Forces for Economic Recovery

Additional Information

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Introduction

I think we can all agree that economic concerns are now top-of-mind for almost everyone these days. Without question, these are historic and unprecedented times. Every day, I see growing evidence of a widespread public desire to better understand what is happening, and why.

For me, the current episode has been unlike any I have seen in more than 25 years at the Federal Reserve. And the volatility is greater than the U.S. economy has experienced since the 1930s. This period has certainly tested my commitment to "lifelong learning," and I have done more than my share of learning and homework these past few months. Indeed, I have spent many weekends on extended conference calls with my colleagues, 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 your business strategies. Here in Northwest Ohio, you face additional challenges as the region's traditional industries confront their worst crisis in decades and as you redouble your efforts to create a more diverse regional economy.

In my remarks today, I will talk about some of the economic challenges that are facing both the U.S. economy and the regional economy. 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.

Please note that the views I express today are my own and do not necessarily reflect the views of my colleagues in the Federal Reserve System.

The Situation - Where Are We?

For two days last week, my Federal Reserve colleagues and I met to discuss current conditions and the economic outlook. In our press statement released after the meeting, we noted that since we last met in January, the economy has continued to contract. The data on employment, housing, and business investment came in weaker than expected. In addition, economic conditions abroad have worsened.

These data confirm that we are still in the midst of a severe recession. At 16 months old, the current recession has lasted beyond the 10-month average of the nation's post-World War II recessions. Unfortunately, it will continue for a while longer.

Whether we are talking about auto sales or industrial production, consumer spending or consumer confidence, these measures have all plunged, either to record lows or to lows not seen in several decades.

Businesses have been slashing production and sharply reducing their capital spending plans for this year.

The loss of consumer wealth from the collapse of housing and equity prices has been staggering. Last year, the net worth of U.S. households declined by more than 11 trillion dollars, or by 18 percent. To put that in perspective, that is close to a year's worth of U.S. gross domestic product.

The impact of this wealth loss on the entire economy has been dramatic. In the fourth quarter of last year, U.S. GDP shrank at an annual rate of 6.2 percent. This was the worst quarterly decline since the recession of 1982.

Labor market indicators characterize the situation in human terms. Every day seems to bring more news of layoffs, pay cuts, or furloughs as companies scramble to reduce costs. Since the beginning of the recession in December 2007, about 4.4 million American jobs have been lost. That is the largest percentage decline since 1982 and the largest absolute decline since 1945.

Well over half of those losses have come just in the past four months. We have also seen a huge increase in the jobless rate since the recession began, jumping from 4.9 percent to 8.1 percent. Ohio's unemployment rate, now at 9.4 percent, is larger than the national rate, and unemployment in the Toledo area is much worse—12.0 percent. Because the Greater Toledo area has a higher concentration of employment in transportation-related manufacturing than the nation as a whole, this region faces even more formidable challenges.

Exports are also an important source of jobs and income to people in this region. In past recessions, we have been able to rely on international markets to cushion a domestic slump, but that's not the case this time. Production and spending activity have been declining around the world. The International Monetary Fund projects that the world economy will grow by only 0.5 percent this year, its slowest rate since World War II.

The turmoil in the housing sector, which led us into the recession, continues. And it will take some time before this important sector regains its health. Housing prices are still declining in many parts of the country, housing starts have fallen by more than 60 percent since their peak in 2006, and the number of unsold homes is still quite large relative to the pace of sales. At the current selling rate, it would take 10 months just to clear the inventory of existing homes.

Credit constraints remain at the heart of the current challenges to the housing and automotive sectors. Credit is truly the lifeblood of our financial system. Extending credit requires both capital and confidence, both of which are in short supply today. Unfortunately, that has meant that credit has been curtailed or is now considerably more expensive for many households and business borrowers.

That's where we stand today. So what is the outlook for the rest of this year? Although my baseline projection is for real GDP to weaken further in the first half of this year, I expect it to stabilize by the end of the year. I expect the economy to begin to recover next year as the fiscal stimulus boosts spending and as we work off excess inventories. My forecast for recovery also presumes the current actions undertaken by the Federal Reserve and the government are successful in restoring financial stability.

I have to warn you, however, that this outlook is subject to a number of strong downside risks. One risk that particularly concerns me is what economists call a "negative feedback loop," in which weakening financial and economic conditions feed off one another and become mutually reinforcing.

How Do Sick Economies Get Better?

With all of that bad news, it may be hard to envision a recovery taking hold. But the economy will recover, and my outlook for recovery relies on four forces.

The first force at work is expansionary monetary and fiscal policies. These expansionary policies have always played a substantial role in reinvigorating the economy when U.S. households and businesses are reluctant to spend. The situation we find ourselves in today is no exception. Consequently, 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 enacted a very sizable stimulus package. I expect these initiatives to contribute significantly to an increase in overall economic activity, and our recovery depends on their success.

