

## Navigating Around Financial Turbulence

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Thank you. I appreciate Bill Ford's invitation to speak here. As you know, Bill is former president of the Federal Reserve Bank of Atlanta, and his invitation was one of the first things to hit my desk when I arrived in March. I accepted without hesitation. I owe Bill because he gave me my first flying lesson. Let me explain.

I'm now a little over six months into my stint as president of the Atlanta Fed. I lived in Atlanta from 1978 to 1988 while heading up Citicorp's Southeast corporate banking activities. I first met Bill about 25 years ago when he invited me to a one-on-one lunch. I remember boning up on all my "Ms" (M-1, M-2, M-3) and on the role of Reserve Bank presidents.

Toward the end of our lunch I asked, "What's it like to formulate monetary policy?" He thought for a moment and gave me a playful response. He said formulating monetary policy is like flying an airplane in low visibility conditions and choppy air. As the pilot, many times you see clouds and not much else. So you rely on your instruments, which are like economic data. The difficulty is half of the readings may be off, and you don't know

which half at any given time.

This is a great metaphor. I'm sure all of you nonpilots—like me—have looked into a cockpit and wondered, what on earth are all those instruments? In setting economic policy we rely on a lot of readings of the status and direction of the national economy. The instruments in our cockpit include economic data, anecdotes and opinion from contacts, economic models, and commercial economic forecasts.

As I mentioned, I started in Bill's old job in March of this year. Lucky for me, during my first few months, flying conditions seemed pretty calm and visibility was good. Then, during the summer, conditions in financial markets became turbulent. The markets—particularly the debt capital markets made up of so-called structured securities backed by residential mortgage assets—became extremely volatile. Markets seized up. Trading plummeted or in some cases stopped. Credit spreads widened. Lenders and traders became wary of counterparties. Investors became suspicious of ratings. None of this is news to anyone here.

A major concern of Fed policymakers has been the effect of the financial turbulence on the broad economy. Connecting these dots is challenging. In a fluid and fast-moving situation we have very little timely macroeconomic data to indicate actual linkages in the current circumstances between the financial markets and the general economy.

Since your conference theme is the economic outlook, I expect many of you want to hear my views on prospects for the U.S. economy. I will try to satisfy you—at least partially—on that score. But I'd also like to discuss the Atlanta Fed's process for gathering information on the economy and coming up with a recommendation on Fed policy as well as recent actions on the Federal Open Market Committee (FOMC).

Let me begin by taking you back in time to the week before the Sept. 18 FOMC meeting. At that point, I had not yet arrived at a decision on my policy recommendation. Our Atlanta Fed economic team and I were in the midst of a briefing and many points of view were expressed. Given the speed of developments, I was trying to keep an open mind as long as possible as we approached the meeting.

### Reconciling different viewpoints

Among our 22 Ph.D. economists at the Atlanta Fed, we have a team of regional economists and analysts. They track regional data and interact with a variety of sources including directors and industry contacts. By these methods they seek detailed knowledge of economic developments in our region. Their composite of the Southeast is doubly valuable to me as an FOMC participant because our region is a reasonable proxy for the nation as a whole.

My responsibility at the FOMC is to contribute to national policy formulation. I am not there to represent the interests of the Southeast—rather to extrapolate from the situation in this part of the country to the national picture. This means I challenge our economists to meet the test of national relevance.

The regional team looks at statewide data across the six states of the Sixth Federal District. Our focus, however, is not governed by political boundaries. So we try to get a picture of what's going on in major economic areas such as south Florida, the Gulf Coast, metro Atlanta, and middle Tennessee.

When we look at the economy in the Murfreesboro area—Nashville, Murfreesboro, and Davidson County—we see a healthy diversification, with a similar broad industry representation as the United States as a whole. One exception, however, is this region's relatively high concentration in auto-related manufacturing. Recent job cuts in that sector have contributed to a slowdown in employment growth this year.

Also, this local area has not been immune to the weakness in the national housing sector. Home construction, as measured by permit issuance, is down by about 10 percent through July of this year. Notably, however, this decline has been mild compared with the nation as a whole, which has seen permits fall by some 28 percent so far this year.

