

FEDERAL RESERVE BANK *of* CHICAGO

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The Economic Outlook and the Role of Credit Intermediation

Chartered Financial Analysts Society of Chicago Lunch

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Introduction

I am delighted to be here today to share my thoughts about the economy and the financial circumstances we are currently facing.

Though I have been president for only six months, I have had the extremely useful experience of attending Federal Open Market Committee meetings since 1995 — first, as a senior staffer, and since 2003, as the Bank's research director. Last September, as a newly installed Fed president, I was certainly looking forward with great anticipation to contributing to the discussion of monetary policy at the FOMC meetings. Considering everything that has happened since last summer, the safest comment I can make about this experience is, it's been everything I expected — and more.

Today, I would like to share my thoughts on the state of the economy and the uncertainties over the outlook. I will be giving particular attention to the effects that a number of unusual and complex asset valuation issues may be having on the financial conditions faced by households and firms. As always, my remarks this afternoon represent my own opinions, and do not necessarily reflect the views of my colleagues on the Federal Open Market Committee or those of the Federal Reserve System.

Review of the Current Economic Situation

Overall, the U.S. economy grew at a solid pace in 2006 and over the first three quarters of 2007. Real GDP rose at an average annual rate of 2-3/4 percent over this period — which is a bit above my assessment of the economy's long-run sustainable rate of growth. This gain was achieved despite a plunge in residential construction, which reduced growth by an average of 0.8 percentage points over this period. Overall GDP growth remained healthy because the rest of the economy was performing quite well: Business fixed investment and household consumption rose at solid rates, and the trade deficit fell, led by robust increases in exports.

This resilience of overall economic growth in the face of significant sectoral challenges is part of a long-running story. Since the mid-1980s, the U.S. has been in the midst of what economists call the Great Moderation, in which fluctuations in overall GDP and inflation have been smaller than they were over the previous 40 years. Improvements in productivity, better policy, and some good luck appear to have made aggregate activity more resilient to the shocks that have hit individual sectors of the economy.

But that resilience continues to be challenged by new developments. Today we are faced with the challenges presented by the recent turmoil in financial markets. By now, this story is familiar to most in the room, but it bears repeating because of its importance.

The underpinnings for this shock began to form earlier in this decade with the rapid expansion of the subprime mortgage market. Most of these mortgages were sold by their originators to financial entities that bundled them together in mortgage-backed securities. In turn, these securities were restructured into a variety of new securities or used as collateral for other financial instruments. At their most complex levels, the income flows from monthly subprime mortgage payments supported many layers of highly structured securities that were held by a wide range of investors. Of course, such complex financial engineering was not limited to subprime mortgages, but was used to securitize a wide range of lending activities.

Historically, subprime mortgages had experienced relatively modest default rates, even during the 2001 recession. However, by mid-decade we now know that underwriting standards had become lax and that originations had expanded significantly. Then, in 2006 and 2007, housing markets began to deteriorate and delinquencies and defaults on subprime mortgages increased substantially. As this continued, it became clear that the payment flows on these mortgages would be insufficient to meet obligations to the owners of some bonds and downstream structured securities. Even the highly rated tranches of subprime-related securities turned out to be riskier than investors had thought at the time they were issued.

In the summer of 2007, a growing number of market participants began to realize the negative implications that these defaults had for the value of subprime-backed debt instruments. Many investors also began to question if they had underestimated the risk of other complex securities, whether they contained subprime-related debt or not. This situation was complicated by the fact that many of these securities had been purchased by special purpose financial institutions that had raised the necessary

funds through short-term borrowing in the commercial paper market. These institutions had difficulty rolling over this paper at existing terms. Investors demanded shorter maturities and higher risk premiums to compensate for uncertainty over the valuation of collateral, potential needs for liquidity, and counterparty risks. Liquidity became scarce — as evidenced, for example, by large increases in spreads between overnight and term financing rates.

These financial challenges began to weigh noticeably on the economy as we went through the fourth quarter. A number of monthly indicators pointed to a slowdown in the pace of growth. Notably, housing fell sharply further in November and December. In part, this reflected fallout from the financial turmoil: Lenders shied away almost completely from originating subprime mortgages; markets also backed off securitizing any mortgage other than those eligible for issuance by government-sponsored agencies. This raised the relative costs of obtaining a jumbo mortgage, even for well-qualified buyers. In addition, labor markets softened — hiring slowed and the unemployment rate rose. Labor income is the most important factor supporting household consumption, and while the level of consumer spending did increase last quarter, it did so at a relatively modest pace.

In assessing the extent of the current slowdown, I find it useful to look at an index we developed at the Chicago Fed in 2000 to summarize the information in a large number of monthly indicators of economic activity. The index is the Chicago Fed National Activity Index, or CFNAI. An index value of zero is consistent with trend growth in overall GDP. The three-month moving average of the CFNAI fell to -0.67 in December. A study I did back in 2002 suggests that readings like this indicate a greater than 50 percent probability that the economy is in a recession. Although there are reasons to discount this likelihood somewhat, it is clear that the U.S. economy currently faces substantial headwinds.

