FEDERAL RESERVE BANK of CHICAGO

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Economic Outlook and Policy Challenges

CFA Society of Iowa
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Introduction

Good afternoon and thank you for inviting me to speak to you today. And thank you, Phelps Hoyt [Vice President of the CFA Society of Iowa] for that kind introduction and arranging my visit.

Currently, we find ourselves in the midst of a serious recession—one that appears headed towards an experience more like the large downturns in the 1970s and 1980s than the moderate contractions of 1990 and 2001. Today I will discuss the events that brought us to this point, the outlook for the economy, and the policy challenges confronting the Fed during these troubling times. I should note that these are, of course, my own views and not necessarily those of my colleagues in the Federal Reserve System.

Background

Over the past 18 months the economy has experienced deteriorating housing markets, large-scale disruptions to our financial services industry, and plummeting consumer and business confidence. These and related developments have resulted in a significant decline in overall spending and production and a rise in the unemployment rate, particularly over the past six months. All of this has occurred despite aggressive actions by the Federal Reserve, the Treasury, and the Federal Deposit Insurance Corporation (FDIC) to address difficulties in credit markets and bolster aggregate demand. And as you know, Congress has been working on a fiscal stimulus package, and the Treasury has recommended new proposals to deal with the financial sector problems. I will touch more on these later.

These certainly are challenging, if not extraordinary, times. How did we get here?

In 2007 housing prices peaked, mortgage defaults rose, and strains began to appear in the market for securitized mortgages. The problems in mortgages spilled over to other segments of our financial markets. Market participants re-assessed risk, and the prices of many assets declined. This cascading process of re-pricing 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.

By the spring and summer of 2008, the tightening of credit conditions had begun to weigh on business spending. And by the fall, household spending was affected as well. Spending was also reduced by the protracted weakness in housing markets, declines in financial wealth, softening labor markets, and substantial increases in prices for energy and other commodities. These factors contributed to a contraction in gross domestic product (GDP) beginning in the third quarter of 2008.

A series of solvency and liquidity events also occurred during this period. Many financial firms reported severe losses, with big names like Bear Stearns, Wachovia, Washington Mutual, Merrill Lynch, Lehman Brothers, and American International Group (AIG) all on the list. Some of these firms appeared unable to survive on their own and were purchased by other financial institutions. In the case of Bear Sterns, this involved assistance from the Federal Reserve. The Federal Reserve and the Treasury also were able to arrange loans and guarantees to AIG in order to avoid large-scale disruptions in markets that had exposures to credit default swaps written by AIG. In contrast, when Lehman Brothers experienced especially large losses last September, no sale or loan support could be made at suitable terms. As a result, they went into bankruptcy.

These developments intensified financial market participants' concerns over the potential losses on a range of assets as well as the ability of their counterparties to meet contractual obligations. One important sector that was disrupted was the money market fund industry. Money funds are major suppliers of financing to the commercial paper and other short-term credit markets. Worried over losses, investors in money market funds began making redemptions. To meet these, some funds had to liquidate assets into an already depressed market, further lowering the prices of these instruments.

This process resulted in a marked increase in the cost of issuing all but the safest, shortest maturity of debt that usually rolls through these markets. Even highly rated firms have found it more difficult and expensive to obtain financing. Some have been able to tap bank backup lines of credit. But this substitution just pushes the funding difficulties back into the banking system, squeezing out the ability of banks to make other loans.

Actions by the Federal Reserve

In response to these extraordinary events, the Fed has implemented a number of policies aimed at mitigating the problems in the financial system and their potential fallout on the rest of the economy.

First, the Fed turned to its traditional principal monetary policy instrument, the federal funds rate. Since September 2007, the Federal Open Market Committee has lowered the target funds rate 525 basis points, bringing it to essentially zero in December of last year.

Although the corresponding injections of broad liquidity helped credit conditions somewhat, it became clear early on that more had to be done to facilitate market functioning.

At first, we simply made a number of adjustments to make it more attractive for banks to borrow from the discount window—which is the traditional way the Fed lends overnight to depository institutions.

Given the events of 2008—in which all types of institutions faced liquidity shortfalls—the Fed created 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."

Most of these facilities have been aimed at the functioning of short-term credit markets. Some lend to broker-dealers that engage in securities transactions with the Fed and have a large-scale presence in short-term funding markets such as the repo market. Others provide a liquidity backstop for commercial paper issuers and facilitate the sale in secondary markets of a number of instruments held by money market funds. As such, these facilities are lending at relatively short maturities—generally not more than 90 days.

More recent Fed actions, however, have taken some longer-term assets onto our balance sheet. In December, we began purchasing debt obligations and mortgage-backed securities issued by Fannie Mae, Freddie Mac, and other government-sponsored enterprises (GSEs). This initiative will help support the flow of credit and lower borrowing costs in mortgage markets.

