SPEECHES

## Current Economic Situation, Outlook, and Recent Actions

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I'm delighted to be in Chattanooga today as your speaker. As you know, things have been quite busy lately at the Federal Reserve. There's a lot I could talk about this afternoon, but I'd like to focus on what I believe is top of mind for the members of your distinguished group.

During my remarks, I'd like to talk about the economy, recent Fed actions, and the economic outlook. I'll close with a few thoughts on guiding fundamentals for policy in these challenging economic times. My views are mine alone and not necessarily those of my colleagues on the Federal Open Market Committee (FOMC).

In the past few weeks, many have asked if the economy is in recession. We don't yet have enough evidence to answer according to the technical definition by the National Bureau of Economic Research, which is charged with making that determination by looking at a host of economic indicators. Also, we have not yet recorded two straight quarters (or even one) of real contraction (negative gross domestic product growth), which is the popular definition of recession. In fact, the most recent quarter remained positive.

That said, it's clear the economy is in a slowdown that resembles past periods that were the leading edge of a recession. Economic growth has been slowing since the third quarter of last year coming off solid growth rates in the second and third quarters of 2007. Following a sluggish fourth quarter, I expect that GDP for the first quarter of this year will show little, if any, growth.

Also, personal income growth has been flat, and there has been significant softening of employment, manufacturing activity, and sales at the retail and wholesale levels. Indeed, some areas such as employment actually have been contracting. Job growth in recent months was negative, and the unemployment rate has moved up to 4.8 percent, compared with 4.5 percent last summer.

It's possible—given certain strengths such as strong business balance sheets and export growth—that the economy will not pass the threshold into a technical recession. In considering the current economic situation, I believe that an important policy objective at this juncture is to ensure that this slowdown is short and shallow.

A critical factor—possibly the critical factor—in the determination of the length and depth of the current slowdown is the performance of the housing sector.

Nationally, house prices declined by 10.7 percent from January 2008 compared with a year earlier, according to the most recent S&P Case-Schiller home composite price index evaluating 20 major metropolitan areas. Of course, local results may differ. Chattanooga area home prices, for instance, last year were still rising—but at a slower rate. On average across the country, though, home prices have declined, in some markets substantially.

The number of housing starts and new home sales has fallen and are at less than half their respective peaks. Unfortunately, cutbacks in construction have made only a small dent in builders' elevated supply of unsold new homes—now at around 10 months' supply at the current pace of sales and up from the average for the past decade of around four months.

Housing weakness has weighed on growth in other sectors. For instance, the retail segment of the commercial real estate sector has weakened, according to anecdotal information. As we know, retail development tends to follow rooftops.

Also, problems with subprime mortgages have led to tighter credit conditions that have restricted mortgage financing, placing further downward pressure on housing activity.

With regard to financial conditions more broadly, markets have not yet stabilized. Although financial instability originated in the residential mortgage-backed securities market, it has spread to affect a variety of credit markets via market linkages or institutional interdependencies. The experience has been traumatic, at times generating primal emotions. Market volatility has been driven by fear, distrust, and flight to safety. I emphasize this point because financial system stability is a central focus of Fed policy at the moment.

At the same time, inflation has become a more prominent concern. Price pressures have been most obvious in energy and commodities, including commodities in the food chain. High and rising inflation—if allowed to persist—can distort household and business behavior.

Both headline and core inflation measures have been elevated in recent months and above a level I would consider in the long run to be consistent with an objective of price stability.

Even when inflation abates, shifts in relative prices of goods such as increases in energy costs—if sustained—can cause painful dislocations that force households to adjust living patterns and companies to change their practices and even business models.

### Fed actions

Today, the U.S. economy faces challenges on three fronts: one, weakening growth; two, unstable financial markets; and three, elevated inflation and heightened uncertainty about the inflation outlook.

To address these issues, the Fed has two basic sets of tools. At the macroeconomic level there is traditional monetary policy, and at the level of specific financial markets there are various liquidity measures.

Changing the federal funds rate target, which is the main monetary policy tool, supports macroeconomic goals—sustainable economic growth and stable prices. This tool changes the overnight interbank price for money.

In recent months the Fed has repeatedly lowered the fed funds rate, which was 5.25 percent last September. At our most recent meeting March 18, the Fed cut the federal funds rate target by 75 basis points to 2.25 percent. This action was taken in response to the weakening outlook caused by tightening credit conditions and the deepening of the housing contraction.

Changes in the federal funds rate can influence but not dictate other interest rates in credit markets. There is not a one-to-one correspondence between changes in the fed funds rate and longer-term interest rates for borrower classes critical to the economy. For instance, while the fed funds rate has declined 300 basis points in the past seven months, the rate for conventional 30-year mortgages has declined about 65 basis points, and the yield on AAA corporate bonds has declined only 41 basis points.

In addition, the ability of reductions in the federal funds rate to address liquidity strains in credit markets has proven to be limited.

A continuation of these liquidity strains presents a serious potential risk to the financial system. As a result, the Fed in recent months has undertaken additional steps to directly improve liquidity conditions in key credit markets.

