Prudent risk taking is the lifeblood of capitalism, especially in its American form, in which the new, the innovative and the more productive constantly sweep away the status quo. If we had not been a nation of risk-takers, we would have never built our $14 trillion economy.

The necessity of risk taking has given rise to agents who service it, providing the means to assess, package and distribute risk. In the old days, their job was fairly straightforward. The agents packaged such instruments as letters of credit, bankers’ acceptances, commercial paper, simple loans and stocks, life and property insurance and fixed-rate mortgages.

More recently, the menu of risk instruments expanded dramatically, thanks in part to technological and theoretical advances that allowed financial players to make computations and assess probabilities at lightning speeds. A lengthy period of abnormally low interest rates and the normal human instinct to seek higher yields stimulated the hunger for the new instruments.

The quest for higher investment returns led the market to create ever-more-exotic investment products, many of which were backed by home mortgages of dubious quality. These products were built on the presumption house prices would always rise. When this proved unsustainable, markets for these products buckled under their own weight. Other markets were soon dragged down with it.

Throughout history, we have witnessed many instances of excessive risk taking that were followed immediately by periods of extreme risk aversion. While this recent episode bears all the hallmarks of a classic boom–bust cycle, this round of speculation and financial amnesia seems to have been driven by an overreliance on statistical models and rating agencies, excessive liquidity and perverse incentives, all of which were compounded by complacency.

Our resilient and highly productive U.S. economy will rise above the current difficulties, but it is still important to understand them. In this issue of Southwest Economy, the “On the Record” interview features Harvey Rosenblum, our director of research and one of the people I most trust for analytical insight. His take on recent events reflects four decades spent at the Fed, monitoring the U.S. economy. Harvey’s words of wisdom provide important and timely lessons.

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