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Coeur d'Alene, Idaho
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The Outlook for the U.S. Economy and Community Banks[1]

Thank you very much. I'm delighted to be able to talk to an audience of community bankers in such a beautiful setting. The 12th Federal Reserve District stretches from Utah to Hawaii, and from Arizona to Alaska. As I travel around this region, I often think how lucky I am to be able to visit some of the most breathtaking places in the United States. Coeur d'Alene is clearly among them.

I will speak today about the difficult economic landscape lying before us and what that means for community banks. It's fair to say that you have been caught in a financial and economic crisis that you did not create, one precipitated in part by exotic financial engineering carried out mainly by large financial institutions, not banks like yours. Community banks generally steered clear of the market for credit default swaps and didn't create structured investment vehicles to keep assets off of balance sheets. Now though all of us must live with the consequences of the culture of risk that permeated the global financial system. The near collapse of that system and the severe recession that continues today have created an exceptionally stressful environment even for well-run banks. That leaves little choice except to take the proper steps to manage through this storm, a point I will expand on later in my talk.

[1] I would like to thank Teresa Curran, John Judd, Maureen O'Byrne, and Sam Zuckerman for assistance in preparing these remarks.

I'll start my remarks by giving you my perspective on the current economic landscape and prospects for recovery. I will then offer some thoughts about inflation, a subject I know concerns many of you. And I will finish by reviewing the situation faced by community banks in the Pacific Northwest and the 12th District as a whole. As always, my comments represent my own views and not necessarily those of my colleagues in the Federal Reserve System.

Economic and financial conditions

It was less than a year ago that the financial system found itself on the very brink of collapse. As home prices tumbled, loan losses cascaded through our financial system. These losses started in subprime markets but spread broadly across nearly all sectors, exposing weaknesses in market structures and the practices of many financial institutions. When Lehman Brothers failed in September 2008, vital wholesale funding markets seized up, precipitating the most catastrophic liquidity crisis since the 1930s. Only the most aggressive intervention by governments and central banks around the world prevented outright financial meltdown. Some people grumble about programs such as TARP, TAF, TALF, and the rest of the alphabet soup. But it's important to remember how close we were to something unimaginable. Those initiatives may not have been perfect, but I believe they succeeded in supporting the system until a measure of confidence returned.

Financial trauma of this magnitude could have nothing but the direst effects on economic activity. As we all know, the financial earthquake of the summer and fall was quickly followed by aftershocks that rocked the broader economy, intensifying a credit crunch, and producing precipitous drops in employment and economic output. The interaction between the economy

and the credit crunch—often described as an adverse feedback loop—led to what could become the most severe recession since the Great Depression.

That's the backdrop to our current situation. And here the picture turns brighter, as we glimpse the first solid signs since the recession started more than a year and a half ago that economic growth may be poised to resume. Indeed, I expect that to happen sometime this year. Financial conditions have improved markedly in recent months. The stock market has rallied and investor appetite for corporate bonds and other assets has rebounded, restoring access to capital at reasonable rates for many healthy companies, including financial institutions. Measures of stress in the markets for short-term funding have also diminished. At the same time, the housing sector finally seems to be stabilizing. Housing starts have leveled off and, in an encouraging sign, sales are beginning to improve. Meanwhile, house price declines may finally be abating. Consumer spending may also be stabilizing. Payrolls are still shrinking at a dreadful pace, but at least the momentum of job losses has slowed a bit in the past two months.

Oregon and Idaho have been hit hard by the recession, with unemployment rising in both states at a faster pace than in the nation as a whole.[2] Both Oregon and Idaho have large proportions of technology manufacturing jobs, which have been vulnerable to the sharp downturn in that sector. And Oregon is highly dependent on international trade,[3] which has experienced a historic contraction. Oregon's unemployment rate was 12.2 percent in June, the third highest in the nation.

[2] Oregon's unemployment rate has risen from a low of 5 percent in April 2007 to 12.2 percent in June 2009, an increase of 7.2 percentage points. Idaho's rate has jumped from 2.8 percent in May 2007 to 8.4 percent in June 2009, an increase of 5.6 percentage points. By comparison, the U.S. unemployment rate went from 4.4 percent in March 2007 to 9.5 percent in the latest period, an increase of 5.1 percentage points.

