

Reflections on the Financial Crisis: *Where Do We Go From Here?*

An Essay by Richard W. Fisher

The past two and a half years have been challenging ones for the Federal Reserve. The financial market turmoil that began in mid-2007 plunged the U.S. economy into a stubborn downturn that raised fears of another Great Depression. Determined to avoid the monetary policy mistakes of the 1930s, the Fed met the crisis head-on, taking a series of bold policy actions that lowered interest rates and funneled credit directly to the private sector.

By the end of 2009, we could breathe easier. Confidence in the banking industry is on the mend, financial markets are returning to normalcy and the economy is showing signs of recovery, however tepid.

It is time to look back—to see what we have learned—and to look forward to reshaping the policy environment, with an eye toward lessening the odds of future financial crises.

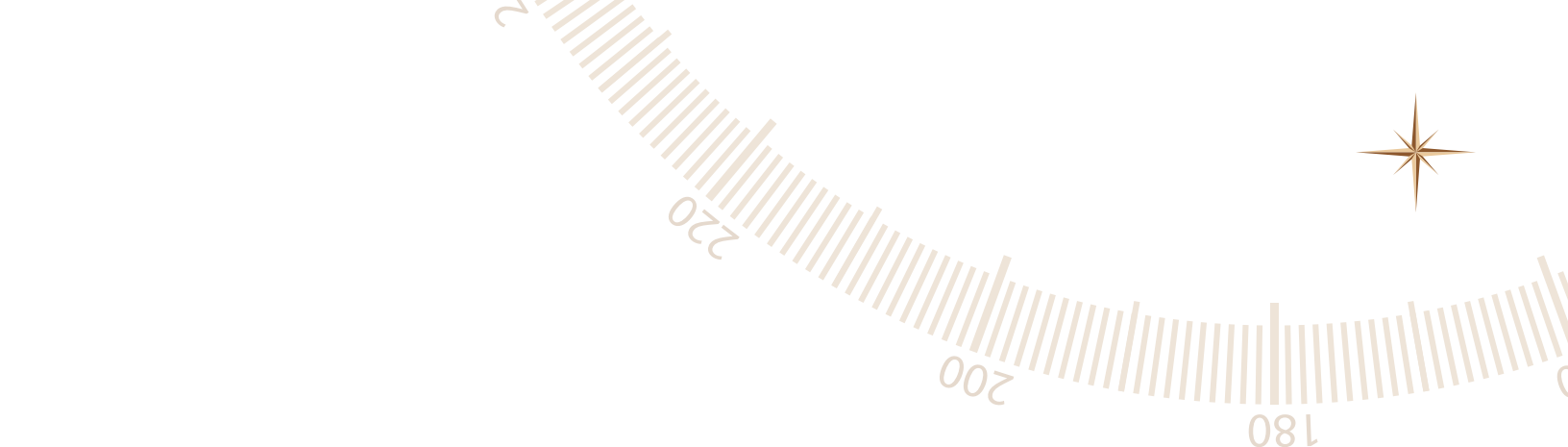
I come away from the past two years with four fundamental beliefs—all honed not only by my five years as a monetary policymaker but also by my decades of experience as a market operator. First, I am more convinced than ever that financial institutions and financial markets require a healthy dose of regulation to function efficiently. Second, I am more convinced than ever of the importance of regulatory and supervisory authority to the proper conduct of monetary policy. Third, I am more convinced than ever

... the right regulatory calibration


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Only by arriving at the right regulatory calibration can we adequately protect our financial system.



that too-big-to-fail banks are dangerous and should be contained, if not broken up. Fourth, I am more convinced than ever that central banks operate most effectively when insulated from political passions.

Taken together, these beliefs underscore the necessity of a forward-looking, carefully crafted re-

structuring of the financial system. An approach that scuttles such time-tested fundamentals as central bank independence will do more harm than good. At the same time, simply defending the status quo will take us down the same path to crisis and recession. We do not want to just do a better job cleaning up the messes in the financial system. We want to avoid the messes in the first place. Only by arriving at the right regulatory calibration can we adequately protect our financial system, and the economy that depends on it, from a repeat of the severe boom-to-bust cycle we have just been through.

