

Two Areas of Present Concern: the Economic Outlook and the Pathology of Too-Big-to-Fail

*(With Reference to Errol Flynn, Johnny Mercer, Gary Stern
and Voltaire)*

Remarks before the Senior Delegates' Roundtable of the Fixed Income Forum



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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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In his upcoming book, *In Fed We Trust: Ben Bernanke's War on the Great Panic*, David Wessel of the *Wall Street Journal* writes that “Fed officials are the Jewish mothers of the global economy. They always have to worry about something ...”¹ He also organizes the Federal Open Market Committee (FOMC) into “cool guys,” “jocks,” “geeks” and “wannabes.” I am classified as one of the “jocks” who, according to Wessel, are “determined to show their manhood by talking tough about inflation and economic rectitude.”² So this morning, you are going to hear from a compulsive worrier preoccupied with price stability and monetary integrity.

If you had turned to page 2 of the *Wall Street Journal* on Monday, you would have seen a felicitous headline that read, “Fed’s Lending Ebbs as Crisis Subsides.” The leading indicators for June that were released on Monday by the Conference Board do, indeed, hint at a crisis subsiding: The index rose for the third straight month and, in doing so, has registered gains comparable to those seen last in the economic recoveries of 1991 and 2001–02. The index reflected recent increases in residential building permits, a modest increase in the manufacturing workweek, a retreat in initial jobless claims and slight improvement in supplier deliveries. Taken together with other, recent economic data releases, these movements might be viewed as signaling improving conditions in manufacturing and distribution. As to the Fed’s lending, had you suffered through my last few speeches, you would have heard me say that the Federal Reserve had pulled the economy back from the abyss as I reviewed the success of the temporary programs we put in place to revive the functioning of the key credit markets.³

The *Journal* is right: Our lending from these facilities has ebbed. To update you: At last count, our holdings of commercial paper had been reduced from \$350 billion at its peak to \$111 billion; the primary dealer credit facility has gone untapped for 10 weeks; overseas central bank borrowing under the swap arrangements we put together at the end of 2007 and significantly expanded afterward is running at a fifth of its peak rate. The term asset-backed securities loan facility, or TALF (which some wags said was too clever by HALF), is still growing but comprises a very small proportion of the Fed’s emergency lending portfolio. And the term auction facility, or TAF—the very first facility we created in December of 2007 to auction significant amounts of discount window credit to primary-credit-eligible depository institutions—is running an average daily balance that is almost half the rate it reached during the fourth quarter of 2008.

So what’s to worry about?

Well, central bankers always find things to worry over—we are genetically programmed that way. Today I’ll speak of two concerns. The first is the longer-term outlook for the economy. The second has to do with the separate but related problem of the concentration of financial power in the hands of too few institutions and the pathology of too-big-to-fail.

The Economic Outlook

The outlook for real activity over the next several quarters is improving. While there is considerable angst regarding the problem of growing unemployment, which in the troughs of the last two recessions was a painful and politically evocative lagging indicator, there are clear signs that the economy is stabilizing and even reviving in critical areas. The mathematics of stabilization is interesting. One of my colleagues at the Dallas Fed calls it “the Johnny Mercer effect,” after the famous Hollywood lyricist who penned the refrain “Ac-cent-tchu-ate the positive [and] e-lim-i-nate the negative.”

Here is how it works. Residential investment, inventory investment and consumer spending each subtracted more than a percentage point from GDP growth, on average, during the fourth quarter of 2008 and first quarter of 2009 (the latest periods for which we have data). The latest monthly indicators suggest that the drag from residential investment has stopped and may even be reversing. Inventory investment is likely to remain negative, but as long as it does not become *more* negative, it will cease to be a drag on GDP growth. And if the pace of inventory liquidation moderates, you eliminate a powerful negative and begin to accentuate the positive.

As to consumption, the most prominent of all GDP components: With the exception of the episode in the spring of 1980 when President Carter imposed credit controls, consumption has suffered its biggest two-quarter drop since records began in 1947. But, as Milton Friedman taught us, households adjust the level of their spending quickly as the economic outlook changes, without waiting for the changes to be realized. In other words, they cut their spending as job prospects deteriorate rather than wait for layoffs to actually occur. This means that the worst may well be over for household consumption, barring new bad news. While we do not expect American consumers to come surging back to fuel a global boom any time soon, latest data on personal consumption expenditures and retail sales appear consistent with Friedman’s theory.