[3] The value of merchandise exports as a share of gross state product was 12 percent in Oregon in 2008. For the United States, the comparable percentage was 9.1 percent.

Looking ahead at the national economy, a variety of sources will fuel growth in the months ahead, including expansionary fiscal and monetary policies, and the normal dynamics of the business cycle. The fiscal stimulus program passed by Congress in February provides tax cuts that have raised household income. In addition, government spending is directly adding to payrolls and boosting demand. More stimulus will come on line as the year proceeds. This program wasn't designed to produce an economic recovery by itself, but rather to cushion our fall. In that sense, it's doing its job.

Monetary policy too has contributed to recovery. As you know, the Fed is using both traditional and nontraditional tools to boost the economy. We have set our federal funds rate target close to zero and indicated that economic conditions are likely to warrant keeping it there for an "extended period." We have provided liquidity to previously dysfunctional markets, such as the asset-backed commercial paper market. And we've purchased Treasury and agency-related securities for our own portfolio to help push longer-term private borrowing costs lower, thereby stimulating demand.

Meanwhile, the normal dynamics of the business cycle are turning more favorable. Some sectors are poised to rebound simply because they have sunk so low. For example, the auto industry has cut production so far that inventories have begun to shrink, even in the face of historically weak demand. Just slowing the pace of inventory liquidation will bolster economic activity. This story holds for many sectors of the economy where spikes in inventories occurred as cautious consumers cut back on purchases of durable goods, and businesses slashed spending on equipment and software. Looking forward, the demand for houses and durables should also eventually revive as old and broken-down goods need to be replaced. The resulting demand will help the economy recover.

But that recovery is likely to be painfully slow. History teaches that it often takes a long while to recover from downturns caused by financial crises.[4] Financial institutions and markets won't heal overnight. And it will take quite some time before households have repaired their tattered finances. Until recently, households were saving less and borrowing more in response to wealth gains in both stocks and housing. This pattern made their balance sheets vulnerable to adverse developments and the crashes in both house and stock prices during the last two years destroyed trillions of dollars of their wealth. Not surprisingly, the personal saving rate has now shot higher and I expect to see subdued consumer spending for some time.[5] The unprecedented global nature of the recession also will act as a drag.[6] Countries recovering from financial crises often receive a boost from foreign demand, but neither the United States nor its trading partners can count on such external stimulus this time.

A gradual recovery means that things won't feel very good for some time to come. The unemployment rate currently is 9½ percent, and this figure is likely to rise further. Moreover, even after the economy begins to grow, it could still take several years to return to full employment. The same is true for capacity utilization in manufacturing, which has declined so far that it has fallen "off the charts"—now standing at its lowest level in the postwar period.

Finally, even though downside risks to the outlook have diminished, there remains some chance that economic conditions could turn out worse than what I've sketched. High on my worry list is the possibility of another shock to the still-fragile financial system. Commercial real estate is a particular danger zone, but I will hold my discussion of that topic until I turn to banking conditions.

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[4] Reinhart and Rogoff (2009).
[5] Glick and Lansing (2009).
[6] International Monetary Fund (2009).

Let me now address another issue that is garnering attention—inflation. This is a subject rife with contradiction. Almost without exception, my business contacts report downward pressure on wages and prices. At the same time, they tell me they worry that the United States is on the threshold of serious inflation. They see large federal budget deficits today and more looming on the horizon. They also note that the Fed has pumped up bank reserves and expanded its balance sheet to fund its financial support programs. They worry that this may amount to financing deficits with money creation. Surely, they say, these things will eventually have to lead to higher inflation.

I'll begin with budget deficits. The gap in the federal budget for the current and the next fiscal years are projected to exceed $1 trillion, far larger than anything we've ever seen before. But a large part of these current deficits are temporary. A portion stems from the impact of the weak economy on the budget. In a recession, tax collections fall and spending on programs such as unemployment insurance rise automatically. A significant portion is due to the fiscal stimulus that has been put in place over the next few years to address the recession. Antirecessionary fiscal policy, in my view, is entirely appropriate. Since that stimulus is temporary by design, the resulting deficits will shrink as the stimulus phases out. But federal deficits will not disappear completely even when the economy has recovered and the stimulus program has phased out. On the contrary, these ongoing or "structural" deficits are anticipated to stretch indefinitely into the future and to escalate over time in a manner that ultimately is not sustainable. The long-term projected structural budget deficit mainly reflects the impact of an aging population and rapidly rising health-care costs on spending for federal entitlement programs, particularly Medicare and Medicaid.

