

FEDERAL RESERVE BANK *of* CHICAGO

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Navigating Market Turmoil

Harper College Economic Forum

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Thank you for inviting me to speak today and for that very kind introduction. I'm delighted to be here this morning to share my thoughts on the economy during this challenging period. I'd like to say a special thank you to Maria Coons, a former Chicago Fed employee and member of our extended Fed family. I'd also like to extend my personal thanks to Rita and John Canning. Rita serves as a member of Harper's Board of Trustees and John is the Chairman of our Chicago Fed Board of Directors. Maria, Rita, and John all helped to arrange my visit here today.

In the course of my remarks today, I will address the subject of monetary policymaking during times of financial stress. I would like to note that the views discussed today are my own, and not necessarily those of the Federal Open Market Committee or my other colleagues in the Federal Reserve System.

Policymaking

The Federal Reserve has a dual mandate: We are charged with fostering financial conditions that promote both maximum employment and price stability. We attempt to achieve these goals primarily by setting an appropriate target for the federal funds rate. That's the interest rate at which banks make overnight loans to each other. The fed funds rate influences to varying degrees the entire array of market interest rates, including those paid by businesses and consumers.

Under normal circumstances, financial markets efficiently channel funds from lenders to borrowers, appropriately supporting the spending capacity of households and businesses. But as we have seen over the past nine months, at times financial disruptions can occur. Such disruptions can hinder the flow of financial capital to creditworthy borrowers and reduce their ability to consume and invest. Accordingly, such situations pose special challenges for policymakers.

At this point, a review of the recent market turmoil is probably helpful. After a period of rapid increases, by the summer of 2007 home prices had leveled off and were starting to decline in some markets. Subprime borrowers, who may have been counting on rising home equity, began to default in significant numbers.

Complicating these developments were the widespread securitization of mortgages and the repackaging of these securities into highly complex financial instruments known as collateralized debt obligations (CDOs). Securitization and CDOs have turned out to be a double-edged sword. On the one hand, they diversified risk among many lenders. On the other hand, their complexity made it difficult to track losses and properly value the portfolios of many financial institutions. This lack of transparency contributed to the deterioration of financial market conditions, leading to a re-pricing of risk and a widening of credit spreads across a broad spectrum of financial securities. For example, not only did the value of mortgage-backed CDOs fall sharply, but market participants began to question the value of other complex securities, even those with no subprime exposure. Furthermore, many borrowers had to turn to very short-term financing as lenders were unwilling to commit funds at normal terms because of uncertainty over collateral valuation and other counterparty risks.

In the banking sector, in addition to suffering losses on subprime-related securities, banks were forced to take additional risky assets back onto their books, which further strained their capital positions. This has made them more reluctant to lend.

So, in summary, in both the bank and securities markets, many creditworthy borrowers have found credit much more expensive or sometimes even unavailable at any reasonable price. In turn, this has weighed on real economic activity.

Setting the Stance of Monetary Policy

I'd like to now turn to how we implement policy. In doing so, I will start by discussing how I evaluate three key factors determining where we set the federal funds rate: These are maximum employment, price stability, and the neutral funds rate. I will then turn to how financial stress impacts our policy decisions.

Maximum Employment

In order for the economy to achieve maximum employment over the long run, it needs to grow at its maximum sustainable rate, which is also referred to as the rate of growth of potential output. This is the maximum rate of real growth the economy can maintain in the long run without leading to an increase in inflationary pressures. Sustainable growth is determined by the underlying trends in two factors—first, the availability of labor resources, and second, the productivity of those labor resources.

Although these underlying trends are unobservable—and can change over time—at the Chicago Fed, our current analysis of them suggests that sustainable growth currently is somewhere in the range of 2-1/2 percent per year. Most other analysts' estimates fall in the 2-1/4 to 3 percent range.

