Risks to Sustained Economic Recovery

(With Lessons Learned from Winston Churchill and Teddy Roosevelt)

Remarks before the Annual Meeting of the Waco Business League

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Thank you, Willard [Still].

Over the years, I have had the great pleasure of having many friends here in Waco. Nancy and I remember especially fondly the Cotton Palace events in which two of our children, Anders and Alison, participated many years ago and the wonderful time we spent around those great weekends with the Dietzes, the Browns, the Olsons—that was before he became a big deal ambassador to Sweden, where he did a superb job—and the Rapoports and so many other big-hearted Wacoans. Most everyone here tonight knows that the freshman women's dorm at Baylor, Ruth Collins Hall, is named for my wife's grandmother and that Nancy's granddaddy, Carr P. Collins, played a major role in nurturing Baylor (I am reminded of him every time I wander past that stern portrait of him on campus). So it is a genuine pleasure for me to be here in Waco addressing the members of the Waco Business League. I love this city and its people. Thank you for inviting me.

These are times that try men's and women's souls: They are not particularly felicitous economic times. The Federal Reserve has worked tirelessly for the past two years to rescue the financial system and the economy from plunging into the abyss of depression and chaos. As last year came to a close, we saw our efforts begin to bear some fruit: Interest rates and spreads between the yields on various key financial instruments have come down significantly. The markets for bonds and stocks have come back to life, and the economy—while subject to taking one step back for every few it takes forward—has nonetheless begun a palpable, if tepid, recovery.

We are not yet out of the woods.

There are many roadblocks we must overcome to get our economic engine running full steam again. Businesses must develop sufficient confidence in the future to begin expanding their order books and payrolls. Banks must be willing and able to lend again. Consumers must regain the wherewithal and the confidence to open their pocketbooks. Tonight, I want to talk about two obstacles I see that are threatening the removal of these roadblocks. The first is widespread concern about our nation's fiscal predicament. The second is the risk that Congress will seek to politicize the Federal Reserve.

Before getting into these weighty matters, let me demystify the Federal Reserve Bank of Dallas.

This is a Federal Reserve note, otherwise known as a dollar bill. If you look closely at the face of the one dollar note, you will see that in the middle of the left side is the letter "K," surrounded by two concentric circles. The outer circle says "Federal Reserve" and "Texas," and the inner circle says "Bank of" and "Dallas." "K" is the 11th letter in the alphabet—in all four corners of the bill are printed the number "11." The Federal Reserve Bank of Dallas is responsible for the administration of the Federal Reserve's affairs in the 11th of 12 Federal Reserve Districts that were set up by Congress under the Federal Reserve Act of 1913. Every one dollar bill bears the imprint of one of the Federal Reserve Banks, starting with the "A" of the Boston Fed and ending with the "L" of the San Francisco Fed. Presently, there is nearly $1 trillion worth of Federal Reserve notes in circulation (Of course, you know that Dallas Fed dollars are of greater nominal value than the others!).

The economic activity conducted within some 350,000 square miles north, south, east and west of Waco by the roughly 26 million people in the Eleventh District—stretching from southern New Mexico, through all of Texas and across the wooded north of Louisiana—is serviced by the Federal Reserve Bank of Dallas and its three branches.

I am the president and CEO of a $70 billion bank. That bank operates at a profit—a profit that we send to the Treasury. Indeed, as we just announced this morning, the 12 Federal Reserve Banks, collectively, expect to transfer $46 billion to the Treasury for 2009. You are looking at an individual affiliated with one of the few public agencies that actually pay *down* the federal deficit.

What do we do for those 26 million people in the Eleventh District? For starters, we make sure they have the cash they need. Last year, the Dallas Fed distributed and received almost 6 billion circulating banknotes, worth nearly $103 billion at face value. Our mammoth machines scan the cash at an average rate around 100,000 bills per hour and process them so they can be shipped from our vaults to banks throughout our district, providing you and the other citizens in our district with folding money. Of course, in addition to making sure there is a sufficient amount in circulation, we have to make sure your folding money is valid and looks respectable: Each month, we cull hundreds of counterfeit bills, and we pluck out over 38 million worn bills that have lived a full life and are ready to be shredded, sent off to Money Heaven and replaced by new, crisp notes.

