FEDERAL RESERVE BANK of CHICAGO

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Economic Update

Michigan Bankers Association
Dearborn, MI

Introduction

Thank you, Doug [Chaffin, president and CEO of Monroe Bank & Trust] for that introduction. And thanks to the Michigan Bankers Association for inviting me to speak today. I'm delighted to be here to share my thoughts on the economy during this challenging period. I'd like to also say a special thank you to Mike Magee, who unfortunately could not join us today. Mike is a member of the board of directors of the Detroit Branch of the Chicago Fed. As a board member, he provides us with valuable information on the regional business outlook and credit conditions. This information not only helps us gauge the local economies within the Seventh District but also contributes to our understanding of developments in the national economy. As such, it is an important input into my thinking about the course of the economy and the appropriate course for monetary policy.

Today I will discuss the recent events in financial markets and the Federal Reserve's responses to them. I will also give you my take on the current economic outlook. As always, these are my own views and not necessarily those of my colleagues in the Federal Reserve System.

Let me begin with the financial crisis.

Early Stages of the Financial Crisis

Over the past year and a half we have witnessed the deteriorating performance of mortgages and a broad array of mortgage-backed securities—some of which, as you know, are highly structured instruments with opaque risk profiles. The problems in mortgages have spilled over to other segments of our financial markets. Market participants have reassessed the risk profiles of other complex securities, and the prices of these assets have declined as well. This cascading process of re-pricing has had a detrimental impact on the liquidity and capital positions of a wide range of financial institutions in the United States and around the world.

The resulting disruptions to financial markets have made credit more costly and more difficult to obtain for many households and businesses. Banks are reluctant to lend even to one another because of concerns over counterparty risk, the desire to preserve liquidity, and limited balance sheet capacity. This has resulted in large increases between the London interbank offered rate, or LIBOR, and the federal funds rate. LIBOR, of course, is a common benchmark for the interest rate charged on short-term interbank lending. Many banks set their interest rates 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 borrowing rates for those of you operating a business today. Before this financial turmoil began, the 30-day LIBOR typically hovered about 10 basis points above the level of the fed funds rate that would be expected to prevail over the term of the loan. Since the summer of 2007 the spread has risen substantially, averaging about 50 basis points between August 2007 and August 2008, with a couple of spikes to about 1 percent.

Strains on financial institutions have also spilled over to other markets, like that for commercial paper. Because of concerns over their ability to meet future payments, some financial services firms have had difficulty rolling over commercial paper. They have seen their costs of issuing paper rise substantially. These difficulties are also affecting the availability and cost of commercial paper funding to nonfinancial firms. Nonfinancial firms often issue commercial paper to fund regular operations such as meeting payrolls and buying materials. In addition, finance companies issue commercial paper to support leasing and to extend credit to nonfinancial customers, such as in the provision of car loans and the financing of inventories.

The tightening of credit conditions has weighed on spending by households and businesses. Their spending capacity was also reduced by the protracted weakness in housing markets, along with earlier increases in prices for energy and other commodities. As a result, aggregate economic activity has deteriorated to the point that the U.S. economy is now in the midst of a substantial downturn.

Over the past couple of months, we have witnessed another wave of large-scale disruptions to the financial services industry. These recent developments reflect a confluence of factors.

As we moved through the summer, the financial system faced increasing difficulties owing to further deterioration of the economy. Consumption began to contract noticeably and labor markets declined at an accelerating pace. The weakness in economic activity intensified the strains on banks, since not only mortgage loans but also business, car, and credit card loans

started to exhibit higher default risks. The deteriorating credit risks led banks to hold on to liquid assets even more and to tighten credit standards even further.

At the same time that the macroeconomic picture was deteriorating, a number of large financial firms were reporting severe losses. Some institutions—notably Wachovia, Washington Mutual, and Merrill Lynch—appeared unable to survive on their own and were purchased by large banks. However, the losses at Lehman Brothers were especially large, and a buyer could not be found. Consequently, Lehman had to declare bankruptcy. At almost the same time, American International Group (AIG), one of the most important issuers of credit default insurance, found itself unable to meet its liabilities without a loan from the Federal Reserve.

These developments dealt a serious blow to market confidence. The problems in these major institutions intensified financial market participants' concerns about the ability of their counterparties to repay debt. This heightened assessment of risk resulted in funding becoming even more difficult and expensive to obtain across a spectrum of markets.

In the interbank market, LIBOR spreads spiked up again, jumping briefly as high as 335 basis points. This, of course, made many types of bank loans even more expensive. Banks also further tightened their credit standards for new lending to both businesses and households.

In credit markets, concerns about the loss exposure of normally highly rated firms led to a fall in value of a wide range of debt instruments and derivative products. In commercial paper, this was reflected in a spike in rates for many issues, particularly those for asset-backed securities and the paper of lower-rated nonfinancial firms.