Economists have known, worried, and warned the public about the damaging consequences of escalating long-term budget deficits in the United States for decades. It's high time for our country to tackle the problem head-on. But the main concern with these deficits relates to productivity and living standards, and not high inflation. Large budget deficits do not cause high inflation automatically. In fact, since World War II, large deficits have been associated with high inflation only in developing countries. That's because developing countries often have central banks that are under the sway of the government, which sometimes induces them to print money to finance government spending.[7] The connection isn't found in countries such as ours with advanced financial systems and independent central banks. Remember that, in the 1980s, the United States ran large deficits just as inflation was coming down. And Japan has had huge deficits through much of the past two decades, yet its problem is persistent deflation—precisely the opposite of inflation. The United States and most other industrialized countries have central banks with long traditions of independence and deep-seated support for keeping politics out of monetary policy. In those countries, the monetary authorities generally have stuck to their inflation objectives, even when governments ran large budget deficits.

In advanced countries, the problem isn't that large deficits cause inflation. Rather it's that they raise long-term interest rates, thereby crowding out private investment, which holds back advances in productivity and living standards. Right now, private investment spending is extremely weak, so financing for the large federal deficits is readily available. But once private spending recovers, the competition for funds between the government and private sectors could drive interest rates up. A decline in productivity growth is a serious problem—one we should strive to avoid—but it is not the same as inflation.

[7] Fischer et al. (2002) and Catao and Terrones (2005).

So what about the Fed's unprecedented balance sheet expansion? Our strong steps to avert financial and economic meltdown have caused our assets to more than double, from under $900 billion at the start of the recession to over $2 trillion now. This expansion is largely financed by increases in excess reserves that banks deposit with us.

Now we come to the crux of the issue: Will this expansion of credit and bank reserves create high inflation? My answer is no. And the reason again is because of current economic conditions. Monetary policy fosters inflation when it loosens the stance of policy enough to create excess demand for goods and services. Right now, we have exactly the opposite—an excess supply of goods and services. We need more demand—not less—to offset slack in labor and product markets. We have seen a noticeable slowdown in wage growth and reports of wage cuts have become increasingly prevalent. Businesses are cutting prices to boost sales. As a result, core inflation—a measure that excludes volatile food and energy prices—has drifted below 2 percent, a level that I and most of my colleagues consider consistent with price stability. With unemployment already substantial and likely to rise further, and industrial capacity utilization at record low levels, downward pressure on wages and prices isn't likely to go away soon. I expect core inflation to remain below 2 percent for several more years.

Of course, the economy will eventually recover and we *will* need to withdraw monetary accommodation. If we were to fail to do so, we would indeed have higher inflation. The Fed is keenly aware of this. We have the tools to tighten policy when the time is right and we have the will to use them. First, many of our emergency programs are already tapering off as market conditions improve. Second, many of the assets that we have accumulated during the crisis—such as Treasury and mortgage-backed agency securities—have ready markets and can be easily sold. Finally, the Fed can push up the federal funds rate and tighten policy by raising the rate of

interest paid to banks on the reserves they deposit with us—authority granted by Congress last year. An increase in the interest rate on reserves will induce banks to lend money to us rather than to other banks, thereby pushing up rates in the interbank market and, by extension, other interest rates throughout the economy. This is an important tool because, even if the economy rebounds nicely, the credit crunch might not be fully behind us and some financial markets might still need Fed support. This tool will enable us to tighten credit conditions even if we maintain a large balance sheet for a time. The experience of central banks in Europe, Japan, and Canada suggests that this approach can be effective.[8]

Let me be clear: In our conduct of monetary policy, we are guided by our statutory mandates of maximum employment and price stability. We are committed to doing everything in our power to foster both goals. Our institution was created as a politically independent central bank, and that tradition is deeply embedded in our culture and practice. When the economy does come back, I can assure you that we will act decisively and appropriately to tighten the stance of policy and maintain price stability.

Banking

Let me shift now to a review of banking conditions. As I noted earlier, when the financial crisis intensified last fall, the Fed worked jointly with Treasury and other regulators to stabilize the banking system and restore confidence in financial markets more broadly.

