SPEECHES

The Economic Situation and Policies to Restore Financial Stability and Growth

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Thanks for inviting me. It's a privilege to be your afternoon speaker for the Birmingham Regional Chamber of Commerce's 2009 Business Outlook Conference.

Earlier today, you heard about the local economy and some industries important in this region. This afternoon, I'd like to speak more broadly about the U.S. economic situation and outlook. I know that times are rough right now, but I believe policies in place and about to be implemented will work to restore financial stability and economic growth for the long term. During my remarks, I will describe some of the signposts I'm looking for on the road to economic recovery.

I want to state up front that these remarks are mine alone and don't necessarily reflect the views of my colleagues on the Federal Open Market Committee (FOMC).

The state of the economy
A little more than a year ago, the economy entered into a recession. By all available indicators, we remain in recession today. And if the consensus economic forecast is accurate, we are likely to still be in recession through at least the first half of this year.

Since the end of World War II, we've experienced 10 other recessions. On average, they have lasted 10 months. So the current downturn is already longer than usual.

Last fall, the pace of business and consumer spending dropped off sharply and the labor market started shedding jobs at a much faster pace than what we had seen over the first three quarters of the year. So at a time when historical experience suggests the economy should have begun to crawl out of the downturn, the recession instead began to pick up momentum.

Let me describe to you in somewhat broad terms the buildup to today and the current economic picture.

The problems originated in the housing market and spread to other sectors as mortgage-related losses damaged bank (and other financial institutions') balance sheets. Counterparty risk aversion first brought liquidity pressures. After a stream of writeoffs, these liquidity pressures progressed to doubts about solvency.

An array of key financial markets—particularly securitization markets—became illiquid. Access to credit through security markets or banks tightened severely. Business and consumer confidence was shaken.

As you know, housing has been particularly hard hit. Existing sales have fallen about 35 percent from peak levels in September 2005, and the inventory of unsold homes has soared and remained at high levels. As a consequence, home prices have fallen 20 to 25 percent nationally—even more in certain areas.

The direct impact of housing on the economy has been substantial. New residential construction has fallen by more than half in the past 20 months, taking about one full percentage point off annual GDP growth. Housing starts today stand below 500,000 annualized. Business models and capacity in the home building and building materials industries were designed for starts at a rate approaching two million.

Yet while housing may have triggered the recession, the downturn—particularly since last September—has gone well beyond residential construction.

Consumers have sharply pulled back spending. Declining home and equity values, worsening income prospects because of a deteriorating labor market, and a general unease about the economy have strained finances in many households.

Purchases of big-ticket items that require a large financial commitment and access to credit—notably autos—have been especially curtailed. But virtually every component of consumer spending has dropped in dollar value by deferral, substitution, or outright elimination from household expenditures.

Led by a decline in motor vehicle and parts production, manufacturing output fell by 2.5 percent in January—the third consecutive steep monthly decline.

At the end of last year, exports and business investment spending became the latest casualties of this cycle of wealth and income destruction. As business conditions around the world began to worsen, previously robust export markets dried up. Last quarter, U.S. real exports fell for the first time in five and a half years.

At the same time, the uncertain sales outlook and credit difficulties pushed capital spending sharply lower—down a bit more than 19 percent at an annual rate in the fourth quarter—its biggest quarterly retreat in 34 years.

The cascading drop in business activity I just described has taken a toll on the U.S. labor market. During the past 12 months our economy has lost a net of 3.5 million jobs, with about half of those losses in the past three months. Even the recession-resilient services sector has lost more than 1.7 million jobs since December 2007.

The rate of joblessness has jumped a full percentage point since October to 7.6 percent. The share of unemployment attributable to layoffs, the share of people who are working part-time because of a weak economy, and the proportion of people who have dropped out of the labor force in discouragement have all risen sharply in the past few months.

The outlook
It's obvious to all that the current state of the economy is extremely weak.

The national economic indicators I have described are evidenced daily in your order books, human resource reports, and income statements. I suspect there is little in these numbers that you don't already know from your direct experience. What is likely "top of mind" for most of you, I am sure, is the question "When does this dreary story end?"

The economic forecast I submitted for the most recent FOMC meeting reflected my view that the economy faces obstacles that are likely to work against a strong rebound of growth over the next several quarters. Those obstacles include credit markets not yet returned to healthy functioning, a housing market still weighed down by an excess supply of homes for sale, and low business and household confidence. None of these is likely to turn around quickly.

But as discouraging as these indicators are for the very immediate future, the economic outlook is not indefinitely bad. Most forecasts, my own included, see catalysts for the start of modest recovery in the second half of the year.

With production falling—and expected to decline significantly more this quarter—I expect some reduction of excess business inventories, putting producers in a position to expand output as spending returns.

There are signs lower mortgage interest rates are helping housing markets on the margin. The January pending sales number was up, and there has been a spurt in refinancing activity. If historically low mortgage rates can be sustained over the coming months, I expect more buyers will be drawn into the market.

