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The Economic Situation and Outlook

Statement

by

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before the

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Chairman Schumer, Vice Chairman Maloney, Representative Saxton, and other members of the Committee, thank you for inviting me here this morning to present an update on the economic situation and outlook.

Developments in Financial Markets

Since I last appeared before this Committee in March, the U.S. economy has performed reasonably well. On preliminary estimates, real gross domestic product (GDP) grew at an average pace of nearly 4 percent over the second and third quarters despite the ongoing correction in the housing market. Core inflation has improved modestly, although recent increases in energy prices will likely lead overall inflation to rise for a time.

However, the economic outlook has been importantly affected by recent developments in financial markets, which have come under significant pressure in the past few months. The financial turmoil was triggered by investor concerns about the credit quality of mortgages, especially subprime mortgages with adjustable interest rates. The continuing increase in the rate of serious delinquencies for such mortgages reflects in part a decline in underwriting standards in recent years as well as softening house prices. Delinquencies on these mortgages are likely to rise further in coming quarters as a sizable number of recent-vintage subprime loans experience their first interest rate resets. I will have more to say about this problem and its implications for homeowners later in my testimony.

At one time, most mortgages were originated and held by depository institutions. Today, however, mortgages are commonly bundled together into mortgage-backed securities or structured credit products, rated by credit-rating agencies, and then sold to investors. As mortgage losses have mounted, investors have questioned the reliability of credit ratings, especially those of structured products. Because many investors had not developed the capacity

to perform independent evaluations of these often-complex instruments, the loss of confidence in the credit ratings, together with uncertainty about developments in the housing market, led to a sharp decline in demand for these products. Since July, few securities backed by subprime mortgages have been issued.

Although the problems with subprime mortgages initiated the financial turmoil, credit concerns quickly spilled over into a number of other areas. Importantly, the secondary market for securities backed by prime jumbo mortgages also contracted, and the issuance of such securities has declined significantly. Prime jumbo loans are still being made to prospective home purchasers, but they are at higher spreads and have more-restrictive terms. Concerns about mortgage-backed securities and structured credit products (even those unrelated to mortgages) also greatly reduced investor appetite for asset-backed commercial paper, although that market has improved somewhat recently. In the area of business credit, investors shied away from financing leveraged buyouts and from purchasing speculative-grade corporate bonds. And some larger banks, concerned about potentially large and difficult-to-predict draws on their liquidity and balance sheet capacity, became less willing to provide funding to their customers or to each other.

To be sure, the recent developments may well lead to a healthier financial system in the medium to long term: Increased investor scrutiny of structured credit products is likely to lead ultimately to greater transparency in these products and to better differentiation among assets of varying quality. Investors have also become more cautious and are demanding greater compensation for bearing risk. In the short term, however, these events do imply a greater measure of financial restraint on economic growth as credit becomes more expensive and difficult to obtain.

Federal Reserve Policy Actions

At the height of the recent financial turmoil, the Federal Reserve took a number of steps to help markets return to more orderly functioning. The Fed increased liquidity in short-term money markets in early August through larger-than-normal open market operations. And on August 17, the Federal Reserve Board cut the discount rate--the rate at which it lends directly to banks--50 basis points, or 1/2 percentage point, and subsequently took several additional measures. These efforts to provide liquidity appear to have been helpful on the whole, but the functioning of a number of important markets remained impaired.

The turmoil in financial markets significantly affected the Federal Reserve's outlook for the broader economy. Indeed, in a statement issued simultaneously with the Board's August 17 announcement of the cut in the discount rate, the Federal Open Market Committee (FOMC) noted that the downside risks to economic growth had increased appreciably.

The Committee took further action at its next scheduled meeting, on September 18, when it cut its target for the federal funds rate 50 basis points. This action was intended as a counterbalance to the tightening of credit conditions and to address in a preemptive fashion some of the risks that financial developments posed to the broader economy.

The Committee met most recently on October 30-31. The data reviewed at that meeting suggested that growth in the third quarter had been solid--at a 3.9 percent rate, according to the initial estimate by the Bureau of Economic Analysis. Residential construction declined sharply during the quarter, as expected, subtracting about 1 percentage point from overall growth. However, the GDP report provided scant evidence of spillovers from housing to other components of final demand: Strong growth in consumer spending was supported by gains in employment and income, and businesses increased their capital spending at a solid pace. A

strong global economy stimulated foreign demand for U.S.-produced goods and services, as foreign trade contributed nearly 1 percentage point to the growth of real output last quarter.