We also process checks. In 2009, the Dallas Fed processed 120 million paper checks. The use of paper checks has been, and will continue to be, on a substantial decline as consumers and businesses take up electronic counterparts. Due to advances in technology, most banks now send us checks in a digital format. We received and processed an average of 70 million electronic images *each month* last year.

Another important function of the Dallas Fed is to provide liquidity to District depository institutions through our discount window operations—in other words, to be the ultimate banker's bank. Those of you in this room who are at all affiliated with depository institutions are certainly aware of this vital function. The lending programs that make up our discount window help relieve liquidity strains by providing a source of short-term funding, which is fully secured and collateralized, to depository institutions to help them conduct uninterrupted business on behalf of you and their other customers. In 2008, we made 273 loans at the Dallas Fed, approximating $30 billion, and in 2009, we made just under 600 loans approximating a similar total. I chair our credit committee and personally review the loans we make every evening. Their size and structure depend on the needs of the borrowing bank.

Among our other responsibilities is supervising the banking industry within our district. We conduct on-site audits of our state-chartered member banks and bank holding companies and monitor bank performance and stability using electronic surveillance technologies.

This supervisory role is important. I began my private-sector career at the bank of Brown Brothers Harriman & Co., where my superiors instilled in me one overarching principle—one I'm sure the bankers in this room know quite well: Know your customer. Well, we at the Fed rely upon our regulatory relationship to better "know our customers," actively monitoring our constituents' needs and services on the front line of the commercial banking industry and using this insight to be better lenders to all our customers. Without that supervisory and regulatory responsibility, we could not operate effectively as the nation's lender of last resort. Moreover, the knowledge gained through banking supervision aids the formation of monetary policy.

The Dallas Fed also organizes public education programs designed to raise financial and economic literacy in our community. We frequently host public events and conferences on significant activities within our economy.

Currency and check processing, banking supervision, lending as a banker's bank and public education efforts are integral parts of the Federal Reserve's job. But you wouldn't know it if you read the papers: They are not the parts of central banking that usually garner the most public attention. The sexier bits of what I do—to the extent anything in central banking is considered "sexy"—deal with monetary policy.

The presidents of the 12 Fed banks, in addition to the five governors of the Federal Reserve Board (two shy of normal, thanks to a holdup in the nomination and confirmation process), normally meet every six weeks to discuss the current trajectory of the economy and craft the appropriate policy response. We do so in a meeting of the Federal Open Market Committee, commonly known as the FOMC. It is in these meetings that we set the base interest rate for interbank lending known as the federal funds, or "fed funds," rate and where we develop other monetary policy initiatives, like the various programs we put in place to restore liquidity in the commercial paper and mortgage and other markets during the recent financial crisis.

I come to each FOMC meeting armed with input from a research team that provides the intellectual heft for informed monetary policymaking, as well as insights provided by my board of directors and the many businesses—large and small—that populate my district and with whom I constantly consult. The Dallas Fed employs a crack team of economists and analysts who study the local, national and international economies. Their work is top-notch. Few of you might know, for example, that Finn Kydland, an advisor to our research team in Dallas for the past 15 years, won the Nobel Prize in economics in 2004.

The FOMC is one of the few public service decisionmaking bodies in the world where members can come together and, in the span of only a few hours, present their positions without fear of political retribution and without posturing for the cameras, then hammer out agreement on a course of action based solely on what they solemnly consider judicious for the long-term health of the economy rather than for political convenience. By 2:15 on the afternoon in which we conclude our discussion, we craft a statement for public release explaining the actions taken. We release a lengthy set of minutes of our deliberations three weeks after our meeting.

