Recovery and Reform

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It's an honor to speak to the New York Chapter of the National Association for Business Economics (NABE).

There was a light moment in a recent Fed meeting when staff reported back the collective assessment of Board and Reserve Bank seniors of the degree of uncertainty we're now facing regarding the economic future. The consensus was (is) that uncertainty at this juncture is heightened relative to history. One of my colleagues asked, "Has there ever been a time when the answer was anything other than uncertainty is higher than in the past?"

The country is now living out a postrecession, postcrisis story. If I were to put a title on the story it would be "Recovery and Reform." We're in an early chapter of the story, and the ending is uncertain—quite uncertain.

In this unfolding story, I see three subplots: (1) the recovery, (2) regulatory reform, and (3) the long-term rebalancing of economic fundamentals. These subplots can be treated as distinct, but I see linkages. Today I will comment on each individually and explain how I perceive the intersection ofrecovery, the regulatory reform deliberations in Congress, and longer-term rebalancing. My aim in this speech is to speak plainly and put forward a connective logic of what otherwise could be considered separate stories.

I must emphasize these are my personal views that are not necessarily shared by my colleagues on the Federal Open Market Committee (FOMC).

Recovery
Let me first discuss the outlook for recovery. In thinking about the possible trajectories of the recovery, I have been using the sorting device of two competing scenarios to sharpen my observation and interpretation of incoming indicators. This approach is admittedly simplistic, but I find it useful to evaluate incoming data as consistent with one or the other scenario.

This group is very familiar with both scenarios. Scenario one is the familiar V-shaped, strong bounce back from severe recession. In this scenario, growth exceeds the underlying long-term potential of the economy and unemployment declines at a steady pace. Both consumer activity and business investment show growth. Net exports contribute measurably to gross domestic product (GDP), reflecting growth of our principal trading partners, particularly in Asia. The banking system successfully navigates a troubled commercial real estate sector and expands credit to both business and consumers, helping the recovery.

By contrast, the second scenario is a relatively modest recovery, with slow reduction of unemployment. Various headwinds hold back GDP growth. They include (1) a weak banking sector that is slow to expand credit in part because of commercial real estate problems, (2) subdued consumer activity reflecting a more frugal consumer mindset as well as restricted consumer credit, and (3) extremely cautious business investment in inventory and capital goods.

Again, these two basic views of the world are familiar to you as they are also captured in the latest NABE forecast.

My current forecast—and that of my staff at the Federal Reserve Bank of Atlanta—lines up with the second scenario, the modest recovery scenario.

The incoming data through last week have not made me alter my basic forecast, but I consider it still too early to make a definitive call on which scenario will play out. The January numbers, as you may know, have been mixed. Consumer spending was strong for the month, while business spending on capital goods was weak, and job growth was flat. Upside surprises in inventories, capital spending, and consumption could tip the scales in favor of a stronger growth forecast. I will be particularly attentive, watching for evidence of these developments as the recovery proceeds.

Because I hold to this forecast of modest recovery and believe inflation is likely to remain subdued, I fully support the message of the most recent FOMC statement to the effect that the fed funds target rate will remain exceptionally low for an extended period.

Regulatory reform
Meanwhile, Congress is deliberating financial regulatory reform. Proposals for comprehensive reform are being formulated in the Senate. Deliberation over the future configuration of public agency roles is taking place in an atmosphere of popular anger at perceived regulatory failures and taxpayer-funded bailouts as well as inflamed Main Street–Wall Street animosity.

Public outrage at economic and financial developments since the summer of 2007 is understandable and should not be ignored. But—easy to say, hard to do—I feel we would all be well served to get beyond the anger of the moment and on to a sober, realistic, and forward-looking thought process about how to avoid another crisis or respond to an incipient crisis. To my mind, the question is how to erect the strongest defenses against a recurrence—in other words, how best to assure future financial stability. Answers must consider what went wrong in the past but also—with some humility—likely future sources of financial instability.