In a similar vein, the latest reports from the Institute for Supply Management show export orders stabilizing as the economies of our overseas trading partners begin to bottom out. Again, we have a reversal of signs and mitigation—if not elimination—of the negative: Falling exports subtracted 3.8 percentage points from GDP growth over fourth quarter 2008 and first quarter 2009. Nonresidential fixed investment was nearly as large a drag: 3.6 percentage points. But, as with residential investment, the latest monthly indicators suggest at least a bottoming out and, hopefully, even the beginnings of a rebound.

Meanwhile, government stimulus spending is about to kick in, turning a 0.2-percentage-point drag on GDP growth into a significant plus.

A lot of former negatives are being eliminated. We are seeing changes from negative impulses to slightly positive ones. This accentuates the positive in the aggregate. We probably have the beginnings of a faint recovery.

How robust and sustainable will the recovery be? There’s the rub—the stuff of concern.

Inventory adjustments, while welcome, are of temporary utility. Any boost to growth from inventory investment will be the result of a rebalancing of supply and demand that is inherently transitory. Sustained growth will have to come from somewhere else.

I doubt it will come from housing or a return to the bad old days of financial Bacchanalia. We do not want—and cannot expect—massive foreign capital inflows or domestic investment indifferent to risk to finance another boom in household spending and residential investment. That means we will need to see a massive reallocation of capital and labor away from such formerly hot growth areas as construction and finance. I surmise that this regearing will take time and that, in the interim, households and businesses will focus on shoring up their savings and balance sheets rather than spending money. For consumption, that translates into a slow crawl out of purgatory. For capital expenditures and employment rolls, it means an emphasis on tight budgeting and continued focus on absolute needs rather than wants.

The needed reallocation of labor and capital has been and will continue to be impeded by financial markets. Although substantially improved from last fall—due in significant part, I would argue, to the work of the Federal Reserve—markets are still a long way from having normalized. We know from our own experience and from the experience of other countries that financial headwinds like these take years to abate.

To offset those headwinds, the fiscal authorities have stepped forcefully into the breach, putting in place a massive stimulus effort. They have done so to prevent unprecedented year-over-year declines in wage and salary income from translating into falling disposable income—while simultaneously trying to goose up capital expenditures on infrastructure.

If you go back to the rudimentary formula taught in high school economics to account for the makeup of GDP—consumption plus investment plus government expenditures plus net exports—the “G,” or government, variable is receiving enormous emphasis while “C” is flaccid, “I” is hesitant and net “X” is tentative. At the present rate of government expenditures thus far this year, federal, state and local authorities—net of intragovernmental transfers—are expected to spend \$5.6 trillion in 2009, equivalent to 40 percent of expected GDP.

The problem is that government stabilization measures almost certainly come with a real long-term price tag: higher tax rates, greater collective indebtedness and the prospect of higher interest rates driven by the government’s issuance of debt. These long-term costs of a larger government put a limit on the American people’s willingness to rely on the public sector to drive growth in the overall economy. A fiscal gag reflex ensues, and the public-sector option looks less and less attractive as anything other than a temporary source of growth.

The major challenge facing U.S. fiscal authorities is meeting the need for near-term economic stimulus while simultaneously pursuing a practicable plan to stabilize the government’s debt-finance obligations. The Secretary of the Treasury is doing his level best to reassure investors—both overseas and here at home—that the programs put in place by the Obama administration will work their magic and then be gradually withdrawn as the economy gets back into stride. He will, incidentally, have to square his corners with the Congressional Budget Office, which estimates that annual deficits will stay above at least \$600 billion a year over the next decade and will require an addition of \$9.1 trillion in debt.