Several factors should lift consumer spending as the year progresses. These factors include the dramatic fall in energy prices, greater stability in the housing market, and improving consumer confidence.

I should mention that last week the U.S. Census Bureau reported an unexpected increase in retail sales during January. I would like to see further confirmation of the underlying strength hinted at in this report, but on its face, the pickup in consumer spending is encouraging.

Also contributing to the upturn seen in the consensus outlook are the large and targeted fiscal, credit, and monetary policies of the government and the Federal Reserve—a topic I will return to in a moment. The intent of these aggressive and unprecedented policy actions is to support spending and fix the dysfunction in credit markets that has so severely constrained the economy's natural forces of growth.

Indeed, we have seen modest, but hopeful, signs that financial markets are improving. A key element in the improved economic environment expected in the latter half of the year is that financial institutions will find more stable footing and begin to provide greater support to business expansion and consumer spending.

Comprehensive policy response
An important consideration in the outlook is the policy effect. Responding to the scope and severity of our economic ills, policymakers have taken and will soon implement unprecedented measures to restore financial stability and economic growth. In my view, the diagnosis is substantially correct and the actions targeted on discrete aspects of the overall problem constitute an appropriately comprehensive approach. Let me bring focus to five aspects of the current problem and connect them to the associated policy actions.

First, there's credit market dysfunction. The Fed has attacked this problem by introducing a number of credit market liquidity programs. For example, the Term Asset-Backed Securities Loan Facility (TALF) supports new lending in credit cards, student loans, auto loans, and small businesses. This program could provide up to $1 trillion and should help repair securitization markets and boost credit to broad categories of consumers and small and mid-sized businesses.

Jump-starting securitization markets is vitally important. Securitization markets are and will be a substantial part of the nation's total credit system.

Another problem is banking system weakness. By injecting capital into banks, I believe the U.S. Treasury has strengthened and will further strengthen bank balance sheets. Under Treasury's new plan, the government also will create a mechanism to in effect remove troubled assets from bank balance sheets, which should help rehabilitate the banking system, a sine qua non of recovery.

A third dimension of today's weakness is falling house prices. The FOMC has stated that the Fed will continue to purchase large quantities of agency debt and mortgage-backed securities to support mortgage and housing markets, and the Fed stands ready to expand the quantity and duration of such purchases. Also, a foreclosure prevention program is included in the Treasury's new plan. If successful, a source of pressure on home prices should be reduced.

The Administration's economic stimulus package is designed to address the recent surge of unemployment, which is a fourth aspect of economic weakness. Rapid downstreaming of funding to state and local governments should help forestall further layoffs and furloughing of public sector employees. Public works and other investment projects should put some of the unemployed back to work, depending on the speed of mobilization.

Finally, there is the broad-based economic weakness that has enveloped almost all industry sectors with a deficit of confidence as both cause and effect. We are in a period of unconventional policy measures, and that is especially true of the Federal Reserve. But the stimulative power of conventional monetary policy in the form of a federal funds rate at its lowest possible level should not be forgotten. The FOMC has stated that low interest rate policy is likely to continue for some time.

I believe these actions—taken as a whole—are not only strategic as argued above but also a coherent response to the problems at hand. In judging coherence, I apply these criteria:

Is the problem correctly diagnosed?
Is the response to each dimension of the problem sufficiently sized?
Is the response timely?
And, is the specific policy reversible when required or appropriate?

There is policy risk, to be sure, by which I mean risk that the policy medicine won't work, won't be enough, or will come too late. But if forecasts of improvement don't materialize, the Fed is not without capacity to act, even with the fed funds rate at its lower bound.

A sober mindset dictates that I, as a policymaker, watch for signposts of both recovery and further deterioration. On my watchlist through 2009 is the commercial real estate sector. For instance, I am following the risk of defaults related to refinancing demands of existing properties and project development loans coming up for long-term financing. I also will be watching the financial conditions of emerging markets as well as growing protectionist sentiment in this country.

Signposts on the road to recovery

As I look ahead, signposts on the road to recovery include sustained normalization in credit markets and stabilization of house prices. Also, I'm watching for an uptick in business spending to give a sign of a return of opportunity seeking and private sector risk taking needed to sustain growth.

I draw hope that the signposts will be biased to the upside from my conversations with businesspeople like yourselves. Increasingly, I'm hearing that this current set of circumstances presents very interesting opportunities for individual businesses. When stronger companies act on those opportunities, an important element of recovery will begin.

We have reached a pivotal juncture. After a rapid onset of problems in the economy and financial system—both global and national—we've reached a point where incremental responses must proceed to something more comprehensive, scaled, and coherent.

I believe the composite policy approach is correct in focus and intent, and now the devil is largely in the details and implementation. I am confident policymakers across the various relevant arms of government understand the importance of moving ahead as quickly as possible to provide detailed rules of the road.

As these policy actions take effect and work in concert, I'm confident the economy and financial sector will respond positively. Thank you.

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