

A Working Financial Sector Matters to Us All

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Thanks for inviting me to speak to your distinguished group. Hurricanes Gustav and Ike brought back memories of Katrina and Rita three years ago and reminded onlookers around the country of the courage and resilience of the people of New Orleans in the face of manifold stresses brought by these storms.

Today we're in the midst of very stressed financial markets with the potential of doing serious damage to the broad economy—Main Street in the current jargon—both here in the United States and abroad.

In a few moments, I will talk briefly about the domestic economic outlook. But considering the fluid and fast-moving developments in the financial markets during the last month, I feel some obligation to address the immediate matters that are front of mind for most Americans.

Specifically, I will comment on conditions in the financial markets. I will try to bring some perspective to the complex situation policymakers currently face. And I will try to draw the connections between the financial sector, where these problems currently reside, and the lives of ordinary citizens.

After my remarks, I will be happy to take some of your questions. Let me add that the views I present are mine alone and not necessarily those of my colleagues on the Federal Open Market Committee.

Conditions

Let me begin by trying to summarize the extraordinary situation that has developed this month (extraordinary even in the context of the continuing financial turmoil that began in August 2007 and has persisted for 13 months).

Credit markets remain quite strained. This is particularly the case in interbank markets in the United States and abroad. The interbank markets are a fundamental element of the plumbing of the financial world. Banks with excess balances put them to work by lending to other banks that have clients—companies and individuals—who need the funds.

The loan portfolios of U.S. banks and financial institutions are, as you would expect, mostly dollar-denominated. But foreign banks in recent years have also built sizeable "books of business" in dollars. The dollar interbank credit contraction is a worldwide problem that affects not only our banks here but banks overseas, particularly in Europe.

When banks lend or take on other forms of exposure to each other, they gauge the counterparty risk. In recent weeks, there has been a widespread withdrawal of confidence in counterparties that has resulted in efforts to reduce exposure.

As part of this, maturities have shortened, risk spreads (typically measured as the interest rate spread over U.S. Treasuries) have widened, the cost of hedging against default risk (another measure of perceived counterparty risk) has risen dramatically, and the range of assets accepted as collateral has narrowed. Also, demand for liquidity provided by the Federal Reserve has intensified.

This contraction in availability and rise of the cost of credit have worsened as well for corporate and business borrowers. We've heard anecdotes confirming this from contacts throughout the Southeast. In short, Main Street is being affected.

The balance sheets of many banks and financial institutions continue to be burdened by illiquid, impaired assets that—because they are illiquid—are exceedingly difficult to value. One frequently hears the complaint, "No one knows what this stuff's worth."

Financial institutions worldwide have been trying to deleverage; that is, offload at acceptable prices some of their stock of impaired assets and generally bring down their leverage ratios. This has proven hard, if not impossible, to do. As you know, a high proportion of the troubled assets is made up of mortgage-backed securities whose financial performance—cash flow—is unstable because of the continuing delinquency and foreclosure saga. Uncertainty about what's in a security is compounded by uncertainty about how individual loans will perform. Projections of loan performance are, in turn, affected by an uncertain economic outlook. All of this has driven off almost any buyer interest in these securities.

In recent weeks, an extremely difficult environment in credit markets—both interbank and corporate—has spread to the sphere of money market mutual funds. Problems have been felt mostly in institutional money market funds. Concern about fund exposure to financial institutions whose liquidity is deteriorating has prompted redemptions. News of redemptions has raised worries—and a few actual cases—of money funds "breaking the buck," taking principal losses. Money market funds were never supposed to do that.

In response, earlier this month, the Fed introduced a new liquidity facility called the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF). This facility provides liquidity to markets by extending loans to banking organizations to finance their purchases of high-quality asset-backed commercial paper (ABCP) from money market mutual funds.

September events

Up to this point, measures in response to conditions and developments have been incremental—dealing with problems as they arise one by one. Let me review the key

developments in the month of September:

Sunday, Sept. 7: The U.S. government placed Fannie Mae and Freddie Mac into conservatorship. This action was taken to stabilize housing and mortgage finance markets.

Monday, Sept. 15: Bank of America announced it agreed to buy the investment bank Merrill Lynch. Also, efforts to find a buyer of Lehman Brothers failed. The same day Lehman Brothers announced it was going to declare bankruptcy.

Tuesday, Sept. 16: AIG received an emergency credit line from the Federal Reserve—an action supported by the Treasury—to facilitate an orderly downsizing of the company.

Friday, Sept. 19: The Treasury's rescue plan was first publicly proposed. As you know, the ultimate proposal presented to Congress after extensive deliberations was voted down yesterday in the U.S. House of Representatives.