Uncomfortable as it may be, a responsible working assumption is that another crisis will occur at some point in the future. This assumption is not intended to be a forecast; rather, it's an anchoring statement to bring a cautionary perspective to the task of regulatory reform.

I would further argue that reform should be grounded in realism about the character of the global financial and banking system going forward as well as the ability to legislate away some disagreeable aspects of that reality.

Let me elaborate. I will make five points. First, systemic risk is real, even if hard to define. And systemic risk is transnational reflecting the global network reality of money flows, securities distribution, and counterparties to financial contracts.

Second, the presence of banks and financial institutions too big, too connected, and too operationally critical to fail is likely to be a condition to be managed for some time while efforts are undertaken to eliminate the problem.

Third, some amount of moral hazard accompanies the necessary safety net in place as a defense against temporary illiquidity of individual institutions and any accompanying financial instability. The Fed's role as lender of last resort is a central element of that safety net.

Fourth, the shadow banking system will remain. Not all systemically influential financial activity will take place in regulated entities.

Finally, financial players will continue to innovate. Market participants will naturally seek advantage, and some competitive advantage comes from new financial instruments and products.

If you take these points as realistic, I think you might also agree that no one can guarantee that there will be no future crises or predict with any certainty future sources of trouble. Regulatory reform legislation can be thought of as an exercise in fortifying defenses against inevitable future stresses and problems.

The first line of defense against excessive risk-taking and imprudent firm management will continue to be the prudential discipline of firms themselves along with market discipline.

That said, the Fed must play a central role in a defense structure designed to prevent or manage future crises. My key argument is the indivisibility of monetary authority, the lender-of-last-resort role, and a substantial direct role in bank supervision. Only the Fed can act as lender of last resort because only the monetary authority can print money in an emergency. To make sound decisions, the lender of last resort needs intimate hard and qualitative knowledge of individual financial institutions, their connectedness to counterparties, and the capacity of management.

There is sentiment in Washington that would separate these tightly-linked functions that are so critical in responding to a financial crisis. Removing the central bank from a supervision role designed to provide totally current, firsthand knowledge and information will weaken defenses against recurrence of financial instability. Flawed defenses could be calamitous in a future we cannot see.

Whatever configuration of agency roles and responsibilities emerges from deliberations on regulatory reform, those arrangements must, in my view, guard and preserve the capacity to act decisively in the broad national interest in an emergency.

Long-term rebalancing
Let me now touch on the topic of long-term rebalancing, which is another way of saying the addressing of economic fundamentals. Again, this audience is quite familiar with fundamentals that are out of balance. Most prominent are the fiscal balance, the external balance, and perhaps also the balance of investment and consumption.

Recovery is possible if these fundamentals are left untouched, but such a recovery is unlikely to prove durable. A scenario in which deep imbalances are ignored would set the stage for the return of problems in the real economy in a few years.

The state of public sector finances is chief among the weak fundamentals. It is difficult for me to see a stable future without a credible path to fiscal sustainability. Failure to convincingly articulate such a path could lead in time to fear of monetization of federal debt—the belief that inflating away the problem is inevitable.

Failure to address persistent weak fundamentals will increase the likelihood of wrenching adjustment and another financial crisis in the future. Major imbalances delineate the geologic fault lines of the world financial system, and they weigh on the minds of market participants. History has demonstrated that obscure incidents and minor parties can set in motion a destructive dynamic. In my professional lifetime, I've witnessed Herstatt, Penn Square, the Thai Baht, and subprime mortgage-backed securities. We cannot know what will trigger the next crisis or when—even if—it will happen.

To my mind, the aim is a durable recovery and prevention of a recurrence of financial crisis accompanied by deep recession. Flawed regulatory reform will weaken crisis defenses, and neglect of imbalances will increase the country's vulnerability to a replay of recent history.

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