Where We Go from Here: The Crisis and Beyond

(With Reference to P. G. Wodehouse, John Kenneth Galbraith, Alan Greenspan and an Unnamed Eller College Student)

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Thank you, Dean [Paul] Portney. You and the CFA Society of Tucson are kind to include me in this year's roster of your distinguished speakers at the Eller College of Management. I am honored to be here.

My much older brother, Mike Fisher, lives here in Tucson, where he has taken refuge in retirement after a stellar career in the institutional investment business. He is here tonight with his wonderful wife, Karen. They picked me up at the airport, and on the way over here, we were reminiscing. When you are with family who have known you for a lifetime, it stretches the imagination to be considered "distinguished"—they know better. To them, you are just a little brother or an ordinary man. To illustrate the point: I once asked my wife, Nancy, if she ever, in her wildest dreams, thought her husband would go off to great universities like the University of Arizona to give "distinguished speaker" lectures. Her answer was a classic: "I hate to tell you, Richard, but after 37 years of marriage, you rarely appear in my *wildest* dreams."

So much for the puffery of being a "distinguished speaker."

Certainly, few imagined in their wildest dreams—or the puffery of the prolonged period in which financial mavens dispensed with common sense and assumed any and all risk assessment could be turned over to math wizards—that the financial environment and the economic disposition of our great country could have turned so rotten so quickly in 2008. Few envisioned we would go through the hell we have endured in the past two years. (Though, if memory serves, Susan Bies spoke here as a governor of the Federal Reserve System on Jan. 18, 2007, and pulled no punches in voicing concern for the precarious state of mortgage financing.)

You may remember that the third quarter of 2007 marked the 25th consecutive quarter of growth in U.S. gross domestic product (GDP). Unemployment bottomed at 4.4 percent in March of that year, and the S&P 500 Index finished the day of Oct. 9, 2007, at an all-time high of 1,565. Shortly thereafter, all hell broke loose. You know the events that transpired—I will not recount them tonight. The great comedic writer P. G. Wodehouse pretty much said it all when he wrote that "… just when a [fellow] is feeling particularly … braced with things in general … Fate sneaks up behind him with a bit of lead piping."[1] The markets and the public were feeling braced by an elaborate conceit that played out too far for too long—that markets are perfect and can price risk accurately; that the price of housing and other financial trees can grow to the sky; that economic history does not repeat itself. As a result, they fell victim to the lead pipe of hubris, and a good old-fashioned panic ensued.

[1] "Jeeves and the Unbidden Guest," by P. G. Wodehouse, *Saturday Evening* Post, 1916.

If there is one thing I would hope you take home with you tonight, it is this: If you want to know where we are likely to go from here, you need to know where we have been. And you need to realize that we have been there before. History does indeed repeat itself. A wise investor or a smart businessperson must heed its lessons.

Consider this quote, from an essay titled "A Time of Unexampled Prosperity" in Washington Irving's *The Crayon Papers*:

"Every now and then the world is visited by one of these delusive seasons, when 'the credit system' ... expands to full luxuriance: everyone trusts everybody; a bad debt is a thing unheard of; the broad way to certain and sudden wealth lies plain and open; and men ... dash forth boldly from the facility of borrowing.

"Promissory notes, interchanged between scheming individuals, are liberally discounted at the banks.... Everyone talks in [huge amounts]; nothing is heard but gigantic operations in trade; great purchases and sales of real property, and immense sums [are] made at every transfer. All, to be sure, as yet exists in promise; but the believer in promises calculates the aggregate as solid capital....

"Speculative and dreaming ... men ... relate their dreams and projects to the ignorant and credulous, dazzle them with golden visions, and set them maddening after shadows. The example of one stimulates another; speculation rises on speculation; bubble rises on bubble....

"Speculation ... casts contempt upon all its sober realities. It renders the [financier] a magician, and the [stock] exchange a region of enchantment.... No 'operation' is thought worthy of attention that does not double or treble the investment. No business is worth following that does not promise an immediate fortune....

"Could this delusion always last, life ... would indeed be a golden dream; but [the delusion] is as short as it is brilliant."[2]

Irving was writing about the Mississippi Bubble fiasco of 1719! So, yes, just as Wodehouse said: Fate has a nasty habit of repeatedly sneaking up behind contented financial markets with a bit of lead piping.

For a more fulsome perspective on the pathology of economies' tendency to slip periodically into financial dementia, I usually instruct my academic audiences to go back and read the classic book on financial folly written in 1841 by Charles Mackay, entitled *Memoirs of Extraordinary Delusions*. Historians among you may remember his seminal conclusion after studying history's financial panics up to that date. "Men," Mackay noted, "think in herds; it will be seen that they go mad in herds"—an insight obviously overlooked by whoever wrote the copy at Merrill Lynch's ad agency more than a century later.