Errol Flynn is reported to have quipped that his problem lay in “reconciling [his] gross habits with [his] net income.” I imagine the American public and its representatives are close to their limit of tolerance of the gross “habits” of government and the net new indebtedness they are

willing to pass on to their children, all of which means to me that reliance on government spending as an antidote to what ails the economy is a thin reed to rest on. Given the expected slow adjustment rate of the other variables that make for sustainable economic growth, my guess is it will be a long time until we reach a point when that growth will carry on at rates to which we had become accustomed. I envision an economic path forward from here that looks something like a check mark, with the Johnny Mercer effect giving us a snap back as the negative momentum of the short, intense down stroke of the check mark abates and turns upward but then settles into a lower growth slope on the elongated side of the mark.

Mind you, one of my professors at Harvard was John Kenneth Galbraith, who warned us that “economic forecasting was created to make astrology look respectable.” I might be totally wrong here. But that is how I see it presently from my perch at the Dallas Fed: Economic growth is likely to be slower in the out years than we have become accustomed to.

The challenge for the Federal Reserve is to provide needed near-term monetary stimulus while maintaining a credible commitment to long-term price stability. This means (a) distinctly avoiding any perception that we are willing to monetize this or any other administration’s fiscal initiatives, and (b) providing the marketplace with a clear sense of how we will unwind in a timely manner the stop-gap measures that have resulted in a dramatic expansion of our balance sheet.

I want to return to the chart on page 2 of Monday’s *Wall Street Journal*. While the temporary liquidity programs I mentioned earlier have retracted, our balance sheet has expanded due to the increase in our holdings of securities held outright. Here are the numbers for the past year through last week: The Fed has taken onto its consolidated balance sheet \$205 billion in Treasury securities, \$102 billion in the debt of Federal agencies and \$526 billion in mortgage-backed securities. We presently carry a total of \$1.3 trillion in securities held outright, accounting for roughly 63 percent of our total assets.⁴ When the Fed acquires securities, the funds enter the banking system and ultimately appear in the reserve accounts held at the Fed by banks and other financial institutions. When these reserves are removed from our balance sheet and lent out to the public, expansion in the money supply and easier credit conditions could ultimately result in inflationary pressures. Mindful of this, concerned parties have asked what our “exit strategy” will be.

Chairman Bernanke provided what I thought was a fulsome exposition of our exit arsenal in his semiannual Humphrey–Hawkins testimony (the CliffsNotes version of his presentation was made available in an op-ed in the *Journal* on Tuesday).⁵ He detailed the means by which the FOMC can either directly reduce the stock of reserves or temper the incentive for banks to deploy them into the economy by making it attractive for banks to keep them on deposit at the Fed through higher interest rate payments. We could also drain reserves and excess liquidity by arranging large-scale reverse repurchase agreements (reverse repos), have the Treasury sell bills to the public to sop up money in the system and place the proceeds on deposit at the Fed and, if necessary, sell outright into the market some of the longer-term securities we hold on the left side of our balance sheet.

I will say no more about this here today; I think the chairman has covered the waterfront on this subject. But I will acknowledge that, yes, to pull the credit markets out of a death spiral, we have taken great risk with the Federal Reserve balance sheet. We never contemplated doing more than

the minimum necessary. And we know that we can do too much. For example, while one can argue that by agreeing to purchase up to \$300 billion in long-term U.S. Treasuries, the FOMC provided a needed short-term tonic to private credit markets, we dare not come to be viewed as a handmaiden to the Treasury. By loosening the anchor we have established for long-term inflation expectations, we could create the perception that monetary policy is subject to political imperatives, doing lasting damage to our ability to maintain price stability and restore full employment. I believe we have come as close as we dare to the line between acceptable and unacceptable risk in this regard, and do not personally wish for us to expand or extend our purchases of Treasuries beyond the cumulative \$300 billion planned by this fall.

To conclude this little diversion on exit strategy, let me say that I am aware some will argue that laying out our arsenal is not enough; we need to convince markets we have the nerve to deploy it in a timely fashion. Within minutes of the conclusion of the chairman's testimony, one commentator sent out a client note, later echoed by many others on op-ed pages and on the web, as follows: We now "know the Fed has the bullets, but fear it will not have the guts to pull the trigger." To a Texan who lives in a gun culture, this is a cute analogy (especially coming from someone who's Swiss!). But I would not doubt our resolve. We know full well that monetary policy trickles in with a lag and that we will have to "pull the trigger" of tightening policy well before it is politically convenient.