Furthermore, the problems in the commercial paper and other short-term lending markets continued to spread following the initial shock. In part, this reflected a feedback loop between these markets and the money market mutual funds. Money market funds hold commercial paper and engage in repurchase agreements with highly rated firms. Money market mutual funds that held Lehman or other now distressed paper were exposed to potentially significant losses. Indeed, the Reserve Primary Fund, ended up "breaking the buck," meaning its net asset value per share dropped below $1, after suffering losses on its holdings of Lehman debt.

As a result of such losses, many investors began redeeming funds from money market accounts or shifting funds into Treasury-only accounts. To meet the redemptions, many money market funds had to liquidate assets into an already depressed market. In addition, other commercial paper was downgraded and became ineligible to be purchased by money market mutual funds, exerting further downward pressure on this market. Furthermore, as perceived price risk and redemption risk increased dramatically, there was a marked reduction in the maturity of commercial paper and other debt being rolled through the markets.

As a consequence of these pressures, even some highly rated firms found it more difficult and expensive to obtain short-term financing through the commercial paper and repo markets. Some of these firms have been able to tap bank backup lines of credit. But this substitution just pushes the money market difficulties back into the banking system. The drawdowns of existing bank revolvers and credit lines increase the size of banks' balance sheets at a time when they are trying to reduce leverage. Thus, they potentially squeeze out the ability of banks to make other loans. This is similar to how the redemptions by the money market funds' customers reduced the funds' capacity to invest in commercial paper that nonfinancial firms then use to fund operations.

Actions by the Federal Reserve

The Fed has implemented a number of policy responses to these extraordinary events, aimed at mitigating the problems in the financial system and their potential fallout on the spending and production capacity of the rest of the economy.

First, the Fed turned to its traditional monetary policy instruments, that is, to reductions in the federal funds rate and the discount rate. In August 2007, the Fed reduced the spread of the discount rate over the federal funds rate from 100 basis points to 50 basis points; and last March it was reduced further to 25 basis points. The first funds rate cut occurred in September 2007. The initial moves during the fall of 2007 were measured, but eventually gave way to more aggressive rate cuts. Today, the funds rate is 1 percent, 425 basis points lower than when we began.

Although the corresponding injections of liquidity into the overnight interbank market have reduced restrictive credit conditions somewhat, it became clear early on that further and alternative extensions of central bank liquidity would be necessary to restore adequate interbank lending at term and further facilitate market functioning.

Even in normal times, the discount window at the Fed is available to sound depository institutions in order to smooth payment difficulties. Such lending can also help the flow of credit in interbank markets more generally and as early as the fall of 2007, the Fed made a number of substantial changes to the operation of the window to encourage its use. One change was increasing the maximum term of the loans to up to 90 days; traditionally, borrowing at the window was overnight or very short term. And since these changes have been made, we have seen a large increase in lending to depository institutions.

Earlier this year, new market dysfunctions emerged, such as the collapse of the auction rate security market. And then there was the sudden demise of Bear Stearns last March. These episodes clearly indicated that in this strained environment, financial market participants other than depository institutions might face liquidity shortfalls that could have serious, far-ranging repercussions for the economy. This led the Fed to create a number of facilities to directly provide liquidity to nondepository institutions; the Federal Reserve Act grants us such emergency powers when the economy is faced with "unusual and exigent circumstances."

At first, these measures were aimed at lending to broker-dealers who engage in securities transactions with the Fed and who have a large-scale presence in the repo and other short-term funding markets. Most recently, we have introduced new lending facilities to help work through the disruptions in the money market mutual fund and commercial paper markets. These programs provide a liquidity backstop for commercial paper and facilitate the sale in secondary markets of a number of instruments held by money market funds.

Although it is still early, I am hopeful that these programs will have substantial, positive effects on restoring liquidity in the short-term financing market. Indeed, the spreads between commercial paper and the fed funds rate have fallen, retracing most of the run-up that occurred in mid-September.

Of course, the Federal Reserve has not been alone in dealing with the crisis. The FDIC (Federal Deposit Insurance Corporation) increased deposit insurance limits and put in place special facilities to insure other liabilities of depository institutions. Congress enacted the Emergency Economic Stabilization Act, which authorized the Treasury Department's Troubled Assets Relief Program, or TARP. Importantly to many of you, this program has so far provided more than $200 billion in capital injections to the banking system to support the lending capacity of banks. And, as you are aware, these capital injections are made through issuance of preferred stock and also include other features that support the prudent stewardship of taxpayer resources.

Most recently, the Treasury, the FDIC, and the Fed have worked together to avoid further market disruption in a number of ways. In late November we provided guarantees, liquidity access, and additional capital to assist Citigroup through a difficult period.

In another joint program, the Federal Reserve and the Treasury are establishing a facility to lend to holders of student, consumer, and small businesses credit, using TARP funds to provide credit protection to the facility.