Along with our regional team, we have a macroeconomics team and a financial markets team. Within the macroeconomics team we have substantial econometric modeling capability. In my view, forecasts from models are helpful inputs to our thinking, especially with regard to the major forces at work in the economy, but are not final and definitive answers.

As we prepared for the September FOMC meeting, the models were also anticipating weakness in the outlook for the real, or nonfinancial, side of the economy. Our models are based mostly on data from different indicators of the economy such as housing market activity and employment. But our models did not formally incorporate the impact of

the financial market turbulence on the outlook. The backflow from the financial economy to the real economy was not built into the mathematical equations.

For that reason I also sought the input from my team of financial markets economists. They described to me the increasing concern with the valuation of claims on subprime mortgages. The problems began to emerge in July, when rating agencies downgraded or put on watch a wave of bonds backed by subprime mortgages. These downgrades were, if anything, overdue. Questions about subprime mortgage valuation sparked a wider reassessment of many financial structures.

Conditions of illiquidity, volatile pricing, weak trading turnover, and very limited new issuance spread from the subprime residential mortgage-backed securities market, to the asset-backed commercial paper market, to the high-yield corporate market, to the London Interbank Offered Rate, or LIBOR, market in Europe, and so on. Financial markets around the world underwent a massive recalibration of relative risk, asset pricing, and investor staying power. In the wake of problems at several European banks, the European Central Bank on August 9 responded with an injection of 65 billion euros.

Equity markets have not been immune from volatility conditions. One of the indices we follow is the "stock investors' fear index." This is a colorful name for a measure of implied volatility in S&P 500 and NASDAQ 100 call options. Stock investors' fear spiked in late July/early August, rising from a relatively low and declining trend line beginning in 2003.

Simply stated, our financial economists described markets trying to cope with a shortage of information and a collapse of confidence. As I framed my thinking for the last FOMC meeting, I tried to discern whether and how these sharp adjustments in the credit markets would affect the broader economy.

To gain a better sense of the economy during these uncertain times of conflicting data, I've also been listening closely to anecdotal information. Before FOMC meetings, I meet with our directors. This diverse group represents a range of industries in the Southeast, many with national or international reach.

Sometimes, their views are expressed in colorful or pithy ways. For example, at our September meeting, one director said, "Some big investors have jumped in a mud puddle, and it has splashed on the rest of us."

Another director said, of the current financial turmoil, "When you swim in the ocean, you don't know who's naked 'til the tide goes out."

Other reports were more matter of fact. For instance, one of our directors described a weakening trend in his consumer business this year while another noted the current strength of his export business.

Taken together, the reports from the Atlanta Fed's 44 directors helped me connect the financial picture and general economic outlook.

#### **The economic situation**

Given the mix of data, forecasts, and anecdotes, I went to the FOMC meeting with a picture of an economy that had significant risk of being weakened by recent financial market turbulence. As you recall, the Fed decided Sept. 18 to lower its fed funds target rate 50 basis points to 4.75 percent. The fed funds rate is the interest rate at which domestic depository institutions lend to one another overnight—sometimes longer—and is our primary tool for influencing the overall economy. The Fed's decision to cut this rate was explained in this statement:

"Economic growth was moderate during the first half of the year, but the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally. Today's action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time." The main point, in my view, was our focus on the total economy.

In a related action, the Federal Reserve Board of Governors also approved a 50 basis point cut in the discount rate to 5.25 percent. The discount rate is the rate at which depository institutions can borrow directly from the Fed. By lowering the discount rate by the same extent as the fed funds rate, the Fed kept the premium that institutions must pay for access to the discount window at 50 basis points.

Earlier, on Aug. 17, the premium for the discount window was cut from 100 to 50 basis points in an effort to help improve the flow of liquidity in financial markets. The purpose of this policy action was to make sure that liquidity was available to banks as needed.

Moving forward, I will be looking carefully at risk factors that could affect my outlook for the economy.

One risk factor is housing. Given the large inventory of unsold homes in many markets and current restraints on certain types of mortgage financing, I believe the bottom of the housing downturn could be a ways off—potentially the second half of 2008 or later. I will be looking closely at incoming data for signs of a turning point in the housing cycle.