The Troubled Asset Relief Program, or TARP, injected capital into the banking system at a time when confidence in the system's soundness was eroding and private funding was unavailable. I believe that it made a positive contribution. One indication of the significance of

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[8] Bernanke (2009a).

TARP capital for community banks in the West is that about one in five banks in the 12th Federal Reserve District took advantage of the program. Participating banks augmented their capital by an average of 2 percentage points. I certainly recognize that some bankers don't like the "strings" attached to TARP and perceive that the goals of the program have shifted over time. But there's no denying that the program measurably strengthened the capitalization of many community banks, putting them in a stronger position to weather difficult times. The stability of bank funding has also been bolstered by the FDIC's temporary liquidity guarantee program and the expansion of deposit insurance limits. Another program that should be helpful to banks is the joint Fed-Treasury initiative known as the Term Asset-Backed Securities Lending Facility, or TALF. This initiative is designed to revive critical securitization markets and help boost the issuance of a wide range of securitized loan products. The Fed's recent expansion of the program to include both legacy and new commercial mortgage-backed securities should enhance the availability of credit for commercial real estate and benefit both large and small banks with significant exposure to this sector by preventing defaults and facilitating the sale of distressed properties.

All in all, I believe that the aggressive responses of the Fed and other agencies served to ease the funding pressures facing a broad range of banks and to stabilize the financial system. The restoration of confidence in the financial system has benefited all banks.

Of course, the crisis has made it self-evident that we must reform our regulatory framework and improve supervisory practice so that a catastrophe of this magnitude never happens again. As you know, the Obama administration has submitted a comprehensive reform bill to Congress, which is holding hearings over the summer on the proposal. Last week, Chairman Bernanke and Governor Tarullo testified before Congress, laying out the Fed's views

on regulatory restructuring.[9] Let me mention just two key areas where our regulatory framework must be strengthened.

First, we need a better way to manage systemic risk. By that I mean improved oversight of the financial system as a whole. Focusing on systemic risk is different than our traditional institution-oriented approach to supervision. It has become painfully clear that when regulators focus exclusively on individual institutions, they can miss broader risks building in the system. In particular, we need to do a better job of assessing how the practices of large institutions may affect their counterparties and the system as a whole. I know that many community bankers consider it unfair that small banks—which did not cause the financial mess—are allowed to fail, while larger banks that took the biggest risks are rescued. That's an understandable reaction. But we can't escape the reality that certain institutions, by virtue of their size or their linkages to key markets, pose unique risks to the system and can bring others down with them. One lesson from the crisis is that it's dangerous to have large, systemic institutions operating outside the regulatory framework or with inadequate capital and liquidity buffers. It's essential that we identify these systemic institutions and subject them to a robust framework of consolidated supervision as well as more stringent standards for capital, liquidity, and governance.

Protecting consumers is a second area where our current system failed in many respects. This is not only a matter of fairness for individuals. It's also a key element in the performance of our economy. Abuses such as inadequate consumer disclosures and unfair and deceptive mortgage lending practices by some institutions contributed to record foreclosure rates that magnified the financial crisis. Given what we've learned about the pernicious effects of

[9] Tarullo (2009) and Bernanke (2009b).

consumer loan defaults on the banking sector and the economy, it's critical that we strengthen our regulation and supervision in this area for both bank and nonbank financial players.

Now let me turn to the business environment facing banks. The industry is going through one of the most difficult periods in modern times. First-quarter data show that the 12th District has been hit harder than any other area of the country. Bank profits are down, loan delinquencies are up, and failures are climbing.

In Oregon and Idaho, community banks are underperforming the nation and have significantly riskier profiles. In terms of return on assets, Oregon was the eighth and Idaho was the eleventh worst performing state in the nation.[10] Moreover, a relatively large fraction of banks in each state lost money in the first quarter—about 40 percent in Oregon and 20 percent in Idaho. Loan quality indicators tell a similar story. Recent net charge-off rates at banks in each state are much higher than the national average. Recessionary effects normally take some time to work their way through loan portfolios. So, even though I expect economic growth to resume in the second half of this year, banking conditions are likely to remain quite weak for another year or two.