In spite of these headwinds, the economy did record positive but very low growth in the fourth quarter of 2007. Real GDP inched up at a 0.6 percent annual rate. For the first quarter of 2008, we have only limited data in hand, but much of these data have been disappointing. Payroll employment edged down in January, motor vehicle sales fell, and some measures of business activity were quite weak. However, some indicators have been a touch more positive. For example, retail sales posted a modest increase in January, and the forward-looking data on orders for capital goods ended last year on a positive note.

In financial markets, the unusual liquidity pressures have receded some since the turn of the year. Some of the earlier pressure reflected financial firms' desire to show very liquid balance sheets on their end-of-year financial statements. In addition, central banks made special efforts to provide liquidity to the financial system. On the Fed's part, we cut the federal funds rate, our principal policy tool, and also lowered the cost and lengthened the maturity at which banks can borrow from us at the discount window. Furthermore, we instituted a new Term Auction Credit Facility to augment regular borrowing at the discount window. However, despite the improvement in liquidity, overall credit conditions are still strained, and the lending environment is much less receptive to risk-taking than it was prior to last August.

So we are in the midst of a period of soft economic activity. We also are in a period of heightened uncertainty about the economic outlook.

The Role of Credit Intermediation

This uncertainty stems from the inherent difficulty in gauging the effects of adjustments in the financial sector on the spending capacity of households and firms. One reason it is so difficult is that the degree of financial turmoil we have experienced over the past few months is a relatively rare occurrence in the modern U.S. economy. We just do not have much historical precedent to go on. Nevertheless, we do know that when financial stress emerges, we must think more thoroughly about the role of credit intermediation in the economy.

As a general principle, difficulties in the credit intermediation process can arise from several sources. I first want to focus on a source that is a particularly relevant issue for the situation today — that is, the effects of an erosion in the value of assets. Asset devaluation reduces both the ease with which borrowers can borrow and the capacity of lenders to lend. In turn, this can decrease the flow of credit from savers to spenders, resulting in a reduction in economic activity.

The first assets to consider are houses. The declines in house prices we have experienced reduce housing equity and erode the collateral value of a home against the original loan. Housing-backed loans are now riskier, and so the costs and terms of such borrowing have become more restrictive.

A number of asset valuation issues weigh on the financial sectors' lending capacity. The lower income flows and the drop in valuations for subprime-related securities reduce the ability of such assets to service existing structured debt securities or to support new liabilities aimed at expanding lending capacity. In addition, both for regulatory reasons and to signal their soundness to investors, lenders seek to maintain a certain minimum ratio of capital to assets. These ratios have been under stress for a number of reasons. Losses on subprime-related assets and other securities directly reduce equity capital. In addition, for legal or reputational purposes, some banks were forced to take assets held by stressed special purpose vehicles back onto their balance sheets at a loss. They also found themselves holding loans associated with leveraged buyouts that they were unable to sell.

Restoring capital ratios requires that lenders either raise new equity, sell assets, or cut back on new lending. Selling assets or reducing lending could have adverse effects on the real economy. Fortunately, a number of large banks have successfully raised new capital, with some of the most publicized deals involving investments from sovereign wealth funds. These infusions will

help buffer the impact of balance-sheet adjustments on bank lending.

Furthermore, the reduced availability of bank loans may be at least partially offset by increased financing from nonbank lenders, such as insurance companies, hedge funds, and private equity funds. And some high-quality nonfinancial firms have raised substantial funds on the corporate bond market. Indeed, in the recent survey of purchasing managers in nonmanufacturing business, despite a very weak reading on overall activity, only 15 percent of the respondents thought that financial turmoil was hampering their ability to obtain financing.

A second intermediation-related issue revolves around how much the cost of credit has increased. One fallout we have seen from the credit difficulties is a reduced appetite for funding risky investment projects. Lenders are demanding greater compensation for risk, and this has resulted in an increase in the price of credit to many households and nonfinancial businesses. For example, in the Fed's January survey of senior loan officers, there was a notable increase in the number of banks reporting tighter standards and increased spreads on loans to both households and businesses. Risk premiums on corporate bonds, particularly those below investment grade, have increased noticeably, and issuance of high-yield bonds is down a good deal. Similar increases in risk premiums have been seen in the secondary markets for higher-risk bank loans and commercial mortgage-backed real estate.

To be sure, some of the increase in risk spreads and tighter lending terms represents a typical response to heightened concerns over the macroeconomy as opposed to atypical effects from the intermediation problems. And some of the increase is likely a healthy return to more prudent risk-pricing.

In addition, the cost of funds has fallen for many low-risk borrowers owing to interest rate declines since August. Monetary policy actions have lowered the federal funds rate 225 basis points; the 30-year conforming mortgage rate has dropped about 100 basis points to 5.7 percent; and rates on investment grade corporate bonds also are down.