Of course, the Federal Reserve has not been alone in dealing with the crisis. The FDIC increased deposit insurance limits and began to offer insurance on some liabilities of eligible depository institutions and financial holding companies. Congress enacted the Emergency Economic Stabilization Act, which authorized the Treasury Department's Troubled Assets Relief Program, (or TARP). This program has so far provided more than $335 billion in capital injections to the financial system to support the lending capacity of banks.

Just yesterday, Treasury Secretary Geithner outlined the Financial Stability Plan. One element of the plan is aimed at valuing illiquid assets and moving them off of banks' balance sheets. By doing so, this should attract more private capital and ease balance sheet restrictions on banks' lending capacity.

We have seen a number of indications that the traditional easing of monetary policy and the nontraditional policy actions are beginning to help the functioning of credit markets and reduce financial strains. The spreads on the interest rates charged for interbank lending and on commercial paper relative to the fed funds rate have come down appreciably since October, particularly at the one-month maturity. $156 billion of debt has been issued with FDIC guarantees, facilitating medium-term funding by eligible financial institutions. And the rates on conforming mortgages relative to Treasury bonds have declined since the Fed's GSE purchase program was announced.

That said, market disruptions clearly remain, and most spreads between private lending rates and comparable-maturity risk-free government debt are still quite elevated relative to where they were before the crisis. Of course, we would not expect spreads and other lending terms to return to those prevailing before the crisis—a period when risk was clearly underpriced. Nevertheless, current spreads and terms seem to be well above where the "new normal" will end up.

Over the longer run, we will reach the "new normal." Policy actions and the work being done in the private sector to reassess risks and shore up balance sheets will help move us back toward something resembling financial stability. This will not be an easy process, and it could take time before financial markets function in a manner that fully facilitates the activities of businesses and households. Until they do, we will continue to experience some drag on activity in the nonfinancial sectors of the economy.

Economic Outlook

As we know only too well, the economy currently is contracting at a disturbing pace. Labor markets have deteriorated significantly. The unemployment rate was 4.9 percent when the recession started in December 2007; last month it reached 7.6 percent. Weak labor markets have held back growth in real incomes, and further declines in the stock-market and homes prices have led to marked reductions in household wealth. Slowing foreign activity and the higher dollar are reducing demand for our exports. Although there has been a modest improvement in some credit conditions, overall they still remain tight. The more pessimistic outlook for the economy has reduced everyone's confidence. In turn, we've seen a further pullback in risk-taking by investors, households, and businesses. They are particularly reluctant to take on longer-term investment or spending commitments.

Together, these factors have led to sharp drop offs in business investment, industrial production, and household spending. Overall output, as measured by real GDP, fell at a 0.5 percent annual rate in the third quarter of 2008 and then dropped at a 3.8 percent rate in the fourth quarter. Last quarter business fixed investment declined at a 19 percent annualized rate,

residential investment fell at a 22.4 percent rate, and consumer spending dropped at a 3.5 percent pace. These are very large declines—on par with those experienced during the recessions of the mid-1970s and early 1980s.

The factors that produced the sharp decline in output in the second half of last year are still in play today. Consequently, I expect real GDP will fall markedly in the first half of 2009. I am currently projecting that GDP will begin to expand some later in 2009, but not enough to offset the declines in the first half of the year. In part, this expected pickup reflects the support from both traditional and nontraditional monetary policies, fiscal actions already taken to address the strains in financial markets, and progress that financial markets themselves make in working through their difficulties. In addition, the new fiscal stimulus package will boost output. However, its full size and impact are still unclear, and our forecast could need some recalibration as we gain knowledge on how the package is affecting the economy. Looking out a bit further, I expect the pace of GDP growth to move back up in the neighborhood of potential as we move through 2010. However, I do not see growth as being strong enough to make much progress in closing resource gaps over this period. Indeed, the unemployment rate—the main resource gap measure in the labor market—is likely to rise into 2010.

On the inflation front, headline consumer prices have fallen in recent months, and core prices—which exclude the volatile food and energy categories—have changed little. This appreciable reduction in inflationary pressures reflects falling prices for energy and other commodities, declines in import prices, and the increase in resource slack due to diminished economic activity. Looking ahead, futures markets expect some increase in energy prices. However, substantial resource slack and the likelihood of some moderate reduction in inflation expectations should hold back overall price increases. Consequently, I expect additional slowing in core consumer price inflation in 2009 and a further edging down in 2010. Over the longer-run, with appropriate monetary policy, I see both overall and core inflation averaging somewhere into the neighborhood of 2 percent, which is a rate I see as being consistent with price stability. That said, there is notable risk that inflation will remain a good deal below this range in the medium term.

Some Perspectives on Policy

I am now going to turn to some broader perspectives on the policy picture. The traditional monetary policy action used to combat sluggish economic activity is to lower the fed funds rate. This in turn reduces other borrowing rates and thus stimulates aggregate demand.

In December the FOMC decided to move the funds rate to near zero and two weeks ago we voted to leave it unchanged. With the fed funds rate near zero, we cannot lower it any further. Yet, clearly, the recession, financial distress, and low inflationary pressures call for more policy accommodation. For the Fed, this means that the Committee will have to focus on other ways to impart monetary stimulus to the economy.