Also on Sept. 19: As mentioned earlier, the Fed introduced the AMLF.

Monday, Sept. 22: Goldman Sachs and Morgan Stanley—the last two independent investment banks on Wall Street—were approved to convert their status to bank holding companies. This meant that going forward they would be supervised by federal banking regulators, conform to bank leverage ratios, and have access to the Fed discount window.

Friday, Sept. 26: Washington Mutual, a \$300 billion thrift, announced that most of its assets would be acquired by JP Morgan.

Monday, Sept. 29 (yesterday): Wachovia announced that most of its banking assets would be acquired by Citigroup with federal assistance.

These events were the most notable effects of deteriorating trends in credit and financial markets that, if allowed to march on, pose a serious threat to the broad economy. Let me elaborate further on those trends.

Conditions, continued

Equity markets are down significantly for the year, particularly in September.

Bond markets have been under significant stress, with major corporations finding it difficult and expensive to issue debt. New debt issuance was \$15.5 billion in September of this year compared with \$101 billion in September of 2007.

In the so-called cash markets, which are short term and normally very liquid markets, commercial paper issuance has become increasingly difficult for large corporations. Total commercial paper outstanding is down \$244 billion from September 2007 and down \$44 billion the week ending September 24.

These data on credit markets translate to accelerating shrinkage of business credit at all levels, from large corporations to small businesses.

The yield last Thursday on the one-month Treasury bill was 0.1 percent versus 3 percent at the beginning of the year and 1.6 percent at the beginning of September. This drop in yields reflects a broad flight from risk.

In sum, the situation in September has been one of accelerating deterioration of the institutional and market landscape of our financial system.

These conditions are still with us and, as of yesterday, show no signs of relenting.

If they persist, they will surely evoke public policy responses in an effort to restore confidence in financial markets. Confidence will return with improved liquidity, more clarity on the value of troubled assets, and the recapitalization of financial institutions. These are prerequisites of credit expansion in support of growth.

The ultimate aim is to avert serious costs to the total economy and facilitate the process of long-term economic recovery.

Implications for real economy

Let me turn to the question of the outlook for the total economy.

At the root of today's financial turmoil is housing sector weakness. In recent months, housing starts have declined sharply, and inventories of unsold new and existing homes remain high. With oversupply, house prices in most markets have continued to decline. Financial instability has affected house prices by tightening credit to potential home buyers.

Prior to September, we at the Federal Reserve Bank of Atlanta had a rather downbeat outlook for the second half of 2008 and early 2009. We expected—and continue to expect—a very weak second half reflecting contracting consumer spending, weaker business investment, and slower export volume.

Export demand has been an important factor that has helped sustain the U.S. manufacturing sector in recent months. But economic growth prospects in many of our major trading partners have weakened notably in recent months, and this weakening has dampened the outlook for the export sector.

Conditions in labor markets also have weakened. During the first half of 2008 the data showed that residential construction and related manufacturing industries were reducing their workforce while other businesses were hesitant to add to payrolls. But more recently the data suggest that layoffs have become more widespread, and hiring intentions have pulled back further.

Weak labor markets feed into weak income growth and sluggish consumer spending. Reports from retailers suggest that the outlook for the upcoming holiday season has been pared back as consumers are expected to tighten their belts further. At the same time, lending standards for most types of consumer credit have tightened.

Louisiana's economy is somewhat an anomaly in the current environment. Recovery efforts following the 2005 hurricanes mean that job creation continues. It's noteworthy that total employment in the state has recently surpassed pre-Katrina levels, although New Orleans remains a much smaller city than before the storm.

As you may know, the Fed has a dual mandate that deals with growth and inflation.

Though I and my staff take nothing for granted, I feel better about inflation. I believe the weaker economy combined with lower oil and commodity prices would serve to suppress inflationary pressures, especially "headline" or overall inflation.

Overall, the outlook for inflation may have improved, but prospects for growth have weakened. Importantly, I believe problems in our financial system add significant risk to the downside for the economy.

A working financial sector matters to us all. Credit is the lifeblood of a modern economy. Illiquid credit markets mean illiquid banks and ultimately illiquid businesses. I don't need to explain to a room full of businesspeople what happens when credit dries up and a business becomes illiquid. Cash becomes king, efforts are made to accelerate inflows, and cash outlays are reduced. Managers focus on discretionary expenses, and then the biggest categories of cash outflows—salaries and investments. Jobs, and livelihoods, are at stake.

Our modern economy involves linkages that aren't always apparent—including vital connections between the financial sector and businesses and households. In my view, we need to deal with today's problems in the financial sector realistically, pragmatically, and as a national community.

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