A third issue is the potential for asset-related credit intermediation problems to generate a self-reinforcing dynamic that harms the economy. The process of selling assets — whether those repossessed in defaults or those that a financial institution sells to restore its capital position — increases the supply of such assets on the market. This can lead to additional erosion of asset values, further cutbacks in borrowing and lending capacity, and broader softness in spending by households and businesses. Such a downward spiral could have a serious impact on the macroeconomy.

The FRB-Chicago Outlook

Taking all of this into consideration, our outlook at the Chicago Fed is for real GDP to increase in the first half of the year, but at a very sluggish rate. However, we expect growth will pick up to near potential by late in the year and continue at or a bit above this pace in 2009.

This outlook takes into account a large number of unusual factors holding back activity. The large overhang of unsold homes will continue to restrain residential investment. Greater caution on the part of businesses and consumers will likely limit increases in their discretionary expenditures. And the strains on credit intermediation and financial balance sheets will likely hold down growth to a degree for some time. Since these financial issues are being worked out against the backdrop of a soft economy, we also have to recognize the risk that interactions between the two might reinforce the weakness in the economy.

In response to these downside influences, and with inflation expectations contained, I believe a relatively accommodative monetary policy is appropriate. At 3 percent, the current federal funds rate is relatively accommodative and should support stronger growth. Indeed, because monetary policy works with a lag, the effects of last fall's rate cuts are probably just being felt, while the cumulative declines should do more to promote growth as we move through the year.

In addition, the fiscal stimulus bill the President signed yesterday will likely boost spending in the second half of the year.

The economy's inherent resiliency and internal adjustment mechanisms also will work to support growth. In the current situation, this adjustment importantly includes the work the financial sector is doing in "price discovery," that is, the process of determining the proper valuation of the assets they hold in light of reevaluations of their expected cash flows and risks to these flows. In addition, intermediaries will do more work in restoring their balance sheets. Together, these activities will eventually reduce the drag from the lending and credit channels on the real economy.

Another part of the internal adjustment process centers on housing. As house prices fall, more buyers will find it worthwhile to enter the market. Eventually, price adjustments will stabilize supply and demand, and the drag from residential construction on the economy will subside.

Finally, there is productivity. Productivity is the fundamental determinant to growth in the longer run — it determines how we can turn labor and capital inputs into the goods and services we consume and invest. The good news here is that, while it is not as robust as it was in the late 1990s and early this decade, the underlying trend in productivity in the U.S. economy is still solid. This trend provides a sound base for production and income generation to move forward over the longer haul.

Although most of the recent concern about the U.S. economy has been focused on growth, we must also be mindful of inflationary pressures. The recent news here has been somewhat disappointing. We have experienced large increases in food and energy prices, and other commodity prices are high; in addition, we are hearing numerous anecdotes of firms passing on

cost increases to their downstream customers. The recent numbers on core inflation — that is, inflation excluding food and energy — also have moved up some over the past several months. Core PCE inflation is now at 2.2 percent, a higher rate than I would like to see in the long run.

I want to emphasize here that, while we often talk about inflation in terms of the core measure, we are concerned about maintaining purchasing power over all of the goods and services consumed by households. Accordingly, our goal of price stability must be defined in terms of total inflation. Traditionally, we have found it useful to concentrate on the core measure because it gave us a less noisy reading of longer-run trends in inflation; in turn, this reflected the tendency for food and energy prices to be volatile in the short run, but to generally average out to the same as core over the medium term. However, if outsized increases in food and energy prices persist, then core becomes a less useful medium-term guide to inflation trends. Furthermore, persistent food and energy price increases will find their way into inflation expectations, which in turn would boost core measures. So the recent developments in food and energy prices are a concern that deserve careful monitoring.

That said, our forecast is for inflation to moderate over the next two years. Slower growth in 2008 will limit price increases somewhat. Furthermore, futures markets point to a peaking of energy and commodity prices. However, they have pointed to lower energy prices for some time now, so we do not want to take too much comfort in their current predictions. Importantly, inflation expectations appear to be contained. If households and businesses expect inflation to be very low over the longer run, they will not build automatic wage and price increases into their plans, helping to keep actual increases in check.

Conclusion

To conclude, I think it is important to remember that the Federal Reserve has a dual mandate — working to foster financial conditions that help the economy obtain maximum sustainable employment and price stability. As the Committee noted in the policy statement following the January FOMC meeting, though downside risks to growth remain, we think the policy actions taken in January, in combination with earlier moves, should help promote moderate growth over time and mitigate the risks to economic activity. We also expect that inflation will moderate over time. Looking ahead, my policy views will depend on the evolution of these risks, as well as how developments influence the price stability component of our dual mandate over the medium term.

Note: Opinions expressed in this article are those of Charles L. Evans and do not necessarily reflect the views of the Federal Reserve Bank of Chicago or the Federal Reserve System.