Looking forward, however, the Committee did not see the recent growth performance as likely to be sustained in the near term. Financial conditions had improved somewhat after the September FOMC action, but the market for nonconforming mortgages remained significantly impaired, and survey information suggested that banks had tightened terms and standards for a range of credit products over recent months. In part because of the reduced availability of mortgage credit, the contraction in housing-related activity seemed likely to intensify. Indicators of overall consumer sentiment suggested that household spending would grow more slowly, a reading consistent with the expected effects of higher energy prices, tighter credit, and continuing weakness in housing. Most businesses appeared to enjoy relatively good access to credit, but heightened uncertainty about economic prospects could lead business spending to decelerate as well. Overall, the Committee expected that the growth of economic activity would slow noticeably in the fourth quarter from its third-quarter rate. Growth was seen as remaining sluggish during the first part of next year, then strengthening as the effects of tighter credit and the housing correction began to wane.

The Committee also saw downside risks to this projection: One such risk was that financial market conditions would fail to improve or even worsen, causing credit conditions to become even more restrictive than expected. Another risk was that, in light of the problems in mortgage markets and the large inventories of unsold homes, house prices might weaken more than expected, which could further reduce consumers' willingness to spend and increase investors' concerns about mortgage credit.

The Committee projected overall and core inflation to be in a range consistent with price stability next year. Supporting this view were modest improvements in core inflation over the course of the year, inflation expectations that appeared reasonably well anchored, and futures quotes suggesting that investors saw food and energy prices coming off their recent peaks next year. But the inflation outlook was also seen as subject to important upside risks. In particular, prices of crude oil and other commodities had increased sharply in recent weeks, and the foreign exchange value of the dollar had weakened. These factors were likely to increase overall inflation in the short run and, should inflation expectations become unmoored, had the potential to boost inflation in the longer run as well.

Weighing its projections for growth and inflation, as well as the risks to those projections, the FOMC on October 31 reduced its target for the federal funds rate an additional 25 basis points, to 4-1/2 percent. In the Committee's judgment, the cumulative easing of policy over the past two months should help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and promote moderate growth over time. Nonetheless, the Committee recognized that risks remained to both of its statutory objectives of maximum employment and price stability. All told, it was the judgment of the FOMC that, after its action on October 31, the stance of monetary policy roughly balanced the upside risks to inflation and the downside risks to growth.

In the days since the October FOMC meeting, the few data releases that have become available have continued to suggest that the overall economy remained resilient in recent months. However, financial market volatility and strains have persisted. Incoming information on the performance of mortgage-related assets has intensified investors' concerns about credit market developments and the implications of the downturn in the housing market for economic growth.

In addition, further sharp increases in crude oil prices have put renewed upward pressure on inflation and may impose further restraint on economic activity. The FOMC will continue to carefully assess the implications for the outlook of the incoming economic data and financial market developments and will act as needed to foster price stability and sustainable economic growth.

Helping Distressed Subprime Borrowers

I would like to say a few words about actions being taken to help homeowners who have fallen behind on their mortgage payments or seem likely to do so. As I mentioned, delinquencies will probably rise further for borrowers who have a subprime mortgage with an adjustable interest rate, as many of these mortgages will soon see their rates reset at significantly higher levels. Indeed, on average from now until the end of next year, nearly 450,000 subprime mortgages per quarter are scheduled to undergo their first interest rate reset. Relative to past years, avoiding the payment shock of an interest rate reset by refinancing the mortgage will be much more difficult, as home prices have flattened out or declined, thereby reducing homeowners' equity, and lending terms have tightened. Should the rate of foreclosure rise proportionately, communities as well as individual borrowers would be hurt because concentrations of foreclosures tend to reduce property values in surrounding areas. A sharp increase in foreclosed properties for sale could also weaken the already struggling housing market and thus, potentially, the broader economy.

