SPEECHES

Toward a Durable Recovery

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The country is suffering from a severe financial crisis that has contributed significantly to an accelerating economic downturn. What started as a housing sector problem became a generalized financial and credit market problem that spilled into the general economy.

Today, I want to provide a good fix on where we are—the current status of the economy and financial markets—and then take stock of what policymakers have done to date in response to developments. Finally, I'll comment on near-term recovery prospects for financial markets and the economy and share some personal thoughts on what's needed for durable recovery over the long term.

I must emphasize that the views you'll hear are mine alone and not necessarily shared by my colleagues on the Federal Open Market Committee (FOMC).

Status of the economy

As you know, the Federal Reserve pursues a dual mandate—economic growth consistent with maximum sustainable employment and price stability.

Recent data indicate that the national economy is in recession. Economic activity as measured by real gross domestic product (GDP) declined an estimated 0.3 percent at an annualized rate in the third quarter, according to the advance estimate. Data for October suggest an even steeper decline in GDP for the fourth quarter.

Recent downbeat readings follow fairly strong GDP growth in the first part of the year. Those results were buoyed primarily by exports and the temporary impact of the federal tax rebate on consumer spending.

GDP data earlier this year probably masked underlying weakness. I say this because employment has declined in every month this year. In recent weeks, business reluctance to hire has shifted into a marked increase in layoffs. The most recent reading of unemployment was released this morning and came in at 6.5 percent—up from 4.9 percent in January 2008 and the highest in 14 years. In 2008, nearly 1.2 million jobs have been lost.

Contraction of the nation's housing sector has also continued to weigh heavily on the overall economy this year, and this has been especially apparent in parts of Florida, such as the Palm Beach area. A spike in foreclosures has added to the supply of homes for sale in the area and accelerated price declines. The problem is particularly evident in the local condo market, where construction continues to outpace demand. West Palm Beach ranks among the top 10 cities in the United States for condo completions, with thousands of units still under construction.

The U.S. economy in September and October appeared to weaken dramatically. Forces of contraction took hold in consumer spending, business investment, industrial production, and foreign demand for U.S.-made goods. Problems are now broad based. Beyond the housing sector, activity has fallen in auto manufacturing, transportation and distribution, retail trade, financial services, and some segments of commercial real estate.

And without question, the dramatic events of September and October in the global financial markets contributed to an extremely cautious posture on the part of consumers and businesses.

To illustrate the relevance to Florida, the tourism industry reflects the erosion of economic confidence. At a tourism industry meeting organized by the Atlanta Fed last week in Miami, it was noted that during the first eight months of this year tourism attendance was steady—although revenue per visitor declined. But starting in September attendance collapsed, with tour operators, hoteliers, restaurants, and other businesses noting a sharp drop-off in activity.

As a result of the widespread weakness in the U.S. economy, inflationary pressures appear to be declining. In particular, sharply lower energy and other commodity prices have contributed to lower headline inflation measures, and businesses appear to be more hesitant to pass on cost increases. The headline personal consumption expenditure (PCE) price index in September eased on a year-over-year basis for the second consecutive month, to 4.2 percent.

Economic outlook

All in all, the near-term economic outlook is not encouraging. The incoming data in September and October have been worse than expected, and these results pushed my staff and me to revise downward the Atlanta Fed's outlook for the economy.

I foresee substantial weakness at least through the first half of 2009. This weakness will exacerbate the employment picture. In my outlook, unemployment will rise some more.

If there is anything positive in this near-term outlook, it is the trajectory of prices. I expect headline inflation to decline over the coming months and fall into an acceptable range below 2 percent by 2010. Over the longer term, inflation experience is influenced by inflation expectations. Encouragingly, the University of Michigan consumer survey's reading for October shows a moderation in inflation expectations both for the year ahead and for the longer term.

Earlier, I mentioned the positive effect of exports on overall economic performance in the first half of the year. Could exports save us? Here too the picture is not encouraging. Economic weakness has spread in recent months to engulf much of the developed and emerging world, including key trading partners in Europe and Asia. This, together with the recent increase in the dollar, should push down exports.

The front-and-center question about the path of the economy is how deep and how long. Economic forecasts always involve substantial uncertainty. The elements interacting today include the complex and volatile behavior of financial markets globally, compounding weakness in the real economies of interdependent countries and regions, the political transition in this country, and the ever-present threat of noneconomic shocks from weather and geological events to pandemics to geopolitical crises.

This litany is intended to emphasize the challenge of economic forecasting. Prudence dictates consideration of alternative scenarios that, taken together, capture a range of outcomes. For instance, there are plausible upside scenarios anticipating rapid stabilization of financial markets and a quick snapback of the economy. And there are, of course, scenarios estimating a deeper and more protracted period of economic distress, and I believe these have to be taken seriously.

The term "risk," as used in financial and economic discourse, means a quantifiable deviation from expectations. So—contrary to popular understanding—you can have upside risks along with downside. In our consideration at the Atlanta Fed of paths for the economy and its components, we commonly make a judgment on the balance of risks around our baseline outlook and include it in the mix of things influencing my policy recommendation. On balance, I must give greater weight to downside risks at this juncture.