Booms, Bubbles and Busts

I am a fierce advocate of free markets. The now-fabled Invisible Hand directs producers to use scarce resources efficiently to churn out an abundance of the goods and services consumers want. We have the magic of the market to thank for the creation of America's unmatched productive capacity and high living standards. Too much regulation burdens economic activity. Even so, my previous incarnation as a financial market operator left no doubt in my mind that markets do occasionally fail: Most notably, asset prices overshoot during booms and bubbles and overcorrect during busts.

By itself, volatility is not sufficient justification for regulation. However, market failures that roil the financial system can have disastrous repercussions, setting off an adverse financial feedback loop of

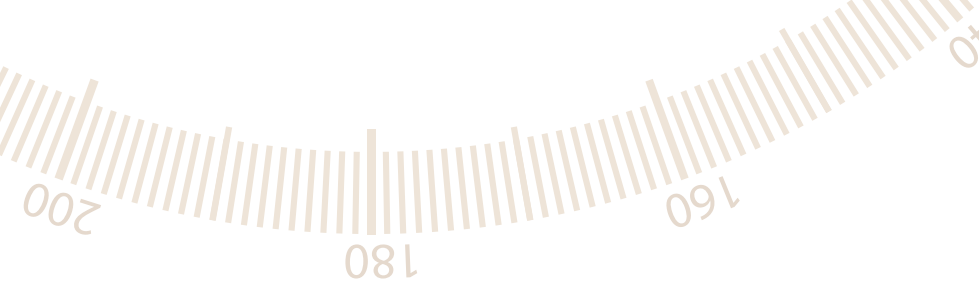
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contracting credit flows, declining economic activity and sustained high unemployment. This reminds us of the vital role money and credit play in maintaining a healthy economy. I liken it to the cardiovascular system. In an economy, the central bank is the heart, money is the lifeblood, and financial markets are the arteries and capillaries that provide critical sustenance to the muscles—the makers of goods and services and creators of employment. A properly functioning cardiovascular system fosters healthy growth; if that system fails, the muscles atrophy and the body breaks down.

... wringing out the economy's excesses





When the financial system comes under stress, liquidity is restrained, creating a major blockage in the financial intermediation process. Credit stops flowing to businesses and consumers, spreading the contagion throughout the economy. That is what happened in the most recent crisis. Elaborate statistical models and complex securitization products created the illusion of control over credit and liquidity risk in the banking system. Misperceptions of risk and misplaced incentives led to misguided actions. As market participants uncovered the truth—as they always do, however late—confidence quickly gave way to fear and doubt. With uncertainty in full fever, cash was hoarded, counterparties viewed each other with suspicion and no business appeared worthy of financing. The economy, starved of the lifeblood of capital, weakened further.

By now, I suspect many share my conviction regarding the need for improved financial regulation. We are even hearing a different tune from those who only a few years ago proclaimed the transcendent efficiency of financial markets—what I refer to as “the elaborate conceit of efficient market theory”—where today’s prices are always right, markets are self-correcting and regulation is best kept to a bare minimum.

Our prosperity requires that financial regulation and supervision maintain the safety and soundness necessary for healthy economic growth. The mission of regulators is to ensure banks are sturdy—and to shut them down if they are not. We do not want our zeal for restructuring the regulatory architecture to obscure our fundamental belief in the power of the market mechanisms. We need to weigh costs and benefits of our regulatory apparatus to determine what needs to go and what needs to be added. The goal should be not simply more regulation but rules that clamp down where they are needed the most, such as excessive risk-taking. An effective regulatory regime strives to corral the financial markets’ animal spirits in a way that does not inhibit the vital work of underwriting prosperity but discourages straying into yet another reckless escapade—a delicate balance indeed.



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The Fed as Regulator

The glamour of central banking lies in monetary policy. The media take note of every meeting of the Federal Open Market Committee, or FOMC, and nearly every utterance by its members. But making monetary policy decisions requires an intimate knowledge of the financial system—the type of knowledge that only a hands-on regulator can possess. To obtain that knowledge, we rely upon our regulatory and supervisory responsibilities—responsibilities we share with the Comptroller of the Currency, the Federal Deposit Insurance Corp., the Office of Thrift Supervision and state agencies, among others.