For many of today's students, Mackay can make for turgid reading—besides, it consumes too much memory in a Kindle and is likely not so pretty on an iPad. So tonight I am going to refer you to a short, very readable book written by one of my old college professors, the late John

[2] "A Time of Unexampled Prosperity," by Washington Irving, in *The Crayon Papers*, 1890.

Kenneth Galbraith, entitled *A Short History of Financial Euphoria*. It is a superb treatise on the dangers of debt and the poisonous attributes of leverage—what Washington Irving referred to as "the facility of borrowing" in the excerpt I just quoted. Galbraith walks the reader through the ins and outs of various episodes of financial panic, beginning with the Dutch tulip craze of the mid-17th century. In his final chapter, he surmises: "The circumstances that induce the recurrent lapses into financial dementia have not changed in any truly operative fashion since the Tulipomania of 1636–1637. Individuals and institutions are captured by the wondrous satisfaction from accruing wealth. The associated illusion of insight is protected, in turn, by the oft-noted public impression that intelligence … marches in close step with the possession of money. Out of that belief … comes action—the bidding up of values, whether in land, securities, or … art. The upward movement confirms the commitment to personal and group wisdom. And so on to the moment of mass disillusion and the crash. This last [development] … never comes gently. It is always accompanied by a desperate and largely unsuccessful effort to get out."[3]

The fact is that in the world of financial panics, nothing is new under the sun. Leverage is always at the root of financial debacles. Asset prices always overshoot during booms and bubbles; they always overcorrect during busts when people desperately and unsuccessfully run for the exits. The thundering herd inevitably gets spooked. The financial mania bumper sticker might read: "Panic happens."

Yet, even if we accept that markets—be they those for bonds or derivatives, stocks or tulips or anything and everything tradable—are given to volatility and panic, we know from repeated experience that market failures that roil the financial system can have disastrous repercussions, setting off an adverse feedback loop of contracting credit flows, declining economic activity and sustained, high unemployment. We at the Federal Reserve would be remiss if we did not use our powers to counter this phenomenon.

The powers we possess are limited to affecting the vital role that money and credit play in our economy. Congress alone has the power to tax and spend your money. The Federal Reserve's influence is limited to the monetary realm. I liken it to the cardiovascular system. In an economy, the central bank is the heart, money and credit are the lifeblood, and financial markets are the arteries and capillaries that channel that lifeblood, providing critical sustenance to the muscles—the makers of goods and services and the creators of employment. A properly functioning cardiovascular system fosters healthy growth; if that system fails, the body breaks down.

As the body began to break down in 2007 and 2008, the Federal Reserve undertook several major efforts to provide well-secured, mostly short-term credit to a dysfunctional financial system. These efforts were designed to make sure that the arterial system of financial institutions—depository institutions, primary dealers, money market mutual funds, commercial paper issuers and others—would have access to adequate liquidity in a time of acute distress.

To be sure, our actions were most unusual and raised many an eyebrow. But they were not without precedent. Had you gone to the history books, you could have foretold many of the steps we took. The basic playbook for how a central bank, as the lender of last resort, deals with a financial crisis was written in the 19th century by two men: Henry Thornton and Walter Bagehot.

[3] *A Short History of Financial Euphoria*, by John Kenneth Galbraith, New York: Penguin Group, 1993, p. 106.

Bagehot's prescription to counter a panic bears repeating. Confronted with a panic: "The holders of the cash reserve must be ready not only to keep it for their own liabilities, but to advance it most freely for the liabilities of others. They must lend to merchants, to minor bankers, to 'this man and that man' whenever the security is good."

Bagehot describes the response of the Bank of England to the Panic of 1825 by quoting a former official as follows: "We lent it … by every possible means and in modes we had never adopted before; we took in stock on security, we purchased Exchequer bills, we made advances on [those] bills, we not only discounted outright, but we made advances on the deposit of bills of exchange to an immense amount, in short, by every possible means consistent with the safety of the Bank...."[4]

All the while bearing in mind the advice rendered by Thornton, writing in 1802: "It is by no means intended to imply, that it would become the [Central] Bank to relieve every distress which the rashness of [bankers and financiers] may bring upon them.... The relief should neither be so ... liberal as to exempt those who misconduct their business ... nor so scanty and slow as deeply to involve the general interests. These interests, nevertheless, are sure to be pleaded by every distressed person whose affairs are large, however indifferent or even ruinous may be their state."[5]

If you are looking for a cognitive road map of what the Fed was up to in 2008 and 2009 as we navigated between the need to "advance most freely for the liabilities of others, lend to bankers and merchants, and 'to this man and that man' whenever the security is good" and the equally compelling need to fend off the moral hazard of relieving "those who misconduct their business," you might dust off your Bagehot and Thornton.

