***Annus Horribilis* or *Annus Mirabilis*?**

(With Reference to Errol Flynn, Robert Roosa, Queen Elizabeth II, Winston Churchill, Felix Rohatyn and Mick Jagger)

Remarks before the Economic Club of New York

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New York City
October 17, 2013

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Thank you Bill [Dudley]. It is a pleasure to be introduced by my colleague from the Federal Reserve Bank of New York. Bill is a friend as well as a colleague. Though it is our custom at the Federal Reserve to only speak for ourselves and never for any other member of the Federal Open Market Committee (FOMC), I think I can safely say that all 11 of Bill's fellow Federal Reserve Bank presidents and, indeed, all the governors at the Federal Reserve Board, are grateful for Bill's skillful leadership and total devotion to our collective mission. He is a hopeless golfer but a great human being. I want to take this opportunity to formally thank him for his service to the Fed and to our country.

Robert Roosa and Wild Dreams

It is a very special honor for me to speak at the Economic Club of New York. My very first job after graduating from Stanford Business School was at Brown Brothers Harriman and Co. as the policy assistant to Robert Roosa. Bob Roosa was the proud chairman of the Economic Club from 1970 to 1971. He used to regale me with its history, of how anybody who was of consequence had spoken here, from Presidents Wilson and Eisenhower and Kennedy to Winston Churchill and Indira Gandhi and Zhu Rongji (and many others since).

I mentioned this to my wife Nancy before flying up here. Without much humility, I asked her, "In your wildest dreams did you ever think that your husband would follow in the footsteps of the world's great leaders and speak to the Economic Club of New York?" You know what her answer was? "Richard, we have been married for 40 years. You don't appear in my wildest dreams."

The Nightmare of Fiscal Policy

I came to speak to you this morning not of pleasant dreams but of the nightmare of fiscal indecision and political chicanery that emanates from Washington, the risk it poses to the reputation of our nation, and the limits it imposes on monetary policy.

I did not come to speak of whether or not we should or might "taper" our asset purchases at the next meeting of the FOMC. Or of how Janet Yellen will lead the committee when she succeeds Ben Bernanke. Or how I might vote when I rotate into a voter's slot on the FOMC next year. I would be happy to *avoid* answering those and any other questions you might have during the Q&A session.

Errol Flynn and Felix Rohatyn

The iconic actor Errol Flynn (who, to the best of my knowledge, was not a member of the Economic Club) is reported to have quipped that his legendary financial problems lay "in reconciling my gross habits with my net income." This is the most concise description I can marshal to explain the problem plaguing our nation's fiscal authorities. And it has not changed with the 11th-hour temporary agreement reached last night by the leaders of Congress and the president. Kicking the can down the road for a few months will not solve the pathology of fiscal misfeasance that undermines our economy and threatens our future.

I have no doubt that we will go on indefinitely increasing the debt ceiling, be it in a regular or a herky-jerky, just-in-the-nick-of-time pattern. For no president or congressional leader dares risk being recorded in the history books as having consciously presided over default and the destruction of "the full faith and credit of the United States." Republican or Democrat, all know full well that your fellow New Yorker, Felix Rohatyn, was spot-on some 37 years ago during New York's great fiscal crisis when he likened default to "someone stepping into a tepid bath and slashing his wrists—you might not feel yourself dying, but that's what would happen."[1]

But there is, I believe, a limit of tolerance for our government's fiscally counterproductive, Errol Flynn-like ways. I believe that razor in hand, we are stepping toward Rohatyn's tepid bath and that the full faith and credit of the United States government is, in fact, at risk.

Haircuts …

We saw an expression of this last Thursday when Hong Kong Exchanges and Clearing Ltd. announced it would apply an increased "haircut" to its valuation of U.S. Treasury securities held as collateral against futures trades, with Treasuries maturing in less than one year receiving a risk discount of 3 percent. This was printed on Friday in a highlighted box above the fold on the front page of the *Financial Times*. Opposite was a picture of Chinese Premier Li Keqiang, who the paper reported had "signaled Beijing's increasing concern at an Asian summit" and then provided a kindly no-wonder reminder that "China has about 60 percent of its \$3.5 trillion foreign currency reserves invested in U.S. assets."[2]

The *FT* could easily have substituted Premier Li's picture with one of the German chancellor or the Japanese or British prime minister or the Mexican president, or any other world leader or business operator or simple observer of events, and ascribed to any of them a more explicit but surely pervasively held concern: "What the hell is happening to America?" Has the American ship of state, as Maureen Dowd wrote yesterday, turned into a "ship of fools"?[3]

… and Tipping Points

My heart bleeds for my country, for no amount of monetary accommodation, no conceivable amount of "large-scale asset purchases," no clever new monetary innovation by the Federal

Reserve can offset the rot that is destroying our fiscal house and the blight it spreads over our economy.

