

Atlanta's Fate in the Current Financial Crisis

Dennis P. Lockhart
President and Chief Executive Officer
Federal Reserve Bank of Atlanta

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In July of last year, the rating agency Standard & Poor's downgraded certain classes of residential mortgage-backed securities. This event precipitated what was then described as a generalized repricing of risk in the financial system. What followed over the next 13 months was a cascading sequence of worsening conditions and dramatic events that culminated in this September's volley of market developments and policy reactions.

Developments in September included

the placement of Fannie Mae and Freddie Mac into conservatorship,
the acquisition of Merrill Lynch by Bank of America,
the failure of Lehman Brothers,
an \$85 billion emergency loan to AIG,
the sale of WaMu (Washington Mutual) assets to JPMorgan Chase,
the drama around Wachovia that ultimately resulted in acquisition by Wells Fargo,
the conversion of Goldman Sachs and Morgan Stanley to bank holding company status, and
the U.S. Treasury Department proposal of a \$700 billion rescue plan for the banking system. As you know, the Treasury's TARP (Troubled Asset Relief Program), which is part of the Emergency Economic Stabilization Act passed by Congress earlier in October, is being implemented.

The situation has been fast-moving and complex. To make sense of it we can identify four dimensions. First, there is the institutional dimension, the micro level of individual firms—the stress endured by individual banks and companies as they cope with developments in the markets. Second, there is the credit system dimension—the dysfunction of the economy's circulatory system as evidenced by constricted short-term funding markets, bond issuance, and flows of bank credit. Third, there is the investment capital markets dimension. In recent days the world has been fixated on gut-wrenching declines in equity markets. And fourth, there is the general economy dimension—the spillover effect of financial turmoil and constrained credit on the nonfinancial economy.

By any measure, September was historic. The events of September contributed substantially to a fundamental restructuring of this country's financial system. It also brought a transition from an incremental approach, including the Federal Reserve's various measures to provide much-needed liquidity to markets, to a comprehensive attack on the diverse elements of the crisis. In October, the global scope of the problem was acknowledged, and the forceful implementation of globally coordinated action was undertaken by most major central banks.

This forceful response by the Treasury, Congress, the Federal Reserve, and collaborating governments distinguishes today's crisis from past financial crises like those leading to the Great Depression and the "lost decade" of the 1990s in Japan. In these prior episodes, policy responses were neither timely nor strong enough to avert long-lasting problems.

Root causes

Books are already being written to chronicle the root causes of this crisis. By now, many of you are familiar with the story line, but let me lay it out again. Following the 2000–01 recession, chronic global savings imbalances made dollar surpluses a worldwide phenomenon. Interest rates were low for an extended period. These low interest rates combined with active capital markets, freely flowing capital, financial innovation, and a generally optimistic growth outlook encouraged leverage and, in retrospect, the underpricing of risk.

Also, low rates set off pursuit of incremental yield. This need was filled by mortgage-backed securities, more specifically subprime RMBSs (residential mortgage-backed securities), among other assets. All manner of business practices grew from these conditions that now seem quite problematic, at least for some borrowers and investors. For example, adjustable-rate subprime mortgages and complex CDOs (collateralized debt obligations) and CDO squared.

Easy mortgage terms helped fuel the demand for housing in the United States, which contributed to a 47 percent rise in the median existing house price between 2001 and 2006. In retrospect, this was clearly a bubble, a bubble pricked by the downgradings in July of last year.

Financial institutions worldwide were caught holding large inventories of residential mortgage-backed securities and CDOs on and off their balance sheets. Much that was off balance sheet came back on. The value of these assets fell significantly in an environment of light or nonexistent trading. The holders of this paper came under increasing suspicion as regards their liquidity and, in some cases, solvency. Wholesale funding became increasingly difficult to roll over. Widespread and massive deleveraging ensued and continues.

These developments exposed the intricate, interactive, and interdependent connections among institutions, between institutions and markets, and among markets, all global in scope. As I said, the situation is complex, and measures to deal with it have been controversial.

One line of criticism and opposition to recent measures to address the financial crisis has pitted Main Street against the financial industry, referred to as Wall Street. This adversarial perspective is understandable but is in no one's interest as the basis of policy responses to the crisis. Main Street and Wall Street intersect in every city and town, every day. Let me explain how Wall Street and Peachtree Street intersect here in Atlanta.

Atlanta situation

Housing markets have been at the root of today's financial turmoil, and Atlanta's experience is instructive. Each major housing market has its own dynamic. Atlanta did not experience the extreme price bubble seen in some areas; instead, pressures here manifested themselves in overbuilding.

A number of factors drove Atlanta's housing supply run-up. One factor is the lack of natural barriers that limit building. In recent decades, Atlanta has expanded dramatically (some would use the word "sprawled") because of an abundance of low-cost land available for residential development. The result was a single-family new home market that was the strongest in the nation in 2005 with 61,000 single-family housing permits issued in the Atlanta area.