The second force we see in most recoveries is a boost from the housing sector due to lower mortgage rates from monetary policy stimulus. In addition, in this recession, several programs have been proposed to further reduce mortgage rates and to stimulate housing demand. The Administration has recently announced a strategy to make homeownership more affordable for first-time homebuyers, and to help millions of distressed homeowners deal with burdensome mortgage payments. Because problems in the housing market have been at the heart of what triggered this recession, restoring stability in housing will be equally critical to our economic recovery. Stabilizing housing prices will help stem foreclosures, shore up consumer confidence, and bolster bank balance sheets by preventing any further decline in the value of housing assets held by banks.

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 approaches. In other words, if you don’t jump at an opportunity, someone else will.

In Northwest Ohio, you are no strangers to opportunity. In January of this year, 16 patents were granted in the western Ohio tri-county area, proving that despite the many challenges the region continues to face, you are still dreaming, planning, and innovating. For example, Xunlight (Sunlight) Corporation has tripled its workforce over the past year thanks to innovative technology, a skilled workforce, and the use of local vendors. The firm has attracted national attention and brought international investment to the region.

Universities and economic development organizations are playing a significant role in fostering this creative edge. The University of Toledo has become a leader in solar energy research and has committed to preparing students for science, technology, engineering and math careers over the next five years. What a great recipe for success and a reminder that even in challenging times, opportunities are out there to set the groundwork for recovery.

The final force that will help us move from recession to recovery is a gradual decline in financial market turmoil. Economic growth depends critically on a well-functioning financial system that can transfer capital from savers to entrepreneurs and businesses. As you know, policymakers are working hard to break the current logjam that exists in financial markets. We are taking bold steps to put the credit markets back into good working order, and to support an increase in bank lending.

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 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 when the financial market turmoil worsened, concerns about capital, asset quality, and credit risk caused banks and other lenders to limit 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 is a funding facility known as TALF, or the Term Asset-Backed Securities Loan Facility.

The TALF is designed to bring investors back into the securitization markets, which is a vital step to enable banks to secure outside funding for their lending programs. Investors will be able to borrow from the Federal Reserve at a favorable rate of interest to fund the purchase of these securities, using the securities themselves as collateral. While investors are of course still expected to shoulder reasonable risks, the terms of these loans reduce investors' downside risk. The goal of the TALF is to restore confidence to the securitization market.

In its first phase, which was launched just last week, the TALF is supporting markets for newly issued consumer credit and for student, auto, and business loans. A second phase will add further support to some of these markets and help mortgage servicers work with homeowners to prevent avoidable foreclosures.

In addition, the Federal Reserve expects to expand the range of eligible securities within the TALF to help restart the markets for certain securitized loans already being held by financial institutions. I firmly believe that all of these steps are crucial to ensure that major investors are able to support the financial system's ability to get credit flowing again.

The Federal Reserve's third policy tool is the direct purchase of certain kinds of longer-term securities for our portfolio. For example, we have announced plans to purchase up to $1.25 trillion of mortgage-backed securities from government-sponsored enterprises by the end of the year. This program is intended to improve the flow of credit to home buyers and encourage existing homeowners to refinance at lower rates.

When we first announced plans to purchase these securities, in late November of last year, the cost of mortgage loans began to decline, and rates continued to fall as we began to purchase these securities.

For example, the 30-year fixed, conventional mortgage loan rate was a little above 6 percent last November, and as of last week, it averaged just under 5 percent.

The Federal Reserve also announced its intention to begin purchasing up to $300 billion of longer-term Treasury securities. The announcement had an immediate effect on Treasury yields. Lower interest rates on these Treasury securities encourage investors to purchase other kinds of investments, which will improve conditions in the private credit markets.

These three sets of policy tools – lending to financial institutions, providing liquidity directly to key credit markets via steps such as the TALF, and buying longer-term securities – have a common feature. They represent our efforts to lower interest rates and ease credit conditions in a range of markets even when the federal funds rate is near zero.

Collectively, 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, and with our recent announcements, we are prepared to expand it further.

In addition to these policy tools, we can also utilize our supervisory resources and authority to improve bank lending and the flow of credit. The Federal Reserve and other bank regulators are stress testing the largest banks to ensure that they have the capital they need to operate safely.

The surest sign that a recovery is on its way and that financial markets are on the mend will be an inflow of private capital into the banking system and a broad-based increase in bank lending. Since the beginning of the year, we have seen declines in commercial and industrial loans as well as loans for commercial real estate. On the other hand, consumer and residential mortgage loans are again increasing, particularly for refinancing. As economic conditions stabilize, more households and businesses will have the confidence to borrow, and more borrowers will become better credit risks. Both developments will contribute to economic growth.

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 Franklin Delano Roosevelt harnessed the still-novel technology of radio to address the American people. He used what became known as “fireside chats” to tell people in an open and honest way how we could work as one country to move forward. Here is what President Roosevelt had to say in one of his fireside chats in the early summer of 1934:

“In our efforts for recovery we have avoided on the one hand the theory that business should and must be taken over into an all-embracing Government. We have avoided on the other hand the equally untenable theory that it is an interference with liberty to offer reasonable help when private enterprise is in need of help. The course we have followed fits the American practice of Government - a practice of taking action step by step, of regulating only to meet concrete needs - a practice of courageous recognition of change."

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