To be clear, the Federal Reserve will take all appropriate measures to preserve money market functioning and stability in periods of acute distress. I view this as an integral part of our formal dual mandate. Chaotic money markets threaten both price stability and business activity and employment. However, it is not our job to fix the budget impasse. Any initiatives we might have to undertake in the course of our duty as a central bank to prevent serious disruptions of U.S. dollar funding markets should not be executed in a way that they might be construed to substitute for fiscal redress. Fundamental, structural imbalances in our economy might be temporarily obscured but cannot be permanently resolved by monetary sleight of hand.

Indeed, I argue that the current monetary accommodation policy of purchasing $85 billion a month in Treasuries and MBS (mortgage-backed securities) risks exacerbating the situation: There is a tipping point where monetary accommodation comes to be viewed not as a pleasant stimulus that levitates bond and stock and housing markets leading to a felicitous “wealth effect,” but instead as an agent of financial recklessness. None of us really know where that tipping point is. But with each dollar of Treasury and MBS purchases the FOMC instructs the New York desk to make, we inch closer to it.

For the remainder of Ben Bernanke’s leadership and from the very first moment of his successor’s, the FOMC will have to astutely maneuver so as to avoid crossing a line that no Nobel laureate or econometric modeler or quant-jock or dealer or market operator can identify ex-ante.

I admit to a preoccupation with this concern. This much I know: As long as inflationary expectations are held at bay, we can fully open the monetary throttle in an effort to deliver on the mandate Congress gave us to help achieve full employment. But it is for naught as long as the fiscal authorities are slamming on the brakes and leaving everyone in the dark as to how they will cure the fiscal mess they have wrought.

No rational businesswoman or man will or should make a long-term commitment to expanding their workforce or commit their precious capital to significant job-creating projects if they have no idea what their taxes will be or how government spending will impact them or their customers or suppliers. And no manager can plan or budget forward while simultaneously working under the yoke of ever-expanding regulations that render incalculable their cost structure, including the full-in cost of the most important variable in that cost structure—the workforce—as long as the Affordable Care Act remains more of a mystery than a clear, understandable program.

The creative capacity of American business for dealing with uncertainty is unparalleled. But doubts caused by fiscal malfunctioning so extreme that the “risk-free rate” of the world’s largest economy and reserve currency is called into question are of a different kind and character than the everyday uncertainties that even the most gifted manager is trained to handle. How does one discount the value of payables and receivables for next year when the world wonders if the U.S. government will validate the full value of Treasury bills?

The Fed to the Rescue?

It is true that unlike the Congress, the FOMC actually makes decisions and does so in a civil manner—both lost traits in Washington. But it is a myth that we have the power on our own to propel our economy forward. We can provide the fuel, but we can't engage the gears of the engine of employment. Only businesses can do that. And businesses cannot do it when they haven't an inkling of how the fiscal mess that is Washington will be resolved. The simple observation is that U.S. businesses and households need confidence that fiscal policy will be conducted responsibly—that revenues and expenditures will come into line, over time. Until that fog is lifted, do not expect the economy to steam forward at anything but a most cautious pace.

***Annus Horribilis* or …**

In contemplating the fix we are in, I thought of a phrase used by Queen Elizabeth in her 1992 speech, marking the 40th anniversary of her accession to the throne. You may recall that was a year when a series of tragedies, including the burning of Windsor Castle, beset her family. With classic British understatement, she told her subjects: "1992 is not a year on which I shall look back with undiluted pleasure. … it has turned out to be an 'Annus Horribilis'"—a "horrible year."[4]

We have suffered much on the financial and economic front these past many years. And, in fact, since 1976 we have on 17 occasions under six of the last seven U.S. presidents experienced a federal government disruption, including shutdowns. Since 2010, we have had eight budget conventions, to no avail. And we've seen several face-offs on the debt ceiling. But the cumulative effect of our government's fiscal ineptitude and propensity to put off taking action on hard decisions, and the frustration I feel about the inability of even the most radical monetary policy to work in the absence of long-term fiscal probity, has tempted me to record 2013 as an *annus horribilis*. It is certainly not shaping up to be a year on which I shall look back with undiluted pleasure.

Sound but Disagreeable

It need not be so horrible, however. In fact, it may be a year of good fortune if our president and congressional leaders summon the courage to put partisan gamesmanship aside and finally craft tax and spending and regulatory policy that encourages businesses to take the cheap and abundant money the Fed has made possible—the cheapest in the 237-year history of the Republic!—and put it to use creating jobs and expanding the wealth of the entire nation, not just that of rich and quick financiers and those with the means to speculate and profit from volatility.