I'm also closely following consumer spending, which accounts for about two-thirds of gross domestic product. With the persistence of the housing downturn it seems likely that there has been some drag on consumer spending. If the housing downturn intensifies, I believe consumer spending is vulnerable to further weakening related to slower home equity extraction and reduction in overall household wealth.

Business investment is another area I'm monitoring. At present, however, troubles in credit markets do not appear to have restricted nonfinancial businesses' access to credit. But I'm listening to business contacts for indications they are getting more cautious with spending and hiring plans.

Finally, the Fed is always monitoring inflation, looking for signs of changes in the longer-term inflation trend. Over the longer term, inflation is influenced by what you, the public, believe is central bank's commitment to low inflation and consequently your expectations for inflation over time.

The Fed's long-term strategic intent shapes public expectations. In turn, these expectations influence the myriad actions of consumers, businesses, and institutions that amount to the real-world execution of the strategic direction. Currently, I believe long-term inflation expectations remain anchored, and measures of current inflation have decelerated during the year from elevated levels in 2006.

Monetary policy involves the apportioning, or balancing, of emphasis. Going into the Sept. 18 FOMC meeting, my opinion was that the balance of risks to the economy had shifted from higher inflation toward slower real growth. I believed, and still do, that the factor weighing most heavily on this change in the outlook has been the potential

negative ramifications of the financial turmoil.

Since the Fed intervened through open market operations and lowering the discount rate in August, conditions appear to have improved to some degree. For the past two weeks, stress in the asset-backed commercial paper market has shown signs of subsiding. For instance, asset-backed commercial paper spreads to LIBOR are less than half what they were two weeks ago.

I've seen a number of credit cycles over the years. And looking ahead, I expect that many of the practices that shaped the market have had their run. I'm referring not only to aggressive retail practices such as no-document loans but also to the layers of leverage and opaque structures employed by multibillion-dollar investment funds at the wholesale level. In my view, a reversion to the high-leverage status quo of a few months ago is unlikely.

In the coming months I expect the financial markets to find their balance. Time has a healing quality, and I believe the healing process will be supported by further disclosure, more rigorous risk evaluation, and a more deleveraged financial reality. Of course, more financial volatility is possible, so I'll be watching this area closely.

#### **Answering our critics**

When policymakers make a judgment call, you can be sure there will be criticism from quarters that see things differently.

After the Fed's action to reduce the federal funds rate on Sept. 18, there was questioning of the decision on two fronts: "moral hazard" and concern about the inflationary consequences of this action.

First, let me comment on moral hazard. Simply stated, moral hazard refers to the tendency for protective measures—insurance for example—to affect a party's behavior toward risk. In the Fed's case, some have asserted that central bank intervention in markets encourages excessive risk taking. Time doesn't permit a full discussion of moral hazard, but I would like to touch on one important point about recent Fed actions.

Federal Reserve purposes are financial stability, price stability, long-run economic growth, and maximum employment. On Sept. 18, I considered the financial turbulence of recent weeks in the context of signs the overall economy had the potential to weaken. I did not see the logic of subordinating the general welfare of our nation's economy to the possibility that some participants in financial markets might draw tainted conclusions about the future landscape of risk. My view is that fulfilling the Fed's institutional purposes takes precedence.

As I said, one of those purposes is price stability. While inflation is currently at the upper bounds of my comfort zone, the Fed has made progress against it. That's why I believe the recent moderation of inflation readings allowed a tactical move to reduce risks to the general economy with a fed funds rate cut.

#### **Closing**

In closing, I want to emphasize that the FOMC actions last week were made after careful consideration of conflicting data and anecdotal reports that suggested a more uncertain economic situation.

Twenty-five years ago Bill Ford equipped me with a useful metaphor of flying an airplane in low visibility as a way to think about my current responsibilities. Will the aircraft glide in for a soft landing? In my opinion, the answer is yes. I believe the current Fed policy abets a flight path of lower but still positive growth with moderate inflation. More turbulence may be ahead. So keep your seatbelts fastened.

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