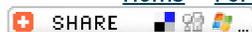


Search

[About Us](#)[For the Public](#)[Community Development](#)[Our Region](#)[Research](#)[Banking](#)[Learning Center](#)[Tours](#) [News & Media](#) [Streaming Media](#) [Speakers Bureau](#) [Savings Bonds](#)[Forefront Magazine](#)[Home](#) > [For the Public](#) > [News and Media](#) > [Speeches](#) > 2009 > Economic Stress and Forces for

Recovery



## Economic Stress and Forces for Recovery

### Introduction

My last speech here in Columbus was in June of last year, to a group of bankers. At that time, I spoke about how the Federal Reserve had already developed some innovative new lending facilities in response to the housing downturn, financial market strains, and a weakening economy. Given the spike in oil and commodity prices at that time, we were also keeping a vigilant eye on what seemed to be a potential rise in inflation.

A lot has changed in nine short months. The economy has worsened significantly, and we are now concerned about an unwelcome disinflation.

Unfortunately, the financial crisis has also become broader and deeper over the past year and is now affecting economies across the world. Whether in banking, housing, retail, or commercial real estate and development, all parts of the economy have been hit hard.

There is no doubt our economic situation is both historic and unprecedented. And for policymakers at the Federal Reserve and elsewhere, there is no question that this situation is testing a number of longstanding economic principles.

For me, the episode has been unlike anything I have seen in more than 25 years at the Federal Reserve. And the volatility is greater than anything the U.S. economy has experienced since the 1930s.

This period has certainly reinforced my commitment to “lifelong learning,” and I have done more than my share of learning and homework these past several months. Indeed, I have spent many weekends on extended conference calls with my colleagues, bankers and my staff, exploring the best ways to ease the turmoil in the financial system.

I know I am not alone in this regard. In your businesses and organizations, many of you have also been spending far too many weekends revising business strategies, looking at worrisome sales figures, and balancing the demands of creditors against cash flow.

In my remarks, I will talk about some of the economic challenges facing the U.S. and explain why the outlook for this year will be strongly influenced by developments in the housing and financial markets. Then I will describe some forces that will lead us into economic recovery. Finally, I will discuss the Federal Reserve’s strategy for dealing with the challenges we are facing.

### The Situation - Where Are We?

#### Additional Information

**Sandra Pianalto***President and CEO,  
Federal Reserve Bank of Cleveland***Commercial Developers Power  
Breakfast**

Columbus, Ohio

*February 18, 2009*

As you know only too well, the U.S. economy has been in a recession since December 2007, and all indicators point to it being a severe one. Already, this recession is longer than the 10-month average of the nation's post-World War II recessions.

The economic news is bleak. Auto sales, industrial production, consumer spending, and confidence measures have all plunged, either to record lows or to lows not seen in several decades.

The loss of consumer wealth from the collapse of housing and equity prices has been staggering. Some estimates place the loss at near 10 trillion dollars since the third quarter of 2007. To put that in perspective, that is close to a year's worth of gross domestic product. Businesses have been slashing production and sharply reducing their capital spending plans for this year.

Labor market indicators characterize the situation in human terms. Since the beginning of the recession, about 3.6 million American jobs were lost. That is the largest percentage decline since 1982 and the largest absolute decline since 1945.

About half of those losses have come just in the past three months. We have also seen a huge increase in the jobless rate since the recession began, jumping from 4.9 percent to 7.6 percent. The rise in unemployment has been widespread across all demographic groups, and more people are staying unemployed for longer periods.

This economic misery is not confined to the United States. Production and spending activity have been declining around the world. In the past, we have been able to rely on international markets to cushion a domestic slump, but that's not the case this time.

Unfortunately, I don't expect things to get better until we see stability return to the housing and financial markets. As you know, the housing boom and bust triggered this recession and sparked severe strains in credit markets. Bankers and investors are still finding it hard to estimate the value of mortgage-related assets that they hold on their balance sheets, and now uncertainty about the economic outlook is adding to the uncertainty about the health of some banks.

In addition, falling housing prices have led to more home foreclosures, as many homeowners now owe more than their house is worth. Stabilizing housing prices will help stem foreclosures, bolster bank balance sheets, restore consumer confidence, and shore up consumer spending.

