FEDERAL RESERVE BANK of CHICAGO

Last Updated: 12/01/09

Unprecedented Times in our Economy

Fond du Lac Area Association of Commerce
Fond du Lac, WI

Introduction

Good afternoon and thank you for inviting me to speak today. It's always a pleasure to have the opportunity to visit Wisconsin, and I am delighted to be here. Let me start by thanking the Fond du Lac Chamber of Commerce and Mike Burch, of National Exchange Bank and Trust, who helped arrange my visit.

Today I'd like to share some thoughts on the extraordinary events that have occurred in the financial markets over the past several weeks. I will also discuss the national and regional economies. Before we begin, though, let me note that the views I express today are my own and are not necessarily shared by my colleagues on the Federal Open Market Committee.

Turbulent Times

Over the past year, we have witnessed the deteriorating performance of mortgages and mortgage-backed securities spill over to other segments of our financial markets. Market participants have reassessed the risk profiles of other similarly structured assets, and prices of these securities have declined as well. This cascading process of re-pricing has had a detrimental impact on liquidity and capital positions in a wide range of financial institutions and markets in the United States and around the world.

And over the past few weeks we have witnessed large-scale disruptions to our financial services industry. Policymakers, financial institutions, and nonfinancial borrowers and lenders are struggling with how best to respond to the stressed markets and support economic growth. We are, undoubtedly, in the midst of extraordinarily turbulent times.

The disruptions to financial markets have made credit more costly and more difficult to obtain for many households and businesses. Banks are reluctant to lend to one another because of concerns over counterparty risk and the desire to preserve liquidity. This has resulted in large increases in the London interbank offered rate, or LIBOR—the common benchmark for the interest rate charged on short-term interbank lending. Many banks set their interest charges on loans to households and businesses as a markup over their cost of funds, as measured by LIBOR. Increases in LIBOR, no doubt, have translated into higher bank borrowing rates for those of you operating a business today. Before this financial turmoil began, the 30-day LIBOR rate was typically hovering about 10 basis points above the level of the fed funds rate that would be expected to prevail over the term of the loan. [1] Since the summer of 2007 the spread has risen substantially—and in recent weeks it jumped as high as 300 basis points.

In the commercial paper (CP) markets, difficulties over some financial services firms' ability to roll over their CP have also strained the markets for other types of CP. This, of course, is affecting both the availability and cost of funding through the CP market to some nonfinancial firms.

As a result of the restrictive lending procedures of banks, and the strains in other credit markets, consumers and businesses have experienced reduced and more costly access to credit. This, in turn, has weighed on overall spending. In addition, the protracted weakness in the housing markets, along with elevated prices for energy and other commodities, continues to be a drag on the economy; these economic conditions have also reduced the spending capacity of households and businesses.

And so, as a consequence of these factors, job creation, consumer spending, and industrial production, have all weakened. Payroll employment declined again in September, bringing the cumulative year-to-date job losses to 760,000. There also has been a sharp rise in the unemployment rate this year—in September it was 6.1 percent, a full percentage point above the level many view as being consistent with "full employment."

Weak labor markets and high consumer prices have held back growth in real incomes, contributing to marked weakness in consumer spending. The average level of real personal consumption expenditures for goods and services in July and August was down more than 2 percent at an annual rate from the second quarter. And the latest data on retail sales point to another decline in spending on goods in September.

Conditions in labor markets and high consumer prices also have impacted some manufacturing industries. Industrial production has fallen nearly 2 percent since last December. The most recent information indicates a 3 percent drop in production for the month of September as compared to August. And after changing very little for about a year, the Institute for Supply Management manufacturing purchasing managers' index was down sharply last month. One bright spot for the U.S.

economy has been exports. In August, real exports were up 10 percent from the previous year. However, the turmoil in global financial markets is reducing the growth of many of our trading partners. So, looking ahead, it may be difficult to maintain the recent pace of export growth.

We also are concerned about the increased rate of inflation. Inflation has risen partly because of earlier spikes in commodity prices—particularly energy prices. Another reason has been soaring food prices. Even excluding food and energy, so-called core inflation for personal consumption expenditures was up to 2.6 percent (year-over-year) in August. In my opinion, this rate has been high. Looking ahead, commodity prices have fallen from their peaks. Also, the dollar has regained ground from its previous lows, which should moderate import prices. Furthermore, the increased slack in the economy will likely reduce more general cost and inflationary pressures. This channel definitely seems stronger today. Although some risks to the inflation outlook remain, a forward-looking assessment would put less weight on inflation concerns than earlier this summer.