Price Stability

Our other—and equally important policy goal—is price stability. In some sense, price stability is achieved when inflation does not significantly distort the economic behavior of households or businesses. Recently, the FOMC further improved transparency by reporting forecasts more frequently and extending the forecasts' horizon to three years. As stated in the FOMC minutes, participants' forecasts for this third year are "importantly influenced by their judgments about measured rates of inflation consistent with the Federal Reserve's dual mandate... and about the time frame over which policy should aim to attain those rates given current economic conditions." ¹ In January, policymakers' forecasts for 2010 had growth in the range of most economists' views for potential and had inflation—measured by both the total Personal Consumption Expenditures, or PCE, Price Index and the PCE index excluding food and energy—in the range of 1-1/2 to 2 percent. This suggests that most policymakers view price stability as being somewhere in the neighborhood of 1-1/2 to 2 percent.

Neutral Funds Rate

Before we go any further, I'd like to describe you how I think about monetary policy in general terms. To evaluate the stance of policy, I start by focusing on the real fed funds rate—that is, the nominal rate less expected inflation—and where it currently stands relative to a hypothetical longer-run benchmark called the neutral real funds rate. The neutral funds rate is the rate consistent with an economy operating at its potential growth path and with stable inflation. There are many factors and uncertainties involved in assessing the neutral rate. With such caveats in mind, I think the neutral long-run real fed funds rate is somewhere in the neighborhood of 2 to 2-1/2 percent.

Real rates above this 2 to 2-1/2 percent neutral point tend to restrict aggregate demand, while real rates below this mark are accommodative and boost aggregate spending. Of course, the real fed funds rate is only one factor affecting liquidity and credit conditions. As we have seen recently, other credit market developments can work to offset or exaggerate the impulse from monetary policy.

Current Stance of Monetary Policy

Now that I have provided some background for how I approach monetary policy issues, let's talk about the current situation.

Market Turmoil

As I discussed earlier, the disruptions in financial markets that began last August have greatly restricted the flow and increased the price of credit and liquidity. Clearly, this has complicated policymaking. Usually, when we decrease the fed funds rate, all short-term interest rates fall by a similar amount. These in turn feed through and affect interest rates across all maturities. As rates adjust, private markets also update their views on credit risks, and these show through to changes in risk spreads between private borrowing rates and those on risk-free Treasury debt.

Financial stress alters this mechanism: It has boosted the risk premia built into private borrowing rates and substantially increased the demand for liquid assets that can be easily turned into cash and used to pay liabilities. An important example of these effects can be seen in the London Interbank Offered Rate, or LIBOR, which is a measure of short-term lending rates between banks. LIBOR is important because it is a common benchmark for many other rates, including those on adjustable rate mortgages and auto loans. The 30-day LIBOR is normally only about 10 basis points above the level of the fed funds rate expected to prevail over the term of the loan. ² However, the recent financial market stress has pushed its average over 60 basis points above the expected funds rate; also, this spread has been highly volatile and at one point was over 100 basis points. Because of this increased spread, many borrowers have paid higher rates than would ordinarily have been the case given the level of the fed funds rate.

New Lending Facilities

The current financial circumstances have added a new dimension to the challenge of monetary policy, and policy has responded in a number of ways. First, we have aggressively reduced the federal funds rate by 325 basis points since September 2007. Second, we have implemented a number of innovative initiatives to increase liquidity in strained financial markets.

The new policies include changes to the Federal Reserve's discount window, through which depository institutions have always had access to overnight loans. Since 2002, the rate of interest we charge borrowers, the primary credit rate, had been set 100 basis points higher than the target federal funds rate. However, while we don't view use of the window negatively, historically banks have been reluctant to use the facility for fear that it would signal weakness or some operational miscalculation. To encourage use of the window, we reduced the wedge between the primary credit rate and the funds rate and allowed borrowing for terms of up to 90 days. We also instituted the new Term Auction Facility, which is an alternative market-based auction system for depositories to borrow at term from the window.