However, the housing sector is still far from stable. Housing prices are still declining in many parts of the country, housing starts have fallen by over 60% since their peak in 2006, and the number of unsold homes is still quite large relative to the pace of sales. At the current rate it would take 14 months just to clear the existing inventory.

Confronting problems in the housing market is a necessary part of the overall effort to restore economic vitality. Congress and the Administration have proposed further steps to assist distressed homeowners and to lend support to the housing industry.

Policymakers are also working hard to break the logjam that exists in financial markets. The capacity of our financial system to provide credit is being challenged tremendously.

Unfortunately, that has meant that credit has been curtailed or is now considerably more expensive for many households and business borrowers. I know many of you are all too familiar with these issues.

That's where we stand today. So what is the outlook for 2009?

Unfortunately, it is not great, and it will not be much better than what we experienced last year.

My baseline projection is for real gross domestic product to decline sharply in the first half of 2009, followed by a modest upturn in the second half of the year. In this scenario, unemployment rates would likely continue to rise through the end of the year.

Having said that, it is always difficult to predict the precise timing of when the economy will begin its recovery and this is a particularly challenging time to make economic projections.

When faced with such uncertain times, I find that history can provide some insights to guide our thinking. One study I found informative examines previous recessions in countries that have also faced significant financial turmoil. This evidence from the past 50 years suggests that recessions linked to financial turmoil tend to be longer and more severe than typical recessions. The good news is that the evidence from past recessions also shows that they all end, and I can say with confidence that this recession will certainly end as well.

### How Do Sick Economies Get Better?

Even so, I am sure that many of you are wondering why I am optimistic enough to expect a recovery to begin later this year. How will it come about?

In fact, my outlook for a recovery in the second half of the year relies on four forces. The first force at work is expansionary monetary and fiscal policies. To counteract recessions, the Federal Reserve and government entities pursue policies that lower interest rates and stimulate spending. The Federal Reserve has been engaged in a very sizable credit expansion program for more than a year and, as you know, Congress and the Administration have developed a very sizable stimulus package.

I will have more to say about the Federal Reserve's specific actions to ensure adequate liquidity, expand credit, and restore stability in a few minutes. But in general, expansionary monetary and fiscal policies have always played a substantial role to reinvigorate the economy when U.S. households and businesses are reluctant to spend.

The second force we see in most recoveries is a boost from the housing sector due to lower mortgage rates. Lower mortgage rates ordinarily result from monetary policy stimulus, but I am singling this out as a separate force in my projected recovery because there are several federal government programs designed to reduce mortgage rates and stimulate housing demand. The housing contraction has been so steep that its eventual bottoming out will be seen as an especially important positive development in this cycle, as indicated earlier.

The third force at work is a more intangible one - it is the entrepreneurial character of American businesses. In the depths of a recession, it is understandable that people are focused on risk aversion, but curiously enough, this is also one of the wellsprings of recovery.

Those long-delayed investment plans become more and more appealing as the bottom, or trough, of the recession becomes more and more likely. In other words, if you don't jump at an opportunity, someone else will.

Examples of this can be found in every recession, but consider another very difficult period for the U.S. economy: the early 1970s. It was a time when wage and price controls were introduced and the

long-established link between the dollar and gold had collapsed.

Between November 1972 and December 1974, the Dow Jones Industrial Average plunged more than 40 percent,<sup>1</sup> the inflation rate more than tripled,<sup>2</sup> and the unemployment rate jumped from 5.3 percent to 7.2 percent.<sup>3</sup>

You might think that nobody in their right mind would launch a business at such a time. But you would be wrong. Consider three companies that got their start during this period: Federal Express, Microsoft, and Southwest Airlines.

While every company's founding is unique, there is also a common denominator - the founders believe they can improve on an existing product, or they believe they have an entirely new product to offer. The opportunity was just too good to pass up.

The three forces I have mentioned come into play in nearly all transitions from recession to recovery, but I am adding a fourth force - namely, that the financial market turmoil will gradually subside. Economic growth depends critically on a well-functioning financial system that can transfer capital from savers to entrepreneurs and established businesses.

The Federal Reserve clearly understands that healthy financial markets are economic enablers; they help to increase the demand for all products and services in our economy. Our actions are a vital part of the national economic recovery program. We are taking bold steps to put the credit markets back into good working order, and to support an increase in bank lending.

We are addressing large and complex problems, and we are extending and expanding our programs as necessary. I am convinced that more progress must be made, and that more progress will be made.