In theory, the Fed's monetary policy and regulatory functions are separate. In practice, they are anything but—rather, they have a symbiotic relationship. They complement each other because effective

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To understand why, we start with how monetary policy influences economic activity and employment. Traditionally, the FOMC's primary policy tool is the federal funds rate—the interest rate that banks charge one another for unsecured, overnight loans. Channeled through the financial system, changes in the federal funds rate affect private sector decisions on how much to produce and how many workers will be needed to do it.

... keeping banks on the straight and narrow





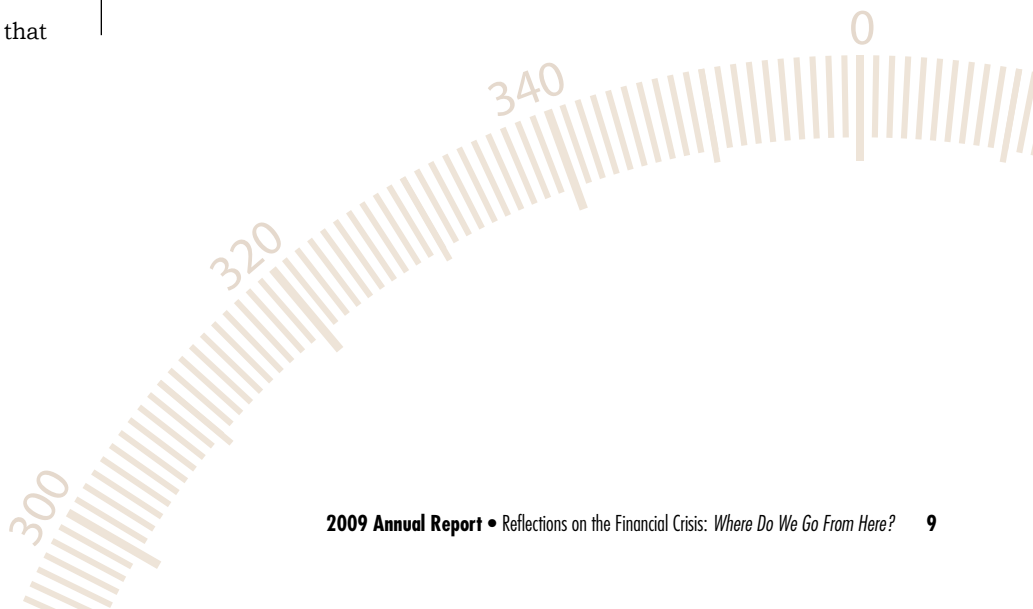
Changes in the federal funds rate directly and indirectly influence the cost and availability of credit throughout the economy. Banks respond by adjusting the pricing and terms they offer to borrowers, affecting buying and investing decisions. Money and capital markets usually move in the same direction, pinching or swelling the flow of funds to larger businesses. Interest rate changes affect the value of bonds, equities, real estate and other assets, the sources of consumers' and businesses' wealth that often serve as collateral for loans. If interest rate movements are larger in the U.S. than overseas, exchange rates may go up or down, affecting international trade and capital flows. Financial regulation's importance to monetary policy centers on keeping these vital arteries open—a job accomplished by establishing rules for sound banking practices and making sure that banks follow them.

The gears linking Fed policy and the real economy operate smoothly and predictably when banks are well capitalized—that is, when they have the financial wherewithal to make loans. This allows the arteries of the system to be open and healthy and strong. Troubles come when banks' finances are shaky—when the regulatory process has not kept banks sound. Sick banks cannot lend and properly act as intermediators—and monetary policy actions lose their capacity to influence the economy with accustomed efficiency. This is what happened in the financial crisis. Weakened by bad loans and investments that

led to massive writedowns, financial institutions were in no position to make new loans because they faced an immediate need to raise new capital. The cost of that capital spiked just when banks needed it the most. The financial system crouched in a defensive stance, tightening its lending standards and charging more for credit. Traditional Fed policy lost its potency. As the FOMC pushed the federal funds rate to the lowest levels ever in 2008, the rates that matter most for spurring economic recovery—the rates charged on credit to businesses and households—rose significantly, leaving the Fed to resort to extraordinary policies to inject liquidity into the economy.