With that in mind, the outlook for real economic activity likely will result in production, spending, and labor markets being very sluggish in the second half of this year and well into 2009. I expect that such activity will then pick up as the housing and financial markets gain headway in working through their problems. Such progress would be signaled by stabilization in construction and improvement in credit flows.

There is, of course, a level of cloudiness in any economic forecast. In the current situation, the substantial stress in the financial markets has led to an unusually high degree of uncertainty. This is because it is extremely difficult to assess how the turmoil will influence markets and how policy responses to address the economic unrest will play out over time.

Last week, after considering all of the issues, the Federal Open Market Committee decided to lower the federal funds rate—the primary instrument of monetary policy—50 basis points to 1-1/2 percent. This brings the cumulative decline in the funds rate since last September 2007 to 375 basis points. We at the Federal Reserve continuously reevaluate the stance of monetary policy in light of current and forecasted conditions, as well as our assessments of the risks to our long-term objectives of maximum sustainable growth and price stability. Currently, these risk assessments must factor in the substantial uncertainties in the outlooks for growth and inflation that I just described. These uncertainties certainly pose difficult challenges for policymakers.

In addition to lowering the fed funds rate, we have also implemented a number of policies aimed at supporting the flow of liquidity through the financial system. Our most recent moves have been to institute lending facilities to support money market mutual funds and the commercial paper market. Collectively, these actions are designed to increase market liquidity by lengthening lending terms, reducing the cost of borrowing relative to the fed funds rate, expanding the range of eligible counterparties, and enlarging the pool of eligible collateral. These actions also have targeted liquidity to those systemically important markets that are experiencing large-scale disruptions in their operations.

Of course, other important policy decisions also are being made. Two weeks ago Congress enacted, and the President signed, the Emergency Economic Stabilization Act. And earlier this week the Treasury announced details of a plan that would inject significant capital into the banking system. These actions are unprecedented in scope to address the difficulties we face as a nation. I believe they will help unlock lending capacity and will move us toward financial stability. I will be happy to address questions on this topic after my remarks, but let me now turn away from "breaking news" and spend a little time on the health of the regional economy and its importance to the national economy.

Regional Economy

Turning to our region's economic performance, the agriculture and manufacturing sectors are of great importance to us in the Seventh Federal Reserve District. Our District includes Iowa and the larger parts of Illinois, Indiana, Michigan, and Wisconsin. This region makes up 13 percent of both the U.S. population and our gross domestic product. It produces nearly 30 percent of America's vehicles; more than a third of America's steel; more than half of its farm machinery; and almost half of our corn, soybeans, and pork. So, of course, we at the Federal Reserve Bank of Chicago closely monitor the agriculture and manufacturing sectors.

Wisconsin is one of the most diverse agricultural production states in the nation, and it's one of the top ten agriculture states. More than half of the land in our five-state region is either cropland or pasture. The agriculture industry in Wisconsin produces nearly $52 billion annually and employs more than 12 percent of the state's labor force. [2]

Given Wisconsin's strong agricultural tradition, it is not surprising that we at the Chicago Fed are interested in measures of innovation in agriculture that promote increased productivity and an economic boost to the region. Of particular interest are areas that transform agriculture through modern science and significantly improve production operations and overall efficiency.

One reason that agriculture has been so successful has been the tremendous growth in productivity in the sector. Research and development activities related to agriculture have led to tremendous output growth. Over the past forty years, corn yields in the District have more than doubled, and milk production per cow has increased almost 150 percent. Continued investment in technological innovations and in research and development will, no doubt, result in further production efficiencies, better products, and higher return on investments for agriculture in the Midwest.

Manufacturing continues to be the bellwether industry for Wisconsin and for much of the Midwest. As measured by personal income, the Midwest economy derives 60 percent more of its annual gross product directly from manufacturing companies as compared with the remainder of the U.S.