## The Federal Reserve in Action

Here are some specific actions that we at the Federal Reserve have been taking to get the economy back on its feet. We have made the largest cuts in our interest rate target in our history. We have lowered the federal funds rate target by about 500 basis points since August 2007 - reducing the rate from 5-1/4 percent to a range of 0 to 1/4 percent.

I am often asked if such a low federal funds rate target means the Federal Reserve has run out of ammunition to counter the economic turmoil. The answer to that question is no! We still have other policy tools at our disposal.

First, we are using our normal lending authority to extend credit in significant amounts to commercial banks. In normal circumstances, we lend overnight. In this period of turmoil, we have extended the term of our loans to 90 days to help banks extend credit to their customers for longer periods of time.

Providing liquidity to banks is important, but as the financial market turmoil worsened, concerns about capital, asset quality, and credit risk caused banks and other lenders to limit their willingness to extend credit, even when they had enough liquidity. To address this issue, the Federal Reserve developed a second set of policy tools to more directly support borrowers and investors in key credit markets. One example of this approach is a funding facility known as TALF, or the Term Asset-Backed Securities Loan Facility, which will likely be in operation within the next few weeks.

Like many asset markets, the market for securities backed by consumer credit has been troubled for some time. These instruments

fund a substantial share of consumer credit, including auto loans, student loans, and credit card debt. In the fourth quarter of last year, securitizations in parts of this market came to a complete halt. These disruptions have important macroeconomic implications.

TALF is designed to reinvigorate buying and selling in the securities markets. Specifically, TALF will allow holders of asset-backed securities to borrow from the Federal Reserve using these securities as collateral. Loan amounts will typically be between 85 and 95 percent of a security's value, for terms of three years.

A major focus of the new financial stability announcements last week was a significant expansion of TALF - from the originally announced \$200 billion to \$1 trillion. Also, additional asset-backed security classes are being considered, including commercial mortgage-backed securities. We believe this intervention to support credit markets will make a big difference in stabilizing the economy.

The Federal Reserve's third policy tool is the direct purchase of certain kinds of longer-term securities for our portfolio. For example, we recently announced plans to purchase up to \$600 billion in housing-related debt from government-sponsored enterprises.

This program is intended to improve the flow of credit to home buyers and encourage existing homeowners to refinance at lower rates. Mortgage rates declined significantly on the announcement of this program, and applications for mortgage refinancing have surged.

The Federal Reserve's three sets of policy tools - lending to financial institutions, providing liquidity directly to key credit markets, and buying longer-term securities - have a common feature. They represent our ability to acquire assets in ways that lower interest rates and ease credit conditions in a range of markets even when the federal funds rate is near zero.

Our actions have been aggressive and unprecedented. Since October 2007, the Federal Reserve's balance sheet has grown from \$855 billion to almost \$2 trillion reflecting the magnitude of the challenges facing the U.S. financial system.

## Conclusion

Let me conclude with an observation. We are in the midst of the most troubling period the U.S. financial sector has experienced since the 1930s, and we really don't know how many more chapters remain in this drama.

The episode has served as a powerful reminder that although market participants have become more sophisticated, we are still vulnerable to extreme market volatility and large-scale financial distress. But we need to remember that in crisis there is also opportunity.

During another period of economic crisis, President Woodrow Wilson reminded Americans that we must act collectively. Wilson was President of the United States when the Federal Reserve System was created in 1913. Then, as now, America faced daunting challenges.

But Wilson was unruffled. In his first Inaugural Address, Wilson said, speaking of all Americans, "We shall deal with our economic system as it is and as it may be modified, not as it might be if we had a clean sheet of paper to write upon; and step by step we shall make it what it should be...."

I remain confident that we will get through this difficult period together. And I want assure you that the Federal Reserve is actively working to restore growth in our economy while maintaining a low and stable inflation rate.

- 1 <http://www.djindexes.com/mdsidx/index.cfm?event=showavgDecades&decade=1970#dowdiary> 
- 2 <http://www.miseryindex.us/irbymonth.asp> 
- 3 <http://www.miseryindex.us/urbymonth.asp> 

[Careers](#) | [Diversity](#) | [Privacy](#) | [Terms of Use](#) | [Contact Us](#) | [Feedback](#) | [RSS Feeds](#)