Getting these incentives right is not an easy task. But it is crucial.

One of the most exalted of the Economic Club's long history of speakers, Winston Churchill, said, "In finance, everything that is agreeable is unsound and everything that is sound is disagreeable." Continuing down the path of hypermonetary accommodation is certainly agreeable, especially if you are invested in stocks or bonds or have been able to refinance your mortgage and participate in the new housing boom. But carried on for too long, it is surely an unsound way to put our nation back on the path to respectability or eliminate the markets' placing haircuts on the value of U.S. Treasuries.

The only way for us to achieve sound footing is for our fiscal leaders to make politically disagreeable decisions. There is no other way for us to regain and maintain our standing as the most prosperous and powerful economy in the history of the world.

Annus Mirabilis?

I mentioned Queen Elizabeth's *annus horribilis*. So as to not leave you despondent, I wish to remind you that the queen's expression was a play on words in a poem written in 1667 by John Dryden, titled *Annus Mirabilis*—or *Year of Miracles*.

Dryden was writing about the year that spanned 1665 and 1666. It 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.

So why the title *Year of Miracles*? Because from the wreckage, London rebuilt itself and arose from the ashes, with wide streets and buildings commissioned by Charles II and designed by Christopher Wren that were so solidly constructed they last to this day. Our collective task is to turn the current *annus horribilis* into an opportunity to emerge from the current fiscal wreckage stronger and more resilient than ever. If England could do it in the 17th century, we Americans, who have never, ever flinched from staring down and overcoming adversity, can certainly do it now.

I am tempted to remind you of how Texas arose from the ashes of the 1980s oil bust and savings-and-loan crisis to lead the nation in job creation for several decades and become one of our most prosperous states. But I am not going to do so.

I was going to tell you how in the Texas renaissance, as the U.S. has seen job destruction in the two middle-income quartiles for the past decade, Texas has seen job creation in those same middle-income groups and has outperformed the nation in creating jobs in the highest-income quartile, too. But I won't.

I am tempted to tell you that Texas came off the bottom to become the top exporting state in the United States. But I shan't. Or that state laws and regulations crafted with the 1980s banking crisis in mind spared Texas the worst of the recent housing crisis.

All these factors, of which I won't breathe a word, have resulted in a workforce of some 12.8 million and, in 2006, catapulted the state to its ranking as the top destination for people who move across states. Americans and immigrants alike come to Texas to seek jobs and opportunity in what continues to be the nation's most dynamic economy. I could tell you about that, but I will refrain from Texas brag.

New York, New York

Instead, let me point to New York as an example of what is possible.

Some of you may remember the predicament in which New York found itself in 1975, the year I came to work at Brown Brothers. It was de facto bankrupt. Garbage piled up on the streets. Crime was rampant. Upper East Side apartments could be had simply for the assumption of maintenance costs. Nothing worked. Everything was dysfunctional. The outlook was so horrific that Mick Jagger wrote "Shattered" after a cab ride around the city. Remember the lyrics? "What a mess, this town's in tatters/I've been shattered, my brain's been battered/Splattered all over Manhattan …"

Then, when the markets showed the city the back of its hand, leaders such as Felix Rohatyn and Gov. [Hugh] Carey and others stepped up to the plate. They and the people of New York turned something truly *horribilis* into a thing *mirabilis*. Disagreeable but sound decisions were made. Those decisions took a tattered, shattered city and put it on the path to becoming the bright, shiny, miraculous Big Apple that it is today.

A Plea

The Federal Reserve is limited in its power to make what took place in New York happen for our nation, and unless the fiscal authorities get their act together, looking to the Fed to solve the nation's economic ills through ever-expansive monetary policy might well make the situation worse. So I end with a plea for our president and our Congress. The markets are restless. Your peers around the world are afraid. There is little remaining tolerance for agreeable but unsound decisions. The bond market is beginning to show us the back of its hand. It is time for leadership. Turning something horrible into something miraculous is the American thing to do. Please get on with it.

Thank you.

Notes

[1] As quoted in "Infamous 'Drop Dead' Was Never Said by Ford," by Sam Roberts, *New York Times*, Dec. 28, 2006.

[2] "Asia Moves to Protect Itself, Just in Case," by Jeremy Grant and Paul J. Davies, and "White House Edges Closer to Short-Term Debt Ceiling Deal," by Richard McGregor, James Politi and Michael MacKenzie, *Financial Times*, Oct. 11, 2013.
[3] See "Pope Trumps President," by Maureen Dowd, *New York Times*, p. A25.
[4] Speech by Queen Elizabeth II, marking the 40th anniversary of her accession, London, Nov. 24, 1992.