To come back to the present, I would like to remind you that as liquidity has improved and as the cardiovascular system of the financial body has been restored, we have phased out our diverse emergency lending programs. After tomorrow, on April 1, the sole remaining segment of this plethora of emergency liquidity initiatives will be the term asset-backed securities loan facility (TALF) for newly issued, commercial mortgage-backed securities (CMBS), and that will be closed on June 30.

We kept our word. We said these would be short-term and extraordinary facilities designed solely to get the patient out of the ER and back on its feet. As the markets for interbank lending, commercial paper, asset-backed securities and bonds and other forms of credit repaired, we wound down our intervention. Total credit outstanding under all of our liquidity programs, including our regular discount window, peaked around $1.5 trillion at year-end 2008. At last count, total credit outstanding was down around $68 billion. (You may track this yourself by going to the Internet and pulling up what is known as our H.4.1 release. We are the only business or government agency I am aware of in the world that reports its balance sheet to the public on a weekly basis.[6]) Imagine that—a government agency actually did what it said it would do and then undid it. And we did so without costing the taxpayer a single penny.

[4] *Lombard Street*, by Walter Bagehot, 1873.
[5] *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain*, by Henry Thornton, 1802.
[6] The Federal Reserve publishes its balance sheet weekly in the form of the H.4.1 release—it is available to the public on the Internet at the following address: http://www.federalreserve.gov/releases/h41/.

That said, in parallel to our expansion and unwinding of the various liquidity facilities we created, we have purchased substantial assets—$300 billion in Treasuries, $175 billion in agency debt and $1.25 trillion in mortgage-backed securities (MBS). These asset purchases have left the banking system with a great deal of liquidity: U.S. banks now hold more than $1.1 trillion of reserves on the liability side of the balance sheets of the 12 Federal Reserve Banks. Combined, the asset purchases we have undertaken and the buildup in reserves that have resulted from those purchases have improved conditions in the mortgage and other credit markets, putting downward pressure on borrowing rates and spreads. But they have left us with a bloated balance sheet, which we desire to slim down as conditions warrant.

The disposition of those assets and liabilities will depend on the course of the economy.

Presently, the economy is afflicted by excess capacity, including high unemployment, and a notable absence of price pressures. I stuck my neck out and declared last August that an economic recovery had begun.[7] This was later confirmed by positive GDP growth in the third quarter and explosive, 5.6 percent growth in the fourth quarter. Much of that burst of growth from the depths of recession was led by inventory adjustments. Now businesses are settling into the basic ground game of advancing one yard at a time—the goal being to grow their top lines and expand their underlying businesses. Generally, the data indicate that we will move down the field this year at about a 3 percent clip. It is less than we had grown accustomed to in the heyday before the crisis, and it may not result in as rapid a reduction in unemployment as we would like. But it is positive and noteworthy.

Those that transport goods by ships are reporting a better balance between supply and demand. Air freight has seen a sustained pickup in traffic these past three months. Volumes shipped year-to-date by rail are up on the order of 3.5 percent. Trucking activity has turned up. There has been a pickup in getting goods to market. Semiconductor manufacturers are adding capacity to meet underlying demand that is, as one company describes, "beyond normal seasonal demands." Real spending on equipment and software is increasing. Telephone companies report that long-distance minutes and roaming activity are on the rise, indicating improvement particularly among business users. Advertising on television and on the Internet is trending upward, indicating greater confidence in the market for goods and services. And if you closely examine retail activity, you will notice that stores and chains that service all but the bottom quartile of shoppers report that consumers, while still value-driven, are beginning to add an item or two to what they take to the check-out counter. This was confirmed by the data on personal spending released yesterday.

Taken together, anecdotal evidence indicates that, absent some exogenous shock, the recovery that began last summer is unlikely to be reversed and will instead proceed, slowly gathering momentum as we progress through the year. The good news is that we are beginning to see some rays of sunshine emerge from the leftover clouds of the frightful storm we have just experienced.

To be sure, the skies are far from clear. There remain far too many workers on the unemployment rolls, and there are questions as to the rate at which businesses will rehire workers once their top lines begin to grow again. The housing situation remains precarious and

[7] "Recession over, Dallas Fed chief says, but jobs lag," *Dallas Morning News*, Aug. 26, 2009.

can best be described as “bouncing along the bottom.” Large businesses that have access to credit and equity markets are, like banks, awash in liquidity, but small businesses still face recalcitrant bankers.

