2008,youdidn'thavetounderstandthecomplexitiesofthefinancialsystemtobeconcernedaboutitshealth.Americahhelditscollectivebreathasageneralsenseofuneasetookhold,feedbynonstopnewsoffinancialturmoil,fallinghomeprices,astockmarketinfreefallandawideningglobalslowdown.Monthaftermonth,consumerconfidenceslidtorecordlows.FormanyAmericans,thesituationwaswrenchinglypersonal-foreclosedhomes,lostjobs,shrinkingcollegefunds,evaporatingretirementsavings.TheNationalBureauofEconomicResearch'searly-DecemberannouncementthattheU.Shadbeeninrecessionforayearonlyconfirmedwhattheyhadlongknown.Texas,whichconstitutesthelargestpieceoftheEleventhDistric,escapedthedownturnformuchof2008andcontinuedtoexpand.Butinthesecondhalf,conditionsdeterioratedrapidly,theresultofthedeepeningglobalcrisisandsharpdropsinenergyprices,high-techactivityandexports.Whilethestate'slosseswererelativelymoderate,risingunemploymentandaweakeninghousingmarketprovedTexaswasnotimmunetothefinancialcrisis.FallingoilandgaspricesadverselyimpactedLouisianaandNewMexico,partsofwhichfallinthedistrict.heFedeRichardFisher,presidentandCEOoftheFederalReserveBankofDallas,spokeandwroteextensivelyonthefinancialcrisisin2008,connectingthedotsforhisaudiences.Hediscussedthefactorsthatcontributedtothecrisisandthecreditcrunch.HeexplainedtheFederalReserve'sresponsetothesituationandtheneedforregulatoryreform.2008AnnualReport•CONNECTINGTHEDOTS5SomeCausesoftheCrisisSpeculationonHousingTherootsofthecurrentcrisis[are]likethoseofearlierbubbles.Theyoriginatedintheseductivepowerofpriceescalation...andtheegocentricityofthepresent,whichledsometobelievewehadenteredanewera.Weeitherdidn'tnoticethiselaborateconceitorfailedtodealwithit.Butitwasthere.ManycoastalareasoftheU.S.werebeginningtosee20to30percentyear-over-yearincreasesinhouseprices,someevenashighas30to40percent.Subprimemortgageborrowing,orlendingtolesscredit-worthyindividualsbylenderswhowereeagertofinancea"surething,"exploded.April9speechToagreatextent,thebubbleinhousingwasaclassiccaseofthebigger-fooltheoryandefficient-markettheoryrunamok.April9speechMarketInefficiencyJudgmentandexperience,includingourownvividexperiencehereinTexasin1980s,teachusthatinboomsandbubbles,pricesovershootandduringbusts,theyovercorrect.April9speechThemarketsincommodities,likethoseofstocksandbonds,aremanic-depressivemechanismsandovershootontheupsideaswellasonthedownside.Onecouldreasonablydeducefromrecentpricereversalsinoilandfoodpricesthattheyovershotontheupsideandthattheirpricerun-upwasone-offdevelopment.Ifyousubscribetothisargument,youenvisionaprocessnotunlikethatofapythondigestingdinner:Itvisiblymovesthroughthesystem,creatingsomemomentsofdiscomfortinthistemporaryinflationarybulge-butisprocessedinreasonabletimeanddonewith.Iamfirminmyviewthatfinancialmarketsremainpronetoriskovershooting,andweseeanelevatedlevelofriskaversionwhentheinevitablecorrectioncomes.Thatiswhathappenedinthesummerof2007,whenwillingnesstotakeonriskseemedtodryupovernight,leadingtosignificantliquiditysqueezesandfundingpressuresatbanksandothercreditors.November/DecemberSouthwestEconomyRapidInnovation:TooFarTooFastWesawaweaveofinnovativemortgageproductsduringthehousingboom.Indeed,therewouldhavebeennowayformanyborrowerstoprocurefinancingwithoutthesenewmortgageproducts.Theseinnovationsinfinancingtooktwoforms.First,credit-scoringmodelsenabledlenderstobettersortandpricemortgagesmadetononprimeborrowers.Thesecondsetofinnovationsallowedtheseloanstobefundedandsoldtonewclassofinvestors.Whiletraditionalmortgageshadlongbeensecuritizedandsoldthroughgovernment-sponsoredenterprisessuchasFannieMaeandFreddieMac,thesecuritizationmarketusheredinnewplayersfromtheprivatesectorthatwouldholdnonprimemortgagesthatcouldnotmeetthestandardsofFannieandFreddieandthatbankswouldgenerallynotholdinportfolio.Newandcomplexsecuritiesslicedanddicedriskintodifferenttranches.Itwasthoughtthatthecollateralizeddebtobligationsandcollateralizedloanobligationscouldbehedgedwithcreditdefaultswapstomakethemappearrisk-free.April9speechWiththeaidoftechnologyandcomputationalpowerthatcanassessprobabilitiesatlightningspeeds,theriskinstrumentsdramaticallyexpanded.Financialintermediariesbeganofferingexoticproducts,statisfyingrisk-takersanywhereintheworld,anytime.April9speechMosteveryoneagreedthatriskappetites-fedbyinnovationsinwaystomeasure,calibrate,repackageandsellrisk-becameexcessiveduringtheboomyears.Theseinnovations-otherwiseknownassecuritizationandtheoriginate-to-distributemodelofbanking-arenew,buttheyhadnewuncharteddimensionsinthisdecade.StructuredcreditproductsbecamealltherageandgaveusanalphabetsoupoffamiliaracronymslikeABS,CDS,CLOandCMO.Newinstrumentsallowedfinancierstosliceanddiceriskassociatedwithmortgagesandothercredits,spreadingitaroundtopartiesmostwillingtoholdit.Inretrospect,theyrisk-compoundedfinancialsystem.November/DecemberSouthwestEconomy...