One way that monetary policy influences financial and economic activity is through the clarity of our intentions and communications. Expectations of likely future outcomes, including those for monetary policy, obviously matter for decisions made by households and businesses today. In this vein, at a time when near-term inflation is likely to be lower than usual, endorsing an explicit numerical objective for inflation could help keep inflation expectations from falling very far. Such an anchor on inflation expectations would help preserve low real inflation-adjusted interest rates.

Another way to increase monetary accommodation is to work to bring down unusual liquidity and risk premia that are raising private and longer-term borrowing costs. As I discussed earlier, the Federal Reserve has already operated in this arena, adopting a number of nonstandard policies that are providing liquidity support to a range of institutions and markets. And, if necessary, such nontraditional tools can be expanded.

In this regard, in November we announced another joint program with the Treasury, called the Term Asset-Backed Securities Loan Facility, or TALF. And yesterday the Fed announced it is prepared to undertake a substantial expansion of the TALF. Although not yet operational, the TALF should be up and running soon. This temporary facility is designed to support the demand for asset-backed securities by reducing the likelihood that future liquidity needs could force investors to sell into a depressed market. Holders of securities that are bundles of student, consumer, and small businesses loans can borrow from the TALF, using the securities themselves as collateral. Other asset-backed securities, such as commercial mortgage-backed securities, could also be eligible. The terms on these loans are more costly than those seen during more normal times. Thus TALF loans eventually will become unattractive when conditions improve in markets for traditional sources of funding. Large haircuts on the collateral and TARP funds provide the Fed with credit protection on the facility.

Another feature of the TALF is that its loans are for three years—medium-term loans that are noticeably longer than at our other lending facilities. So, like our GSE purchases, it can directly affect interest rates further out on the yield curve.

I should also note that, as conditions warrant, we will be expanding existing programs. In addition, we are considering the purchase of longer-term Treasury securities, if evolving circumstances indicate that such transactions would be particularly effective in improving conditions in private credit markets.

A common question I hear is: "What principles guide the implementation of these new initiatives?"

Let me step back for a second and discuss these programs at a more conceptual level. In a well-functioning financial system, arbitrage moves funds across markets and balances out profit opportunities. It thus aligns term and risk-adjusted returns across markets. This is the reason, for example, why our typical moves to lower the short-term risk-free federal funds rate affect borrowing rates over a large range of maturity and risk structures. In such an environment, we can focus on the size of the liquidity injection instead of the particular segment of the market in which the injection occurs.

But that is not the case today. There is abundant evidence that arbitrage opportunities remain unexploited. Due to balance-sheet capacity limitations, or because uncertainty and risk aversion are so much higher than normal, participants are largely avoiding markets that are undergoing unusual stress. For example, many student loan payments are guaranteed by the federal government. Despite the guarantees, liquidity disruptions have all but shut down the auction rate security markets that student loan providers had used to obtain a good deal of their funding. Subsequently, they have had substantial difficulty in attracting investors to other types of securities backed by student loans.

One way of thinking about these developments is that markets have become highly segmented. We do not see funds flowing in to take advantage of apparent profit opportunities with respect to distressed assets. Such an action could ease liquidity pressures in these sectors and help keep some problems from spilling over into solvency concerns.

The flip side of this segmentation is that liquidity injections aimed directly at a particular distressed market are less likely to leak out to other areas. The injections thus hold open the possibility of improving that market's functioning a good deal, seeding its transition to more normal liquidity and risk valuations. This is the rationale for why our nontraditional policies focus on loans and securities that affect transactions in particular key markets where we see points of stress. But a downside is that markets outside of this segment could experience stress because of the separation.

As stressed markets improve, more normal functioning of the financial system as whole can be achieved. Financial firms will become more willing to carry on their usual arbitrage activities, and market segmentation will diminish. As such, both the need and effectiveness of the special programs will diminish.

Because segmentation will change dynamically, the effectiveness and unintended consequences of credit policies can shift over time and in unexpected ways. This highlights the need for careful design and continuous monitoring of these programs.

More generally, as economic activity recovers and financial conditions normalize, the use of nontraditional policy tools and the size of the Fed's balance sheet will be reduced, and the FOMC will return to its traditional focus on the federal funds rate. Some of this wind-down will occur naturally as market conditions improve, given the particular pricing and maturity design features of these programs. Still, financial market participants need to be prepared for the eventual dismantling of the facilities that have been put in place during the financial turmoil. Fortunately, it is most likely that this dismantling would be associated with better economic and financial performance.

Conclusion

To conclude, the U.S. economy faces many challenges. The Fed has been proactive in addressing market liquidity stresses during the financial crisis—first by using our traditional monetary policy tools and later through our nontraditional lending facilities. Moving forward, we will be vigilant in monitoring the risks to growth and price stability. It is also important for us to continue to collaborate with policymakers throughout government and across the globe 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 efforts 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.