The recent disruptions in financial markets also have caused serious liquidity problems for another important conduit for channeling credit, the primary security dealers, which include several major investment banks. To address these problems, the Fed established the Term Securities Lending Facility and the Primary Dealer Credit Facility to lend to them. Since the dealers are nondepository institutions, these loans required the Fed to invoke its authority to lend to nonbanks under section 13(3) of

the Federal Reserve Act. Under this act, such lending is only permissible under "unusual and exigent circumstances." Such loans are the first extensions of credit by the Federal Reserve to nondepository institutions since the 1930s. Our recent actions regarding Bear Stearns were also authorized by this act.

Finally, we have consulted closely with foreign central banks during this period. In particular, we instituted swap arrangements with both the European Central Bank and the Swiss National Bank to help provide dollar-denominated liquidity to European banks.

Together, all of these initiatives have lowered short-term market interest rates, reduced the cost and lengthened the maximum term of banks' borrowing directly from the Fed, broadened eligible collateral, and expanded lending to nondepository institutions.

Implications for Traditional Monetary Policy

So how does all of this affect policy? I think it is helpful at this point to note some similarities to the period following the recession of late 1990 and early 1991. You might recall that after the deregulation of the Savings and Loan industry, many S&Ls made imprudent real estate loans. The ensuing losses substantially reduced the lending capacity of the industry as insolvent S&Ls went out of business and others were forced to recapitalize. In addition, banks were reluctant to lend as they struggled to bring their capital in line with the then new risk-based standards set by the Basel I Accords. These restructurings created financial headwinds that made the recovery from recession frustratingly slow. In fact this period was later characterized as a "jobless recovery."

Today, banks again are recapitalizing after making imprudent loans; and again, they are doing so in the face of a sluggish economy. However, one key difference is that today much more overall lending activity is securitized. This has spread losses among a wider swath of financial institutions and has made it more difficult to quantify losses. As a result, we have seen a broader disruption of credit flows, even than those of the early 1990s. This suggests we may again be in for a period of weak growth.

Now let's consider the stance of policy. Today, the nominal funds rate is at 2 percent. In January, projections FOMC members made for PCE inflation in the medium term were in the range of 1-3/4 to 2-1/4 percent. This means the real fed funds rate is close to zero or perhaps slightly negative. Looking back at the early 1990s, the nominal funds rate bottomed out at 3 percent in 1992. Given the higher inflation expectations at the time, this also translated into a real funds rate that probably was close to zero—just like today.

In normal times, a real funds rate near or below zero would be considered highly accommodative. However, then, as now, the boost to aggregate demand from the accommodative funds rate was offset to some degree by financial market turmoil. Because we think the disruptions today are more significant than in the early 1990s, this offset also is larger today. In contrast, today we have in place the various additional measures that provide extra liquidity. No such facilities were in place in the early 1990s. It is difficult to weigh the various factors. But with this difficulty in mind, and given my reading today of economic prospects, my judgment is that the current net stance of monetary policy is accommodative—and this is appropriate in order to address the way we currently see the sluggish economy unfolding in 2008. I also believe that the current stance roughly balances out substantial risks to the outlooks for both growth and inflation—which I see as being to the downside for growth and to the upside for inflation.

Economic Outlook

Let's now turn to the outlook for growth and inflation.

Current Economic Situation

As you may know, real gross domestic product grew at an annual rate of just 0.6 percent in the first quarter of the year. This was the same sluggish rate as in the fourth quarter of 2007. Not surprisingly much of this weakness stemmed from the household sector, as residential investment declined at an annual rate of almost 27 percent and personal consumption grew well below its long-run average. Slower income growth, falling consumer sentiment, higher food and energy prices, lower housing and equity wealth, and tighter credit conditions are all restraining household spending, and are likely to do so in the near term. And, importantly, the labor market has softened. Nonfarm payroll employment fell an average of 80,000 jobs per month in the first quarter and dropped an additional 20,000 in April. And these losses came on the heels of a steady decline in job growth over the course of 2007.