I think it is worth discussing an expanded Fed regulatory role in nonbank financial institutions. This is where a great deal of the reckless lending, perverse incentives and, in some cases, downright dishonesty took place in the years leading up to the financial crisis.



The past two years have highlighted the interconnections of monetary and regulatory policy, underscoring the need for the Fed to maintain a major role in regulating and supervising firms across the financial system. The central bank cannot conduct monetary policy effectively without targeted and timely information on the health of the financial system. We depend on our regulatory arm to provide in-depth, hands-on assessments to guide us as we perform our duty as the financial system's lender of last resort—a duty that requires us to “know our customers,” as the old banking adage goes. We cannot perform that duty or operate a discount window if we lack a firsthand knowledge of our borrowers' financial health. It is simply impossible to properly evaluate the condition of a potentially troubled borrower with information generated by an outside agency, which might not give us what we need or might not be sufficiently responsive in

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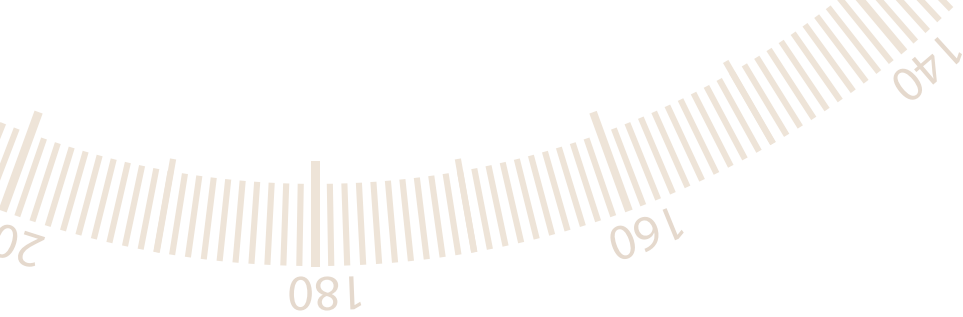


real time. This was one of the harsh lessons learned from examining the entrails of Bear Stearns, Lehman and AIG, over which we had no regulatory oversight at the time of their rupture.

Only by staying abreast of developments in the banking and financial system can the Fed acquire the knowledge necessary to implement monetary policy effectively. And only then—with full responsibility and accountability for financial stability—can the Fed be fully effective in pursuing its dual mandate of stable prices and full employment.

... crafting the right mix of policies






Keeping monetary and regulatory policy together reinforces accountability. At any given time, maintaining a healthy economy and sound banking system may require a purely regulatory response, a purely monetary response or a combination of the two. The appropriate mix may be unclear to an agency that has but a single mission. If monetary and regulatory authorities are separate, each side might justify inaction when tough decisions are needed by claiming it assumed the other would act. By placing responsibility for both monetary and regulatory policies under one authority, the blame game is no longer possible.

It is essential that the Fed not only maintain but also enhance its role in banking and financial regulation. I do not want a turf war with other regulators. In fact, I see advantages to maintaining several overlapping but separate regulatory approaches—different sets of eyes looking at the situation from different perspectives. However, I think it is worth discussing an expanded Fed regulatory role in nonbank financial institutions—also known as the shadow banking system. This is where a great deal of the reckless lending, perverse incentives and, in some cases, downright dishonesty took place in the years leading up to the financial crisis.

In my view, proposals to shrink the Fed’s regulatory and supervisory responsibilities are misguided. To keep with my cardiovascular analogy, I would argue that removing the Fed from supervision and regulation of banks of all sizes and complexity—from community banks to the most complex large financial institutions (LFIs)—would be the equivalent of ripping out the patient’s heart. That would surely prevent another heart attack but would likely have serious health repercussions. If we are to lower the chances of repeating the crisis we have just endured, the Fed must be deeply involved in financial supervision and regulation—so it can recognize the signs of an economy that is overheating. The Fed must address the extreme fringe of aggressive risk taking in a more preventive way, using all its available tools to prevent the next bubble from reaching critical mass. And—this is a crucial “and”—it will need to do a better job.