Home losses through foreclosure can be reduced if financial institutions work with borrowers who are having difficulty meeting their mortgage payment obligations. In recent months, the Federal Reserve and other banking agencies have issued statements calling on

mortgage lenders and mortgage servicers to pursue prudent loan workouts.¹ Our contacts with the mortgage industry suggest that servicers recently have stepped up their efforts to work with borrowers facing financial difficulties or an imminent rate reset. Some servicers have been proactive about contacting borrowers who have missed payments or face resets, as experience shows that addressing the problem early increases the odds of a successful outcome. Foreclosure cannot always be avoided, but in many cases loss-mitigation techniques that preserve homeownership are less costly than foreclosure. To help keep borrowers in their homes, servicers have been offering assistance with repayment plans, temporary forbearance, and loan modifications. Comprehensive data on the success of these efforts to avert foreclosures are not available, but my sense is that there is scope for servicers to further increase their loss-mitigation efforts. The development of standardized approaches to workouts and the sharing of best practices can help increase the scale of the effort, even if, ultimately, workouts must be undertaken loan by loan. Although workouts are to be encouraged, regulators must be alert to ensure that they are done in ways that protect consumers' interests and do not disguise lenders' losses or impair safety and soundness.

The Federal Reserve has been participating in efforts by community groups to help homeowners avoid foreclosure. For example, Governor Kroszner of the Federal Reserve Board serves as a director of NeighborWorks America, a nonprofit organization that has been helping thousands of borrowers facing current or potential distress to obtain assistance from their lenders, their servicers, or trusted counselors through a hotline. The Federal Reserve Board's staff has been working with consumer and community affairs groups throughout the Federal Reserve

¹ Board of Governors of the Federal Reserve System (2007), "Working with Mortgage Borrowers," Division of Banking Supervision and Regulation, Supervision and Regulation Letter SR 07-6 (April 17); and "Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages," Supervision and Regulation Letter SR 07-16 (September 5).

System to help identify localities that are most at risk of high foreclosures, with the intent to help local groups better focus their outreach efforts to borrowers. Other contributions include foreclosure prevention programs, such as the Home Ownership Preservation Initiative, which the Federal Reserve Bank of Chicago helped to initiate, and efforts by Reserve Banks to convene workshops for stakeholders to develop community-based solutions to mortgage delinquencies in their areas. The Federal Reserve System is also engaged in research and analysis that should help inform policy responses to these issues.

The Congress is also focused on reducing homeowners' risk of foreclosure. One statutory change that could help is the modernization of programs administered by the Federal Housing Administration (FHA). The FHA has considerable experience helping low- and moderate-income households obtain home financing, but it has lost market share in recent years, partly because borrowers have moved toward nontraditional products with more-flexible and quicker underwriting and processing and partly because of a cap on the maximum loan value that can be insured. In modernizing the FHA, the Congress might encourage joint efforts with the private sector that expedite the refinancing of subprime loans held by creditworthy borrowers facing resets. It might also consider granting the agency the flexibility to design products that improve affordability through such features as variable maturities or shared appreciation. Also, the FHA could provide more refinancing options for riskier households if it could tailor the premiums it charges for mortgage insurance to the risk profile of the borrower.

As I have discussed in earlier testimony, the Federal Reserve is taking steps to avoid subprime lending problems from recurring while preserving responsible subprime lending. In coordination with other federal supervisory agencies and the Conference of State Banking Supervisors (CSBS), we have issued principles-based underwriting guidance on subprime

mortgages to help ensure that borrowers obtain loans that they can afford to repay and have the opportunity to refinance without prepayment penalty for a reasonable period before the first interest rate reset. In addition, together with the Office of Thrift Supervision, the Federal Trade Commission, the CSBS, and the American Association of Residential Mortgage Regulators, we have launched a pilot program aimed at strengthening reviews of consumer protection compliance at selected nondepository lenders with significant subprime mortgage operations.

Finally, using the authority granted us by the Congress under the Home Ownership and Equity Protection Act, we are on schedule to propose rules by the end of this year to address unfair or deceptive mortgage lending practices. These rules would apply to subprime loans offered by any mortgage lender. We are looking closely at practices such as prepayment penalties, failure to escrow for taxes and insurance, stated-income and low-documentation lending, and failure to give adequate consideration to a borrower's ability to repay. Using our authority under the Truth in Lending Act (TILA), we expect that we will soon propose rules to curtail abuses in mortgage advertising and to ensure that consumers receive mortgage disclosures at a time when the information is likely to be the most useful to them. We are also engaged in a rigorous, broader review of the TILA rules for mortgage loans, which will make use of extensive consumer testing of disclosures.

Thank you. I would be pleased to answer your questions.