To me, some of the most worrisome clouds are being seeded by uncertainty created by government. This is occurring on two fronts—first, on the regulatory side and second, on the fiscal front.

I need not tell an audience at one of the nation’s most prominent public business schools about the perils of uncertainty. A good business school teaches its students to manage under conditions of uncertainty, for nothing is ever certain in the world of commerce or finance. But this task has become more challenging as the administration and Congress have sought major changes in the regulatory framework governing health care and emissions standards and money and banking and other areas—and in the taxes and fees they will impose to implement them. Until all of these changes are agreed to and announced, businesses will be unable to cost them out and discern how their franchises will be impacted. So long as they face this uncertainty, businesses will be inhibited from hiring significant amounts of workers or committing substantial dollars to investment in plant and equipment and technology.

On the fiscal front, the most vexing issue relates to deficits being run by Congress. I know this is a hot topic in Arizona. Here is a little tongue-in-cheek vignette sent to me by an angry citizen who likened it to Congress’ appropriation of the people’s monies.[8]

This would all be funny if it were not so serious. Even under the most optimistic of scenarios, large deficits will be run for as far as the eye can see. This means there will be substantial growth in federal debt. In fiscal year 2009, the Treasury went to market for almost $1.4 trillion in net new borrowing. This year, the number is expected to be about the same, maybe a little higher. A former colleague of mine—who, in the spirit of Washington Irving, Charles Mackay and John Galbraith, warned of the risk of “irrational exuberance,” but to no avail—recently noted the pressure this is putting on interest rates at the longer end of the yield curve, calling this “the canary in the coal mine.”[9] The Federal Reserve has anchored the short end of the curve at near zero. But the markets, fearing the consequences of runaway deficit financing, have bid up longer-term nominal rates, resulting in a yield curve that is now historically steep. Some of this may, of course, reflect an improvement in economic growth—but we cannot turn a blind eye to the effect that growing government indebtedness has on investors’ confidence and Treasury yields.

You might well ask the “what if” question regarding Treasury borrowings. “What if the insatiable borrowing of the Treasury leads to upward pressure on rates? Would the Fed then step in and buy a bundle of Treasuries just to hold rates down?” I think not. For, should we do so, we would only become an accomplice to the fiscal incontinence of Congress. We would be perceived as “monetizing the debt,” a trap that inevitably leads to hyperinflation and economic destruction. We would lose all the hard-earned credibility we have gained by our conduct in the crisis if we came to be viewed by markets as a handmaiden of spendthrift political forces. That would be a bit of lead piping we could ill afford.

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[8] A video was shown at this point in the speech.
[9] Alan Greenspan as quoted from Bloomberg’s television program “Political Capital with Al Hunt,” March 26, 2010.

Earlier this week, I prepared for this lecture by speaking to some of your undergraduate students by phone. One of the most memorable of them described the Fed's balance sheet as being "really pimped out!" I would not have chosen those words, but, yes, our balance sheet is presently gussied up. We aim to get back to the basics of holding mostly plain vanilla Treasuries—in size needed solely for conducting prudent monetary policy—on the asset side of our balance sheet. And we wish to have banks put their reserves to work, financing growth of the businesses of America, rather than piling those reserves up on the liability side of our balance sheet.

Of course, we must be wary that the assets we hold are not sold into the financial system in a disruptive way and that the excess reserves held by banks on our balance sheet are not released into the system so rapidly as to create inflationary pressures. Thus we are hard at work developing a tool kit to affect an exit strategy that will not prove disruptive to either the markets or the goal of preserving price stability.[10] Achieving these goals requires that the Fed be intimately familiar with the inner workings and linkages of financial markets and institutions—a familiarity, I might add, we would lack without the insights we acquire as a bank supervisor and regulator. As we progress through this recovery period, we will continue to put those insights to use, developing and executing monetary policy in such a way that accomplishes our long-term objectives without sacrificing financial stability. And I expect the next time I visit your campus, that student's description of the Fed's balance sheet will (hopefully) be a trifle different.

If you look to history as your guide for the Federal Reserve's next move, you will note that central bankers are the least fashionable of species. Thomas Jefferson once said, "In matters of style, swim with the current; in matters of principle, stand like a rock." Central bankers earn their credibility by standing like a rock on the principle of good monetary policy. We have done what we felt was consistent with our duty to pull the economy back from the brink. We are now focused on restoring our balance sheet to a more normal configuration. Now, it is up to the fiscal authorities to configure their policy so that the businesses of America might once again thrive, and prosperity will blossom.

[10] "Federal Reserve's Exit Strategy," testimony by Federal Reserve Chairman Ben S. Bernanke before the House Committee on Financial Services, March 25, 2010.