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Too-Dangerous-to-Permit

A truly effective restructuring of our regulatory regime will have to neutralize the biggest threat to our financial system's stability—the so-called too-big-to-fail, or TBTF, banks. In the past two decades, the biggest banks have grown significantly bigger. In 1990, the 10 largest U.S. banks had almost 25 percent of the industry's assets. Their share grew to 44 percent in 2000 and almost 60 percent in 2009.

Banking has become more concentrated at the top because of laws that allow institutions to operate nationwide and offer a broader range of financial services. However, some of this growth has occurred because of the government guarantees—implicit as well as explicit—that allow big financial institutions to grow faster by pursuing riskier strategies that yield higher returns, at least in good times.

The risks of the 21st century are no match for a regulatory scheme put in place in the 1930s, then

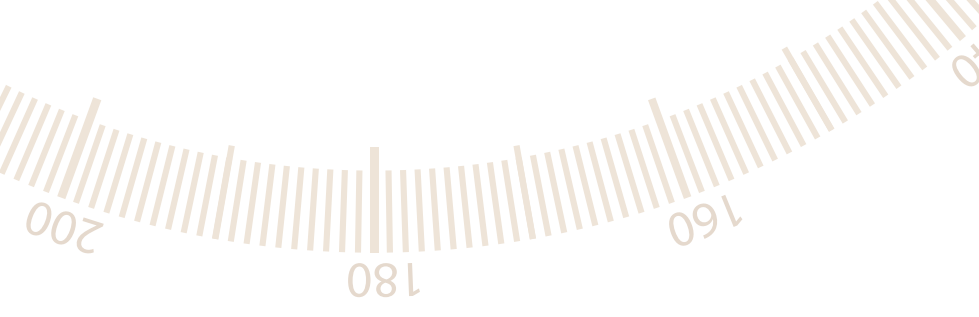
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revised in a piecemeal fashion since. The existing rules and oversight are not up to the acute regulatory challenge imposed by the biggest banks. First, these banks are sprawling and complex—so vast that their own management teams may not fully understand their own risk exposures. If that is so, it would be futile to expect that their regulators and creditors could untangle all the threads, especially under rapidly changing market conditions. Second, big banks may believe they can act recklessly without fear of paying the ultimate penalty. They and many of their creditors assume the Fed and other government agencies will cushion the fall and assume the damages, even if their troubles stem from negligence or trickery. They have only to look to recent experience to confirm that assumption.

... institutions of more manageable size





Some argue that bigness is not bad, per se. They contend that the U.S. cannot maintain its competitive edge on the global stage if it cedes LFI territory to other nations—an argument I consider hollow given the experience of the Japanese and others who came to regret seeking the distinction of having the world’s biggest financial institutions. Big banks interact with the economy and financial markets in a multitude of ways, creating connections that transcend the limits of industry and geography. Because of their deep and wide connections to other banks and financial institutions, a few really big banks can send tidal waves of troubles through the financial system if they fail, leading to a downward spiral of bad loans and contracting credit that destroys many jobs and businesses.

No government wants to take that risk. So in hard times, regulators dutifully close smaller banks—the FDIC shut down 25 banks in 2008 and 140 in 2009—but tiptoe around big banks with shaky financial foundations. Weak TBTF banks are propped up, even if their capacity to lend has been seriously compromised. And so they sit in limbo, a potential obstacle to monetary policy because of their power to obstruct the channels that transmit Fed actions to the economy.

I have not been reticent about the dangers posed by TBTF banks. To be sure, having a clearly articulated “resolution regime” would represent steps forward, though I fear it might also provide false comfort—large firms under special resolution authorities might be viewed favorably by creditors, continuing the govern-

ment-sponsored advantage bestowed upon them. My preference is for a more prophylactic approach: an international accord to break up these institutions into ones of more manageable size—more manageable for both their executives and their regulatory supervisors. This cannot be done after the onset of an economic crisis, when the consequences of faltering TBTF institutions become a front-burner issue. By then, the mistakes have been made and cannot be reversed, and TBTF banks plod along among the living like zombies in science fiction films.