The FOMC is where Texas and the parts of Louisiana and New Mexico that we cover have a voice at the policymaking table for the most powerful and essential central bank in the world. The president of the United States appoints and the Senate confirms the governors of the Federal Reserve System. The 12 Federal Reserve bankers like me who sit side by side with those governors are not subject to that process. We are hired and fired by nine-member boards of directors that represent the financial institutions and stakeholders and economic diversity of our respective districts. I want to make this clear: I am not accountable to any Washington politicos, be they Democrat or Republican. I am politically neutered, devoutly nonpartisan and guided solely by what I believe is the best way to craft policy so as to encourage sustainable economic growth with price stability, regardless of who is in the White House or the Congress. I represent only the views and ideals of my part of the country. My fellow bank presidents and I represent Main Street, not the Washington or Wall Street establishment. I want you to know that every time I speak or intervene in our policy discussion at the FOMC—which is quite often (I am, after all, a Texan)—I do so very much with that in mind.

Which brings me around to what currently preoccupies me.

Over the holidays, I read two terrific books about Winston Churchill by two eminent historians: Paul Johnson's just published tome simply titled *Churchill* and Richard Langworth's remarkable compendium of everything Churchill ever said, or didn't actually say, appropriately titled *Churchill by Himself*.

Langworth cites a speech given by Churchill at the Waldorf Hotel in London in 1926 in which he noted that "in finance, everything that is agreeable is unsound and everything that is sound is disagreeable."[1]

In his book, Johnson notes that in the debacle that surrounded the attempt to seize the Dardanelles—that narrow strip that was the key to the Sea of Marmara and Istanbul in the First World War—Churchill advocated the right policy but made some blunders as head of the Admiralty. He was thus sacked by a desperate prime minister, Asquith, leading a desperate parliament. Here are the passages from Johnson that caught my eye: "If Asquith had then appointed Churchill *supremo* of the operation," Johnson wrote, "the campaign might still have succeeded." But "Churchill was out and had to watch, impotent and silent, while the politicians … compounded their mistakes and the operation, after a quarter of a million casualties, ended in ignominious evacuation. Though an official inquiry eventually exonerated [Churchill], at the time (which is what mattered) he got the blame. As Theodore Roosevelt once remarked of a financial crisis: 'When people have lost their money, they strike out unthinkingly, like a wounded snake, at whoever is most prominent in the line of vision.'"[2]

Hold that thought about how political imperatives resulted in a disaster and the business about "[striking] out unthinkingly, like a wounded snake, at whoever is most prominent in the line of vision." I'd like first to dwell on the problem of what is agreeable but unsound.

While it appears urgent, if not agreeable, to use massive public spending to stimulate an economy under duress, an economy cannot sustain long-term growth under the weight of

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[1] *Churchill by Himself: The Definitive Collection of Quotations*, edited by Richard Langworth, Philadelphia: Perseus Books Group, 2008, p. 17. Langworth cites Churchill from March 15, 1926, at the Waldorf Hotel, London.

[2] *Churchill*, by Paul Johnson, New York: Penguin Group, 2009, pp. 52–54. I noted with interest that one of Churchill's blunders was to bring Admiral Sir John Fisher out of retirement to become First Sea Lord. According to Johnson, "Fisher was now into his seventies and increasingly arbitrary and childish (his wild letters often ended with 'Yours till Hell freezes')." I am not a descendant of Admiral Fisher, and I am but 60.

significant fiscal burdens. At some point, what is considered a temporary economic prosthesis becomes a hindrance to the workings of the private sector.

Over the past 10 years, discretionary spending has grown at an average real annual rate of 5 percent, outpacing the 2.6 percent annual growth rate of the overall economy during that period. And discretionary spending for fiscal 2010, excluding defense and stimulus-related items, is currently forecast to grow by 8.2 percent nominally. Add to this the double-digit dips in last year's federal and state tax revenue, and you've got quite a fiscal pickle.

When tax receipts fall while discretionary spending soars, deficits are an expected consequence. A shortfall of nearly half a trillion dollars in fiscal 2008 was quickly supplanted in the history books by a $1.4 trillion shortfall last year—10 percent of GDP. The most optimistic projections peg mid-decade deficits—while fortunately lower—at an eye-popping $300 billion annually. Remember: We're talking about a time after this recession has ended, after at least some of the Bush tax cuts have expired and after fiscal stimulus will have largely played itself out.