To date, the community banks under greatest financial stress are those with high real estate concentrations in construction and land development lending. Banks that liberally funded speculative housing and condominium construction, and those that funded land acquisition and development, have been hardest hit. Over 20 District financial institutions have failed since last year. The vast majority of them had high concentrations in residential construction and development lending. In fact, these banks had construction loans that averaged about 40 percent

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[10] These and other statistics on bank performance are from Federal Reserve Bank of San Francisco (2009).

of their loan portfolio, well above the District average of 16 percent. Unfortunately, some banks that aggressively pursued these loans had weak appraisal and risk-monitoring systems.

The next area of significant vulnerability for the banking system, particularly for community and regional banks with real estate concentrations, is income-producing office, warehouse, and retail commercial property. Market fundamentals in most western states are deteriorating. Vacancy rates are rising and rent pressures are hurting property cash flows. Office vacancy rates in both Boise and Portland are expected to reach or exceed 20 percent over the next year or two, the highest rates these cities have seen in many years. Retail shopping centers are struggling with falling occupancy rates and pressures to grant rent concessions. Property values are falling sharply across wide areas of the country, including the Pacific Northwest. Some analysts forecast that commercial property values could experience falls similar to housing of 30 to 40 percent.

Regrettably, a number of banks failed to implement risk management steps outlined in the guidance on commercial real estate loan concentrations that was issued by regulators in 2006. Banks need to take proactive steps to address emerging credit problems, obtain new appraisals, and recognize impairment when warranted. But we also encourage banks to work out problem loans with troubled borrowers when this is prudent.

Our biggest concern now is with maturing loans on depreciated commercial properties. In many cases, borrowers seeking to refinance will be expected to provide additional equity and to have underwriting and pricing adjusted to reflect current market conditions. In some cases, borrowers won't have the resources to refinance loans. TALF and the Treasury's Public-Private

Investment Program can support the commercial real estate market. But the economic forces hammering commercial property are unlikely to reverse anytime soon.

Another area I'd like to touch on is liquidity. For most banks, funding has stabilized since last fall but remains quite fragile. We've seen rapid growth in the use of noncore funding channels, such as brokered deposits and Federal Home Loan Bank (FHLB) advances. Brokered deposits constitute an average of less than 4 percent of deposits nationally. But in Idaho, that concentration is more than double. And, in Oregon, it's more than three times higher.[11] Although many banks have managed their liquidity positions effectively, one lesson of the current period is that funding options can evaporate when a bank is facing declining asset quality, diminished earnings capacity, and falling capital. And that holds for brokered deposits, correspondent lines, and FHLB advances.

I know this sounds woeful, but my advice is to hope for the best and plan for the worst. That means anticipating a range of bad and worst-case scenarios that reflect local economic conditions and a bank's particular risk profile. It can be helpful to perform stress tests based on these scenarios to assess potential effects on earnings and capital, and to develop appropriate contingency plans. The commercial real estate guidance that I mentioned earlier emphasizes the importance of stress tests. The testing that the largest 19 banks recently conducted offers examples of techniques that community banks can adopt, such as two-year portfolio loss estimates and methods of estimating revenue. Appropriately designed stress tests can help bank managements and boards make decisions about loan-loss provisioning, capital planning, and strategic initiatives.

[11] The Idaho concentration is 8 percent; Oregon is 13 percent.

It also makes sense to perform liquidity risk analyses that assess potential funding pressures. These analyses should include forward-looking metrics such as cash-flow projections, and should examine a range of possibilities, such as reduced correspondent borrowing lines, higher FHLB haircuts, and loss of access to brokered deposits. Banks would be well advised to have in place well-tested backup plans before any potential funding crisis, including procedures for using the Fed's discount window.

On the subject of capital, regulatory minimums are just that—minimums. They're not guarantees that a bank will have enough capital to weather a future storm. The Fed and other regulators are placing much more emphasis on forward-looking capital analyses that consider a range of difficult economic scenarios and include earnings and loss estimates, and assessments of an institution's ability to raise private capital. Capital retention is an integral part of this equation, and that implies a rigorous review of dividend policy. I encourage bank managements to consult with their primary regulators about dividends in the context of capital planning discussions.

Although my message is that you should plan for the worst and exercise caution, I want to stress that it is also critical that you continue to make loans to creditworthy borrowers. The profits that quality loans generate will serve you well as you safeguard capital. They are the core earning assets that will power bank profitability as we head out of this recession. And, of course, the credit provided by prudent, well-functioning depository institutions will play an important role in supporting the broader economic recovery that now seems to be on the horizon. Thank you very much.

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