Finally, the Fed is also launching a facility that will purchase debt obligations and mortgage-backed securities issued by Fannie Mae, Freddie Mac, and other government-sponsored enterprises. The initiative will help support the flow of credit and lower credit in mortgage markets.

I believe that together the actions by the Fed and the other branches of government will help unlock lending capacity and will move us toward financial stability. It will not be an easy process, and it could take some time before financial markets function in a manner that does not impinge on the activities of businesses and households. But we will continue to use all of our resources to preserve the strength of our banking institutions and promote the process of repair and recovery of our financial markets.

Economic Outlook

That brings me to recent developments in the nonfinancial sectors of the economy, as well as the outlook over the next few years.

The National Bureau of Economic Research declared the U.S. economy peaked in December of 2007 and subsequently entered into a recession. Both income and payroll employment started to fall, with the declines accelerating in recent months. Overall gross domestic product (GDP) growth has been choppy, but in the third quarter GDP fell at an annual rate of 0.5 percent and appears to be headed for a much larger decline in the current quarter. Payrolls, which had been declining slowly, fell sharply in September and October, bringing the year-to-date job losses to 1.2 million. October also brought a sharp rise in the unemployment rate to 6.5 percent. Weak labor markets and rising consumer prices have held back growth in real incomes. These, along with the financial strains, have led to marked weakness in business investment, industrial production, and consumer spending. Indeed, the declines in consumer spending over the past few months have been very large—on par with the drops experienced during the 1990 and 1982 recessions.

At this time it is very difficult to judge how long the downturn might last and how deep it ultimately will be. As financial markets work through their problems—with important help from government policy—and credit flows improve, we will see a return of growth in spending, production, and employment. But given the magnitude of the problems that we face, we could see activity remaining quite sluggish through much of 2009.

This thinking shaped the forecast that I submitted at our most recent Federal Open Market Committee (FOMC) meeting on October 28 and 29. At that time, the central tendency of the forecasts of the Governors and Reserve Bank presidents for GDP growth for 2008 as a whole was a range of 0 to 0.3 percent. Given that GDP growth averaged a little under 2 percent in the first half of the year, you can do the math: These forecasts imply a noticeable decline in real GDP in the second half of the year.

In explaining their forecasts, many participants noted the weakening data on consumer spending, stock market wealth, consumer confidence, and labor market conditions, as well as the severe dislocations in credit markets. These factors were expected to weigh heavily on household and business spending in 2008 and persist to some degree in 2009. Furthermore, weakness abroad was expected to hold back growth in exports. Accordingly, participants were looking for a relatively gradual recovery, with most of the forecasts for 2009 being somewhere between a one-quarter percent decline and a 1 percent increase in real GDP. The recovery is expected to take hold more firmly in 2010 and 2011.

In this growth environment, most forecasts had the unemployment rate rising to between 7.1 and 7.6 percent by the fourth quarter of 2009 before moving down to between 5-1/2 and 6-1/2 percent by the end of 2011. Such unemployment rates would mean that a substantial degree of resource slack would remain in the economy over the next few years. This slack, along with the recent declines in the prices of energy and other commodities, should bring down inflation. Increases in the price index for total personal consumption expenditures were projected to fall from the 2-3/4 to 3 percent range in 2008 to between 1.4 and 1.7 percent in 2011. To me, this outcome would be consistent with price stability.

When submitting these forecasts, the Committee members also noted that the degree of uncertainty about the outlook was unusually high. In large part this reflects the wide range of possible outcomes for the financial crisis and the associated interactions with the real economy.

Personally, I thought it was easier to envision the bad outcome scenarios than the good ones. Most of my colleagues agreed, and so viewed the risks to the forecast as being skewed to the downside.

Indeed, since these projections were made, the incoming data, particularly on consumer spending and labor market conditions, have been weaker than I had expected. As I just mentioned, overall activity appears to be contracting markedly this quarter. That said, not all of the news has been bad. The prices for energy and other commodities have come down further. And, as I mentioned earlier, we have seen some declines in spreads on interbank borrowing rates and in the commercial paper market. I am hopeful that we will see continued improvement in financial market functioning and that this will show through in improved credit terms for households and nonfinancial businesses. But, as I noted earlier, it likely will be a while before markets are functioning in a manner that we would characterize as smooth and efficient.

Conclusion

To conclude, the U.S. economy continues to face many challenges. The Fed has been proactive in addressing market liquidity stress during the financial crisis—first by using our monetary policy tools and later through our improvised lending facilities in response to financial markets. Moving forward, it is important that we be vigilant in monitoring the risks to growth, as well as any risks to the prospects for obtaining price stability. It is also important for us to continue to collaborate with global policymakers in the pursuit of financial stability worldwide. We likely are in for a protracted period of poor economic performance. But the policy actions taken by the Fed and other governmental agencies over the course of the financial crisis, and the effort of the private sector to work through its difficulties, will eventually help support a recovery in economic growth.

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.