The consequences are too dire. The time to break up TBTF banks is before the crisis—when the economy is relatively healthy and they pose no immediate dangers. That way, they will not be around to wreak havoc when the economy enters a period of stress.



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Independence

Central banks must take a long-term view of the economy and craft appropriate policy responses. When the situation warrants, we must have the leeway to raise interest rates when others want cheap credit and rein in risky financial practices when others want easy profits. A Fed committed to wringing out the economy's excesses and keeping banks on the straight and narrow is not going to win many popularity contests. Some of those displeased by Fed decisions will seek to satisfy their desires by resorting to political pressure.

It is for that reason that Congress, nearly a century ago, had the foresight to establish the Federal Reserve System—a monetary authority, together with a regulatory arm, set apart from the exigencies of the day. While our tools and mission have evolved over time, our independence has remained paramount to our efforts to pursue a steady course untainted by political accommodation.

Independent does not mean unaccountable. The Fed has always been subject to appropriate oversight and transparency. The Fed chairman and members of the Board of Governors are nominated by the president and confirmed by the Senate. Our statutory authority includes a grant of certain powers to influence

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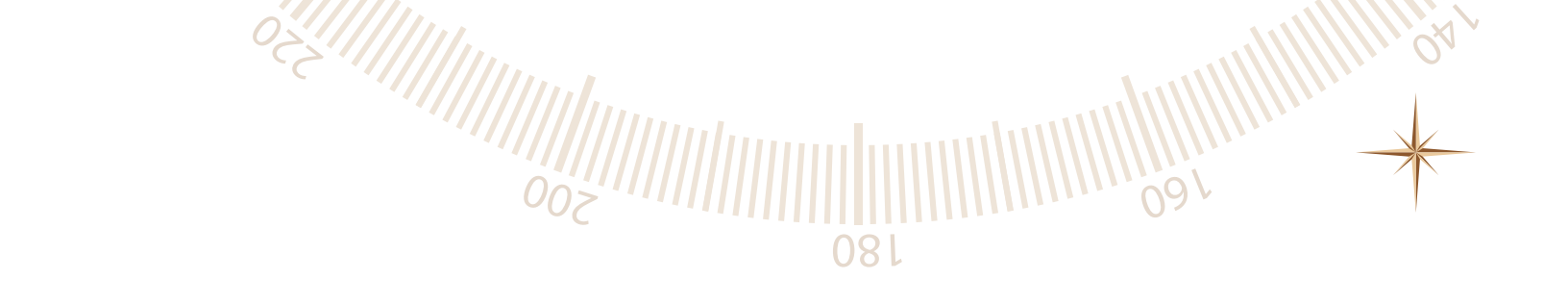


the financial system, and that authority is limited to our mandated goals of sustainable employment growth and price stability, along with the prerequisite objective of banking and financial stability. We are the only business I know of that releases a public accounting of its balance sheet every week—the H.4.1 release, available on the Internet. Since Ben Bernanke took the chair, we have ramped up our efforts to be as transparent as is prudent in the conduct of monetary policy. We now release more fulsome economic projections and minutes of our meetings. At the semiannual testimony before Congress required under the Humphrey-Hawkins legislation, the Chairman fields questions from members of appropriate oversight committees, and we have responded favorably to those suggestions that aid the Fed's ability to fulfill its mission.

However, Fed policymakers maintain distance from the political fray because board members serve staggered, 14-year terms, muting White House influence. The regional bank presidents, who serve alongside the governors on the FOMC, are further insulated because they are hired and fired at the will of their boards of directors. These nine-member boards are entirely removed from the D.C. establishment, with

... independence has remained paramount





the exception of the Board of Governors' selection of three members. Needless to say, my fellow bank presidents and I, and our boards, represent the views of our constituents on Main Street—not those of the Washington elite.

A Fed insulated from short-term, political impulses can focus on crafting the right mix of policies for the economy in the long term. It has enough space to make the tough calls—most notably, when interest rates have to be pushed upward to slow the economy in flush times. Fed independence does not just matter for monetary policy. A central bank insulated from politics and accompanying lobbying can also be a tougher regulator, insisting on strict adherence to capital and leverage requirements and prudent lending.