When sales began to slow in 2006, inventories climbed higher. Inventories of single-family homes are now at more than a year's supply at the current pace of sales, according to some sources. With the excess supply of houses, the Atlanta area has been experiencing sharper declines in permits than the nation as a whole.

Both Atlanta and the nation saw permits peak in the fourth quarter of 2005, but Atlanta has experienced an 81 percent decline since that time, compared with a 61 percent decline for the nation as a whole.

Foreclosed properties coming on the market have aggravated the inventory situation. Georgia's nonjudicial foreclosure process turns quickly, contributing to a spike in bank-owned real estate inventories over the last year.

As I said earlier, house price appreciation was more moderate in the Atlanta area than the nation as a whole. Existing home prices in the Atlanta region have fallen more than 8 percent—a not insubstantial number—from their peak in July 2007, according to the S&P/Case-Shiller index of September 30. Existing home prices in major metropolitan statistical areas (MSAs) across the country peaked in July 2006 and since that time have declined almost 20 percent.

In addition to housing, commercial real estate has been a vital part of Atlanta's economy. Amid the housing woes, Atlanta's industrial and commercial vacancy rate held steady through the first quarter of this year but has been drifting upward since then. Construction also has slowed much like the rest of the nation. In the retail sector, many projects in this area have been put on hold or delayed.

The pullback in real estate development activity has added to a decline in overall employment. About 5 percent of all jobs in Atlanta are in residential and commercial construction. The Atlanta area's unemployment rate has risen for the past four months and today is measured slightly above the nation as a whole, where the unemployment rate was 6.1 percent last month.

Atlanta's economic hit has been broad-based. Jobs have been cut in financial services, manufacturing, and other industries. Earlier this year, the run-up of energy costs prompted layoffs at a variety of employers ranging from airlines to car dealerships. Also, because Atlantans travel more vehicle miles per day than any other major metropolitan area, higher energy costs have hit households particularly hard.

Because of job losses and credit issues, consumer spending has been quite weak. As a result, Georgia sales tax collections in 2008 through September fell more than 4 percent from a year earlier. Budget shortfalls have also affected the city of Atlanta and other area governments.

Looking ahead

My economist colleagues at the Atlanta Fed often cite Georgia as a reasonable proxy for the U.S. economy. With Atlanta representing approximately two-thirds of the state economy, we can assume a high correlation between Atlanta's trajectory and national trends.

In addition, Atlanta has earned a reputation over the past three decades as a "world city." Author Joel Kotkin uses this term to describe a city that is highly integrated with the world outside its immediate hinterland. Atlanta is highly connected to the world economy in its role as a transportation and logistics hub, trade entrepôt, headquarters city of global corporations, and provider of financial and business services.

This global status will serve the city well over the long term, but near-term prospects are not as positive. Export growth had been a bright spot in the nation's economy until recently, but forecasts of global growth have been revised downward because of the financial crisis. Growth is likely to decline in developed economies in Europe and Pacific Asia, although the slowdown should be less pronounced in developing countries such as India and China.

Atlanta cannot evade the downturn in national economic and international activity and the fallout of the recent financial crisis. But I believe Atlanta's problems in this period are cyclical, not structural. Atlanta enjoys core strengths and assets that will sustain the city's prosperity. Among these are a world-class airport and logistics infrastructure, higher education infrastructure, growing tourism amenities, and the city's renowned physical beauty and agreeable climate.

Of all metropolitan areas in the country, Atlanta had the nation's largest numerical gain in population from 2001 to 2007. Notably, Atlanta is recognized as a top city for young professionals. Over time, their continuing migration to this area should help ease the problem of excess supply in the housing market and contribute to a strong and vibrant local economy.

Looking ahead at the U.S. economy, this is a period of vexing uncertainty. There has been a great deal of focus on credit availability and terms as a consequence of severe problems in our banking system. Recent measures of credit conditions—ranging from interbank spreads to surveys of bank lending officers—has indeed been very discouraging. In response, a broad set of policies have been devised and forceful actions taken to mitigate the effects of this credit contraction. I believe these policies will work.

With the deterioration in economic conditions and the recent associated falloff in energy and many other commodity prices, I anticipate further dissipation of inflationary pressures. Nevertheless, given high inflation readings during the summer and into the fall, I'll continue to watch developments closely.

We at the Atlanta Fed expect weakness to persist for some time into 2009 as credit markets gradually improve. The thawing of credit markets is a necessary condition for a recovery back to levels of growth consistent with the economy's underlying potential.

Closing

In closing, Atlanta, along with the rest of the nation, is experiencing a period of financial turmoil and economic downturn. I am confident this will pass, and the solid strengths of our city—and the nation too—will express themselves in a return to health and growth.

Contact: [Jean Tate](#) 404-498-8035

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