Unfortunately, fiscal profligacy today hinders our ability to address fiscal challenges tomorrow.

Those challenges are coming. Pundits and analysts like to focus on the year in which Social Security will go permanently into the red on an annual cash flow basis—which recently was projected to occur in 2019 but could occur as early as 2016. But they largely ignore the more pressing problem: accumulated entitlement debt over the infinite horizon. That debt has now reached $104 trillion—trillion with a 'T'—in discounted present value terms. The lion's share of the shortfall (nearly $90 trillion) comes from Medicare—not Social Security.

Medicare is by far the most serious fiscal storm cloud on the horizon, and it is a cloud we are poorly positioned to weather given the rapidly deteriorating medium-term deficit outlook. Yet maintaining economic growth over the long term requires us to do so.

Now, this is not the job of a central banker like me. The burden of doing the disagreeable thing to make Medicare and the fiscal position of our country sound falls on the shoulders of the Congress. Only the Congress can tax and spend our monies. That is its purview, not the Federal Reserve's. For too long, the Congress, under both Republican and Democratic leadership and with both Republicans and Democrats in the White House, has chosen the most agreeable but unsound path of kicking the fiscal can down the road. The disagreeable but sound burden of bringing us back to fiscal sanity now falls on its shoulders, and I pray its members will find the resolve and the support from their constituents to get it done.

I know one thing, however, that would make this predicament worse, and that is if the Congress decided to turn to the Fed to print its way out of the fiduciary cul de sac it has driven itself into. This leads us to the Roosevelt quote and the lesson imparted by Paul Johnson about Churchill's experience with the Dardanelles fiasco.

We know from history that when fiscal authorities turn to the monetary authority to monetize their debts, the result is inevitably inflation and financial ruin. This is the lesson learned from Ancient Rome, from Weimar Germany, from Nationalist China, from Argentina and, in its most egregious present form, from modern Zimbabwe.

Presently, there are before the Congress of the United States several acts suggested by advocates in both parties that would result in putting the Federal Reserve under direct command of the fiscal authorities. These acts sound agreeable at first blush, but remember that "in finance, everything that is agreeable is unsound." I wouldn't go so far as to say, as Teddy Roosevelt did, that they are striking out "unthinkingly, like a wounded snake, at whoever is most prominent in the line of vision." I believe many of their advocates truly believe they are being thoughtful. But I note that the Federal Reserve, having taken great and significant actions and risks to save the financial system from imploding, is, like Churchill, very much "in the line of vision." Both Republicans and Democrats, eager to come up with solutions in desperate times, appear to me to be playing something like Asquith to our Churchill—eager to defenestrate the Fed because, at the present moment, it seems like the most agreeable thing to do.

For example, the House of Representatives recently passed legislation that would require audits by the General Accountability Office, not simply of the Federal Reserve's balance sheet, but also of our monetary policy decisions. This was initially signed on to by over 300 members, including some who are well known by this audience and represent the great state of Texas. There are other initiatives from other House members and senators that would make the presidents of the 12 Federal Reserve Banks or even the chairmen of their boards subject to presidential appointment and Senate confirmation.

While the Fed is the only business in America that I know of that provides a public accounting of its balance sheet every week—it is called the H.4.1 release and you may pull it up yourself on the Internet on a weekly basis—I suppose another set of eyes might provide further confidence regarding our holdings. But making the discussions held by me and my colleagues at the FOMC subject to congressional second-guessing or creating a process where bank presidents and their politically independent boards have to worry about satisfying Washington powers rather than representing their districts' views—thus upsetting the delicate balance that prevails at FOMC deliberations—can only lead us straight to the fate that was suffered by once great economies like pre-Weimar Germany and pre-Perón Argentina.

In Monday's *New York Times*, the currently embattled president of the Bank of Argentina noted that he is the 55th to serve in that role in 75 years. He went on to say: "That makes the Argentine system unstable."[3] I would hate to see some future Federal Reserve chairman utter those very same words about the United States of America.

A great and powerful economy cannot create the conditions for sustainable noninflationary growth if its central bank is governed by a politicized monetary authority.