Central bank independence has become the global standard. Nations around the world have come to realize that successful central banks must be independent from political pressures. The European Central Bank—the monetary authority that governs the nations of the European Union—was established in 1998 and guaranteed political independence by treaty. Banco de México's insulation from political considerations has been codified in the country's constitution.

Over the past few decades, numerous economic studies have shown that independent monetary authorities are indeed associated with lower inflation and higher, steadier economic growth. History tells us what happens when central banks succumb to the political demands of the day. The examples of the havoc wrought by politicized central banks stretch from ancient Rome to modern-day Zimbabwe, where hyperinflation effectively destroyed the currency and the nation's economy.

In his entertaining book *Lords of Finance*, Liaquat Ahamed tells an interesting anecdote arising from the German Reichsbank's founding in the 1870s. At the time, Otto von Bismarck received a warning from his confidant Gershon Bleichröder: "There would be occasions when political considerations would have to override purely economic judgments." Bleichröder informed Bismarck that "at such times too independent a central bank would be a nuisance."

Herr Bleichröder's advice proved particularly unwise. Students of economic history are keenly aware of the political crisis that faced Germany after World War I and how it contributed to the debilitating hyperinflation that nearly destroyed the German economy. I am sure that most Germans who suffered through that difficult period would have gladly seen the Reichsbank act a nuisance in the name of economic sanity.

Bleichröder's mistake highlights an important fact: A politicized central bank is a crippled central bank. Leaders in Congress and the White House would do well to recall the relevant historic precedents as we emerge from this, the greatest financial crisis in post-World War II history. Our nation's monetary authority must retain its separation from political pressures, or it will have no hope of operating effectively and responsibly.



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Addressing Our Critics

Some may argue that the Fed had its chance and muffed it. They will say we failed to act despite the ominous signs that preceded these past two years of economic woe—so we should not have the broad authority and independence we had leading up to the crisis.

I have been in outspoken agreement on the first point—that we at the Fed made mistakes. I have stated many times that regulators at the Fed, and those at other agencies, were insufficiently vigilant about the risk exposures and overall financial mania

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that permeated our economic system. In all candor, we at the central bank should have seen these problems coming and acted to defuse them. With the benefit of hindsight, we see that our monetary policy was too loose and our regulatory practices were not tight enough.

... a long-term view of the economy





The Fed is taking the necessary steps to address these concerns, recalibrating and repairing its regulatory and supervisory apparatus to encompass more preventive and coordinated measures. We intend to move forward with this new and improved tool kit, putting it to use in conjunction with the execution of sound monetary policy.

To our critics' second point—that the Fed's authority or independence should be reduced—I might refer them to the four convictions I laid out earlier in this essay. Booms propelled by greed and busts born of fear are as old as time itself. As Charles Mackay reminded us nearly 170 years ago in his book *Memoirs of Extraordinary Popular Delusions*, "Men ... think in herds; it will be seen that they go mad in herds...." This quirk of human nature will always ignite the euphoria that fuels the ups and exacerbates the downs.

That is why we need a monetary policy that leans against that propensity for financial bubbles. We need regulatory and supervisory powers that lead to a policy that ensures a sound financial system, capable of most efficiently channeling central bank action to the real economy. We need to keep our monetary and regulatory authority united, so we can work together in the interest of the entire financial system—not just the interests of the largest institutions and those too big to fail. And we need to ensure that this authority is free from short-term political pressures.

Public policy should promote economic growth that is sustainable rather than fleeting. After seeing our economy wrenched by an overheated housing market sparked by loose credit, followed by a financial crisis in which the conduits of capital nearly froze up, it is time to construct a financial system more conducive to a more comfortable and sustainable economic temperature.

An independent Fed, equipped with the authority to responsibly execute monetary policy and aided by a strong supervisory and regulatory arm, is the most effective weapon we have to meet the need for increased stability and contain the dangerous spillovers that threaten the economy in periods of distress. Now that policymakers have pulled our economy back from the abyss, it is time to apply the lessons we have learned and put the Fed's abilities to best use.



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