In the business sector, spending on equipment, software, and structures declined at a 2-1/2 percent rate in the first quarter, reflecting tighter credit conditions and less need to expand capacity in a slower economic environment. One bright spot has been net exports. The weaker dollar, which is down around 25 percent since 2002, as well as continued growth abroad, has kept exports rising at a solid rate; last quarter, they grew 5.5 percent.

Inflation, as measured by the year-over-year change in core PCE prices, was 2 percent in the first quarter of 2008. But once we include the volatile food and energy components, total PCE inflation was 3.4 percent.

Future Economic Outlook

Looking ahead, our outlook at the Chicago Fed is for continued weakness in real GDP over the near term. Activity is likely to remain weak for a number of reasons. Strains on intermediation and financial balance sheets mean that credit conditions will likely continue to restrict spending for some time. Businesses and consumers could limit their discretionary expenditures because of caution over the economic environment. And housing continues to be a downside factor. The unsold inventory of homes will continue to restrain residential investment, and it will take time for this overhang to unwind.

However, eventually the cumulative adjustments in house prices will bring more buyers into the market and activity will stabilize. While we don't expect any significant contributions to growth from residential construction for some time, the drag from the sector ought to at least diminish as we move through the rest of this year and next. Similarly, as financial market participants revalue portfolios and repair their balance sheets, the drag from credit conditions ought to diminish over time. Furthermore, even given the financial turmoil, the stance of monetary policy is accommodative and supportive of growth. Productivity growth, although below the lofty rates enjoyed in the late 1990s and earlier this decade, is still solid. Finally, the effects of the fiscal stimulus bill are likely to boost spending in 2008.

Summing all of these factors, we think conditions will improve in the second half of this year, but not enough to prevent economic activity from still running at a relatively sluggish pace. We expect real GDP growth will return close to potential as we move through 2009.

Regarding the outlook for inflation, we project improvement over the medium term, with core inflation in the range of 1-1/2 to 2 percent by 2010. This forecast assumes that the resource slack being generated by the current weakness in the real economy will work to offset the cost pressures from higher energy and commodity prices. Productivity also is a plus in holding down costs. For example, although compensation increased 3.4 percent over the past year, overall unit labor costs changed very little because workers were quite productive. Productivity, which is the amount of output per hour worked, grew at a quite healthy 3.2 percent rate.

Our forecast also assumes—in line with current readings from futures markets—that energy and commodity prices will stabilize some time over the medium term. Clearly, there are risks to the inflation outlook if this stabilization does not occur. We also could be adversely affected by higher prices for imported goods. Finally, although the persistently high readings of commodity, food, and energy prices do not appear to have had a major impact on longer-run inflation expectations, we have to be mindful of their potential to do so. Any increase in inflation expectations would pose an important risk to the achievement of price stability.

Conclusion

To conclude, the U.S. economy has experienced some very large shocks since mid-2007, and economic policy, including monetary, fiscal, and financial, has responded aggressively to address the strains in the economy and financial markets. In my opinion, monetary policy is accommodative and appropriately situated to address the substantial risks that remain both for sluggish economic activity as well as unwelcome inflationary pressures.

It is important to recognize that monetary policy influences economic activity and inflation with a lag. Furthermore, given the challenging financial circumstances, it seems likely that credit conditions will also require adjustment time, as financial institutions reevaluate their portfolios and capital needs. As a result, the level of uncertainty regarding future developments continues to be high and the path forward may be uneven. We must keep this in mind as we evaluate the outlook. I am confident that policymakers will continue to respond to future unexpected changes in the environment for growth and inflation as needed in order to promote sustainable growth and price stability.

Notes

¹ Summary of Economic Projections in the Minutes of the Federal Open Market Committee, January 29–30, 2008, page 5.

² The expected fed funds rate can be measured by the overnight index swap (OIS) rate.

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.