I don't want to suggest a truly dark, doomsday-like scenario. Such storylines get much airing in times of stress but ignore the self-correcting nature of financial markets as well as the arsenal of policy tools available.

Status of the financial crisis

The intense correction in the housing sector—clearly evident here in Palm Beach—has undermined confidence in the broader financial sector that has, in turn, fed economic weakness and further housing decline. This adverse feedback loop is very real. This dynamic has exposed the highly reticulated reality of our modern financial economy that helps explain the surprising spread of what was widely thought to be a disturbance limited to the U.S. housing sector.

Here is my sense of the status of the financial crisis: The dysfunction is centered in the credit markets including interbank, mortgage, corporate and business, municipal, and commercial real estate. To varying degrees, these markets remain quite strained. Also, equity markets have expressed pessimism about the effect of constricted credit flows on the broad economy and about the obvious weakness of incoming economic data.

In many credit markets liquidity remains tight, maturities remain short, new issuance remains subdued, and pricing remains wide relative to precrisis levels. Fears of counterparty insolvency remain widespread in the interbank funding markets. September and October saw a flight to safety as evidenced by demand for Treasury securities, for example. There have been signs of improvement lately, but concerns persist that this is a false dawn, and more trouble could lie ahead.

Smaller businesses don't access credit markets directly; rather, they borrow from banks. About 75 percent of domestic banks last month reported tighter lending standards for loans to smaller firms, according to the Fed's Senior Loan Officer Opinion Survey. That rate is up from 65 percent in the July survey.

What's been done

As financial troubles have gathered over the last few months and the systemic scope and scale of the situation have become evident, an impressive array of creative measures have been employed to forestall further deterioration. These measures can be organized under the rubrics of monetary versus fiscal, liquidity versus solvency, and domestic versus international.

The federal funds rate target has been lowered by a total of 425 basis points since August 2007. On October 29, the FOMC dropped the target fed funds rate by 50 basis points to 1 percent—the lowest level since 2004. This cut followed a drop of 50 basis points on October 8. Also, earlier this year, the Fed lowered the premium for discount window borrowing.

In my view, these decisions were forceful responses to deterioration of the overall economy and the continuing dysfunction and volatility of the financial system. Now is not a time to be tentative.

The Fed has also undertaken several liquidity-enhancing measures over the past year, including six special-purpose facilities known by their initials: TAF, PDCF, TSLF, AMLF, CPFF, and MMIFF. To encourage resumption of interbank and wholesale lending, the Federal Deposit Insurance Corp. (FDIC) has temporarily guaranteed most short-term deposits.

The fiscal authority—the U.S. Treasury, with Congress approving—put Fannie Mae and Freddie Mac into conservatorship. In addition, the Treasury Department is now implementing the TARP (Troubled Asset Relief Program) approved under the Emergency Economic Stabilization Act. A key feature of the TARP is the injection of capital into the banking system, a program aimed at preserving solvency. This follows implementation of a fiscal stimulus package earlier this year.

Under the heading "international," the Fed has put in place dollar swap facilities with a number of central banks. These facilities provide U.S. dollars to the monetary authorities of countries whose commercial banks require dollar-based liquidity support. And on October 8, as already mentioned, the Fed participated in a coordinated action of rate cuts along with five other central banks. Much has been done.

I expect these cumulative measures will help create the conditions needed for financial markets to stabilize and find a new normal. What's got to happen? Two things: First, U.S. house prices need to stop falling, and the volume of defaults and foreclosures needs to stop rising. These factors should help stabilize troubled asset values. Second, deleveraging of the financial sector must run its course. Deleveraging continues—both voluntary and forced (forced by regulatory ratios, fund redemptions, and tougher lending terms between financial counterparties). Progress on these fronts should enhance clarity regarding the condition of counterparties in transactions internal to the financial sector and lead to a general return of confidence. Restoration of confidence is essential.

Recovery will certainly come, and there are hopeful signs these last few days in the credit markets that the process has begun.

With sustained improvement of term funding and other indicators of credit market health, my rather sober and downbeat short-term economic outlook proceeds to an eventual recovery of growth near potential with inflation returning to an acceptable range.

Building a long-term, durable recovery

Let me close with some thoughts for the long term. In some respects, the current financial crisis and economic fallout can be seen as a painful adjustment made necessary

by macro imbalances that are global in nature. Symptoms in this country of such imbalances have included a highly leveraged financial system, a savings shortfall in the household sector, and growing public sector deficits.

In my view, a mere cyclical recovery that returns to the status quo ante will not be durable. The shape of that recovery must witness coming to grips with deep structural imbalances in our economic arrangements if we are to lower the potential for a recurrence of instability. Ideally, the return of confidence and the better conditions this will bring should be accompanied by progress or even resolution of these imbalances as part of a durable recovery for the long term.

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