H.4.1 and the Foreign and International Monetary Authority (FIMA) custody holdings reports of the Fed will detect that foreign official holdings of U.S. Treasuries and agencies have been growing at a robust pace, not shrinking. And from what I can detect from the activity of so-called indirect bidders in Treasury auctions—indirect bidders submit competitive bids through others rather than directly; central banks are among those who commonly bid indirectly—there continues to be strong demand for longer duration Treasuries—again, contrary to rumors and press reports. Thus, to date, our actions have not given rise to concern that we will violate Paul's Dictum.

This is important, for there are concerns in some quarters that the Federal Reserve will be politicized. For example, there have been suggestions that Congress should be involved in the selection of Federal Reserve Bank presidents, who, unlike the seven members of the Board of Governors, are not appointed by the president nor confirmed by the Senate. I trust that 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 speak to you tonight. I will now do my utmost to avoid answering any questions you have.