Federal funds rate changes determine the size of the Fed's balance sheet—the foundation of the money supply. The Fed's liquidity tools work primarily by changing the composition of the asset side of the Fed's balance sheet. For example, by temporarily exchanging some currently illiquid assets for other more liquid assets, the central bank can mitigate some of the pressures that have prevented credit markets from functioning smoothly.

A listing of recent liquidity actions can sound like an alphabet soup—the TAF, or Term Auction Facility, announced December 12; the TSLF, or Term Securities Lending Facility, announced on March 11; and most recently, the PDCF, or Primary Dealer Credit Facility, announced March 16 to allow certain nonbank financial institutions to borrow from the Fed.

Each of these measures are simply extensions of the traditional tools of the Fed—the discount window and open market operations. Collectively, the four major liquidity-oriented programs had the following elements—a lengthening of term of lending, broader types of collateral, a wider set of counterparties, and a lower premium for the primary credit rate, which is the rate at which the Fed lends directly to banks through the discount window.

These Fed liquidity actions can be likened to a surgeon's instruments—designed to get at precisely the problem at hand—and no more.

Also, the Fed's liquidity actions can be viewed as a complement to monetary policy, a point that was made in the FOMC's statement following its March 18 meeting: "Today's policy action, combined with those taken earlier, including measures to foster market liquidity, should help to promote moderate growth over time and to mitigate the risks to economic activity."

A week ago Sunday, the acquisition of Bear Stearns by JPMorgan Chase was announced. Earlier this week, the deal was changed from the original $2 per share to $10 per share, and certain specifics were adjusted. To facilitate this transaction, the New York Fed—through a limited liability company formed for this purpose—will take control of a portfolio of assets valued at $30 billion as of March 14. JPMorgan Chase will bear the first $1 billion of any realized losses in this portfolio, and any gains will accrue to the New York Fed. The arrangement was undertaken with the support of the U.S. Treasury.

This action was taken to bolster market liquidity and promote orderly functioning of short-term funding and credit risk markets.

As I said earlier, financial stability must be a central concern at this time. The Fed has taken strong measures to avoid potential damage to the broad economy.

**Outlook**

Looking ahead, my forecast has been affected both by an economic slowdown that has been sharper than I had expected and the recurring spells of financial market turmoil. A few months ago our forecast at the Atlanta Fed saw growth slow in the first half of 2008, then pick up in the second half of the year. But it now appears to me that the contraction in housing and the dampening effects of financial turmoil on household and business spending could persist through the remainder of this year. The recovery in growth I had expected in the second half of this year may be delayed.

The tax rebates should provide some stimulus in the second and early third quarters of this year. But given the uncertain atmosphere I expect will continue to prevail in May and June, I do not expect full flow through of the rebates into personal consumption expenditures.

I expect it will take much of the rest of the year for house prices to bottom out and financial markets to restore the necessary preconditions of stability—that is, confidence in asset values and confidence in transaction counterparties.

Looking ahead further to 2009, my outlook becomes more optimistic. It will take longer than I earlier expected to return to solid growth, but by the fourth quarter of 2008 the conditions should be in place to support a return to healthy growth next year.

With regard to the inflation outlook, I've learned not to be dismissive of inflation risks in this era of surging global demand for commodities. But my expectations are in accord with the FOMC statement of March 18 that inflation should moderate in coming quarters. This moderation reflects a projected leveling out of energy and other commodity price increases and the impact of generally weaker demand conditions in the economy. In any event, it will be necessary to continue to monitor inflation developments carefully.

**Guiding fundamentals**

As I said earlier, the U.S. economy faces challenges on three fronts: growth, inflation, and financial stability. I'd like to close by grounding my remarks in what I believe are some guiding fundamentals appropriate for this challenging period.

Integral to the Fed's dual mandate of maximum sustainable economic growth and stable prices is the goal of financial stability. Orderly markets and the flow of credit to businesses and households are necessary for the sustained prosperity of all sectors of the economy—not just Wall Street. My view of recent Fed interventions is that they are an attempt to help preserve or restore normal market functioning.

I am aware there are risks inherent in these actions. The line that separates restoring market function from merely redistributing losses and gains is not a bright one. This is the reason that policymakers only rarely and reluctantly intervene in markets.

Also, the distinction between liquidity problems and insolvency is not a trivial one when monetary authorities respond to troubles of market players. The critical evaluation is the systemic risk posed by the failure of an institution.

Some believe the Fed has overreacted. Others have said the central bank has been slow to respond to building problems. And still others have warned that the Fed has crossed lines that define appropriate function.

But from where I stand, Fed actions were taken with a prudent acknowledgement of the unintended consequences that may accompany almost all policy interventions. The actions taken by the Federal Reserve over the past several months were taken in perilous and fast-moving circumstances. Given the likelihood of continued financial and economic uncertainty, the public authorities charged with achieving and maintaining financial stability must preserve the capacity to act decisively in the best interest of the economy as a whole. I believe the Fed has done that. Thank you.

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