Too Big to Fail

Fiscal and monetary authorities today face the additional, special challenge of reforming financial regulation so as to minimize the chances of a future meltdown. Here, again, there is a tension between the short term and the long term. In the short term, once a financial crisis has begun to develop, the natural focus is on limiting the damage—on preventing contagion. A real danger is that in the longer term, the prospect of these government damage-control efforts will lead financial institutions to take inappropriate risks, making the financial sector even more dysfunctional.

The financial crisis has had some important consequences for the structure of the banking industry—indeed, the financial industry as a whole. We saw the investment banking model largely disappear as some of the major players—Goldman Sachs and Morgan Stanley—converted to bank holding companies, while some others—Merrill Lynch, Bear Stearns and Lehman Brothers—are no longer with us. The restructurings that have taken place have certainly altered the shape of the U.S. banking industry.

A major concern of mine is that all the crisis-related acquisitions we have seen may further consolidate financial assets and power into the hands of a few large organizations, leading ultimately to reduced competition and a less diverse and efficient financial sector. The massive government assistance recently provided to large banks may be artificially tilting the competitive balance in favor of large institutions.

For example, each of the four largest commercial banking organizations, and others as well, was provided with substantial government assistance during the crisis—all, at least implicitly, in the name of the too-big-to-fail doctrine. As a group, the total asset base of the four has grown 30 percent since June 2007.⁶ In contrast, industry assets outside the four have grown a smaller 12 percent.

That growth reflects acquisitions. Bank of America's assets grew 51 percent from June 2007 to March 2009, assisted in no small part by its acquisitions of Countrywide Financial and Merrill. Wells Fargo's asset base grew 138 percent, thanks mainly to its acquisition of Wachovia. J.P. Morgan Chase acquired both Bear Stearns and Washington Mutual and grew 43 percent.

The only institution among the top four that did not grow is Citigroup, whose assets declined almost 20 percent. And here's an interesting observation: Rough estimates suggest the top four institutions together would have shrunk—not just Citigroup—if not for the acquisitions just mentioned. Taking out the acquired assets, the current top four likely would have shrunk 7 percent as a group over the period in question.

The acquisitions of troubled banks have worked to perpetuate size concentration in the banking industry. The top four currently control 44 percent of industry assets. If we simply take away from the top four the assets they recently acquired, they would have “only” 30 percent of the industry's asset base.

In using acquisitions to resolve the crisis, we may have unwittingly perpetuated one of its root causes—the too-big-to-fail doctrine.

Thoughtful critics will point out that too-big-to-fail is economically perverse: There is something inherently anticapitalistic when you have a system that allows banks, their shareholders and creditors to profit when things go well but leaves the taxpayer holding the bag when things turn sour.

The economist Allan Meltzer likes to say that “capitalism without failure is like religion without sin: It doesn't work.” In order to have a financial system that remains the fountainhead of credit and the wherewithal for business men and women to bring forth new ideas and products and create employment, we must have a dynamic system that rewards winners rather than coddles losers, that incentivizes prudent behavior and harshly penalizes imprudent behavior.

My colleague Gary Stern—the outgoing president of the Minneapolis Fed who literally wrote the book on TBTF (too big to fail)—recently gave a speech that pulled no punches on this front. He said (a) “it is striking that most of the losses suffered to date during the financial crisis have been at the largest institutions operating in the country,” (b) the problem of too-big-to-fail was “not ... addressed effectively by the FDICIA legislation of 1991 [Federal Deposit Insurance Corporation Improvement Act]” and (c) “creditors of such [large] complex financial institutions expected, on the basis of relatively well-established precedents and on an understanding of policymakers' motivations, protection if failure threatened.”⁷ Thus incentivized, management of these institutions took excessive risk, and the market underpriced that risk. And it follows in President Stern's mind, as it does in mine, that unless incentives are focused upon in seeking to cure the problem of TBTF, we will not only fail to address this most troublesome pathology but may make it worse.