Of course, manufacturing performance varies sharply from sector to sector. Currently, you will not be surprised to hear that production of transportation equipment—which in the Midwest largely means the automotive industry—shows steep declines. In contrast, our machinery sector—which builds a host of capital goods—is holding up much better. By historical standards this deviation is somewhat unusual. It largely reflects strong economic growth by our international trading partners that are demanding items we make, such as tractors, construction equipment, medical devices, generators, and mining equipment.

Differences in the concentration in specific industrial sectors have influenced the economic performance among the states in the District. Since 2000, the automotive-intensive states of Indiana and Michigan have experienced deteriorating labor markets relative to the national average. In contrast, several metropolitan areas in Illinois, Wisconsin, and Iowa with machinery-intensive manufacturing operations have held up better than in the past. We have a "tale of two industries" within the District, with significant stress in many of our automotive-dominated metropolitan areas, but also continued prosperity in many of our machinery-concentrated areas.

Much like the broader region itself, parts of Wisconsin's economy continue to be tied to the automotive industry. The Janesville area has been adversely affected by high gasoline prices and slowing auto sales. This will, undoubtedly, have a downward effect on other Wisconsin companies that supply parts and machinery to the automotive industry. However, in comparison to the manufacturing sectors in Michigan, Indiana, and Ohio, Wisconsin's is more concentrated in capital equipment rather than in motor vehicles. Wisconsin is an important producer of machine tools construction and farm machinery, food processing equipment, electronic control systems, and diagnostic medical systems.

Sales growth in these sectors has been holding up well in recent years, as U.S. manufacturers have expanded markets to both customers across the nation and, increasingly, customers around the world. Over the two-year period ending in 2007, Wisconsin's export goods expanded by over 28 percent, reaching over $19 billion annually as of 2007. Nonelectrical machinery topped the list of export product categories for the state, with over $6 billion (2007), followed by electrical machinery and scientific/medical instruments. Nonelectrical machinery grew at a pace of 10 percent annually from 2005 through 2007; the second highest category of exports, electrical machinery, grew by over 20 percent annually.

Wisconsin's capital goods orientation largely reflects a national restructuring that has seen a steady shift in the specialization of U.S. manufacturers producing goods and services; it also reflects a continued export growth. Today, The U.S. produces more than 20 percent of the world's manufactured goods—the largest output in the world—with less than 5 percent of the global population. In 2007, manufactured exports made up 6.6 percent of the nation's output—and an estimated 8 percent of the output of the Seventh Federal Reserve District.

Wisconsin's long-standing investment in academic excellence is also beginning to spawn new industries. The University of Wisconsin at Madison ranks in the top 20 in receipt of National Institutes of Health funding for health and life sciences research, and the University produces prodigious numbers of graduates in related fields. As a result of this activity, along with close attention to tech transfer and economic development, over 250 biotech, health, agriculture, and life sciences firms are up and running in the footprint of the University around Madison. By their nature, biotech goods and services serve wide national and global markets. While the dollar export levels do not yet approach Wisconsin's mature machinery industries, pharmaceutical products now rank 30th among state export categories, after rising over 3.5 times since 1996.

Conclusion

Currently, the economy faces serious challenges. The housing market is a continuing strain, and we are experiencing disruptions in worldwide credit markets that are without precedent in the post-World War II era. Such challenges call for innovative and vigorous fiscal and monetary policy responses. In response, the Fed and other central banks have implemented a number of nonstandard facilities for injecting liquidity into strained markets, and they have made a coordinated reduction in their monetary policy interest rate targets. Fiscal authorities also have responded to economic challenges. In the U.S., we enacted the Emergency Economic Stabilization Act and instituted programs to insure some debt of financial institutions. These actions complement efforts by other nations to recapitalize their banking systems and facilitate interbank lending.

I believe these efforts will be of great help in unlocking lending capacity, enhancing the flow of credit to consumers and businesses, and moving us toward financial stability. But bringing credit markets back into full functionality won't happen overnight. And when normality is ultimately restored, the "new normal" will likely operate through different channels and under different constraints than before the financial turmoil. Yet, the "new normal" will represent a substantial improvement from where we are today.

As credit flows do begin to improve, the risks to growth will diminish, and we will be able to concentrate again on our traditional policy tools, using them in ways that help the economy achieve maximum sustainable growth and price stability.

Notes

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

[2] Wisconsin Farm Bureau Federation, 2008, web site, available online.

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.