Now, let me be clear: I do not believe the Fed to be blameless in the run-up to our current crisis. For quite some time I've said that I felt the Fed held interest rates too low for too long in the early half of the 2000s, thus fueling reckless speculation in housing and other sectors.[4] And I have freely admitted that a host of regulators, including those at the Federal Reserve, were caught unawares by the risk being taken by large financial institutions that later came a cropper.

[3] "Argentine President and Central Bank in Standoff," *New York Times*, Jan. 11, 2010, p. A8.
[4] "Confessions of a Data Dependent," speech by Richard W. Fisher, Nov. 2, 2006, and "Responding to Turbulence," speech by Richard W. Fisher, Sept. 25, 2008.

This does not mean that those who dwell in the political realm should try to "fix" the problem by throwing themselves into the monetary mix. We should not now politicize an institution that, in the turbulence of this period, pulled our economy back from the brink of the abyss and has taken significant steps to repair the holes in its regulatory and supervisory apparatus. As a central bank, we had the flexibility to expand our balance sheet to shore up the financial system and put out the fire. In comparison with the Treasury, we had a greater ability to quickly lend against collateral. And we did so not only in accordance with the flexibility that Congress granted to the central bank years ago, but also in consultation with the Treasury in a way that did not politically constrain us. In this way, our current structure gives us the ability to put out fires while remaining accountable after the fact.

The other day, I opened a bottle of iced tea bottled by a company named, appropriately, Honest Tea. Printed in the cap was the English translation of what it said was a Chinese proverb. It read: "If we don't change the direction we are headed, we will end up where we are going." Students of history are keenly aware of the course we chart when we discuss the possibility of politicizing the Federal Reserve System. They know by heart the pathologies that afflicted Weimar Germany and modern Zimbabwe, ancient Rome and the economic mess that remains Argentina. Those who will determine the future scope and shape of our central bank would do well to keep those pathologies in mind and resist the agreeable urge to "strike out" at the Fed. I know there are many senators and members of the House of Representatives who understand this well and will, in the end, resist that temptation. I want to be on record here tonight in reminding these good people that if the Congress is not careful and ends up where it is going in tampering with the independence of the Federal Reserve, it will indeed lead us down the path to the politicization of the central bank of the world's greatest economy, putting the United States on a road that leads directly to economic ruin.

Enough of this dismal stuff. While I am a banker and have been trained all my life to be sober and skeptical, I am not given to seeing every glass half empty. Let me end with a more upbeat scenario.

Consider that in the year 1667 John Dryden wrote a poem titled "Annus Mirabilis"—"Year of Miracles." The year of miracles began with the Great Plague of London—a pandemic akin to the bubonic plague—and ended with the Great Fire that burned London for five days. Dryden might easily have referred to the year as an "annus horribilis"—a horrible year—rather than a year of miracles.

So why did Dryden call it the "Year of Miracles?" Because from the wreckage, London rebuilt itself and arose from the ashes with wide streets, modern sewers and buildings commissioned by Charles II and designed by the great architect Christopher Wren—buildings so solidly constructed that they last to this day. Our task is to turn the current "horribilis" economy into an opportunity, just as the Brits did nearly 350 years ago, so that we will emerge from the current economic wreckage stronger and better and more resilient than ever. If England could do it in the 17th century, we can certainly do it today. Turning something "horribilis" into a thing that is "mirabilis" is the quintessential American—and *Texan*—thing to do.

So I ask you tonight to do two things: First, carefully consider the risk of politicizing the Fed and so guide your elected representatives. And second, take advantage of the opportunities that always abound in times of adversity. My job is to continue working to create the monetary conditions that make for sustained, noninflationary growth and well-functioning financial markets—to keep that Federal Reserve banknote worthy of being the currency of a great power. Your job is to take advantage of a healthy, nonpoliticized monetary policy and financial stability and make the investments and create the businesses that have led this great country of ours to unparalleled economic success.

Americans are at their best when we confront our problems squarely, pick ourselves up and overcome the most horrific obstacles we face to accomplish economic miracles. We've been doing that for over 200 years. We can't stop now. Let's get on with it.

Thank you.