Stern argues that the Treasury proposal now on the table to correct the problem “fails” in regard to corralling incentives for managers of large institutions to repeat the errors for which the public has recently paid so dearly. Here is his punch line: “I would describe the Treasury plan ... as ‘status quo plus’—[with] more capital, more liquidity, better supervision, [and] far-reaching resolution authority for the largest institutions. [But] [t]here is little reason to think that these

steps will ... succeed in reining in TBTF effectively over time because they do not change the incentives which create the problem. In fact,” Stern concludes, “there is nothing in the Treasury proposal designed to put creditors of large, systemically important financial institutions at risk of loss. ... [T]he Treasury proposal ... leaves the financial system considerably more vulnerable ...”⁸

As we grapple with TBTF and with the overall regulatory treatment of so-called Tier 1 institutions, we are going to have to bear Gary Stern’s criticism in mind. The only way to ensure a robust financial system is to enforce a system that marries risk-taking to consequences and see to it that the consequences for mismanagement are loss of managerial positions and the capital of shareholders and creditors, including uninsured depositors, rather than a second chance that only further concentrates financial power.

This is important—not only to ensure a more efficient economic system but to better facilitate the implementation of monetary policy. The extent and duration of the extraordinary steps taken by those of us at the Fed are complicated by the prolonged existence of financial institutions that fall into this troublesome category.

Banks that are too big to fail exacerbate business and credit cycles. In the good times, these institutions use excessive leverage and their cost-of-funds advantage to grow more rapidly than smaller banks. Expansionary monetary policy is then given a boost as these institutions grow at eye-popping rates.

But what happens when financial conditions worsen? Too-big-to-fail banks must de-lever, shrinking their asset books and, in general, swimming against the tide of easier monetary policy. As the weak capital position of these institutions becomes widely recognized, they find it difficult and costly to raise funds. A weakened financial system with several of these banks will induce a flight to quality, increasing credit spreads and interest rates at a time when the Fed is attempting to do just the opposite. This slows economic growth, reducing asset values and overall wealth as credit availability deteriorates further. An adverse-feedback loop is created, working in direct opposition to the policy efforts of the central bank.

The existence of financial institutions that are too big to fail dramatically impacts the transmission mechanisms of monetary policy. The blockages they create—in credit markets and on balance sheets throughout the economy—compound our travails by making it more difficult to get the timing and dosage of monetary policy “right.” They reduce the effectiveness of our traditional tools, introducing a need for special liquidity and credit facilities that are difficult to unwind.

I know my opinions on this subject will hardly endear me to the largest financial institutions. On his death bed, Voltaire (who was neither a Hollywood lyricist nor a movie actor nor the president of the Federal Reserve Bank of Minneapolis) was asked to renounce the devil. He is said to have replied that this was no time for making new enemies. Some think that during this time of crisis and with financial and economic recovery still so tenuous, it is not the right time to think about proposals that make the perfect the enemy of the good. I disagree. I believe we need to “think long,” as the Californian George Shultz likes to say, and the current policy prescription for treatment of TBTF is a bit shortsighted or, at best, necessary but not sufficient. If we want to avoid a repeat of what has just happened over the past 18 months, we need to exorcise the notion

that an institution is too big to fail and remove all incentives for any institution to risk infecting the health of the financial system. If we make some enemies in the process, so be it. The object is to get it right.

Thank you. I would be happy to avoid answering any questions you might have.

Notes

¹ *In Fed We Trust: Ben Bernanke's War on the Great Panic*, by David Wessel, New York: Crown Business, 2009, p. 130.

² See note 1, p. 124.

³ "Back from the Abyss: Now What?" May 15, 2009, and "Remarks Before the Washington Association of Money Managers," May 28, 2009.

⁴ Federal Reserve Statistical Release H.4.1, July 16, 2009.

⁵ "The Fed's Exit Strategy," by Ben Bernanke, *Wall Street Journal*, July 21, 2009, p. A15.

⁶ Data on banking assets include the nonbank subsidiaries of bank holding companies, not just the bank subsidiaries. In this way, while these numbers do not encompass the financial sector as a whole, they are broader than just bank numbers alone. The statistics presented here make the point that crisis-related consolidation worked to perpetuate concentration of assets and financial power.

⁷ "Remarks to the Helena Business Leaders," Federal Reserve Bank of Minneapolis President Gary H. Stern, July 9, 2009.

⁸ See note 7.