The View from the Federal Reserve:
Financial Conditions and the Economic Outlook

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Introduction

For the basis of my remarks today, I thought I would discuss the state of the economy, the economic outlook, and actions taken to restore financial stability. Obviously, that is a lot of ground to cover, and I recognize that in reviewing a wide range of material I will necessarily gloss over some highly relevant nuances. Perhaps we can cover those during the question-and-answer session. And in any event, I must remind you that, as always, I am speaking only for myself and not for others in the Federal Reserve.

As to organization of these comments, I will start with the financial crisis, the importance of reestablishing stability and well-functioning financial institutions and markets, and actions that should be taken to avoid these problems in the future. The state of the financial world is essential to understanding current economic conditions and prospects for the economy, and these subjects will form the latter half of these remarks.

Financial Conditions

At the risk of belaboring the obvious, it is both undeniable and an understatement to observe that these are challenging times – indeed, historic times – for participants in financial markets and for policymakers as well. Beginning about 21 months ago, financial markets were rocked by a series of shocks which ultimately had global implications and whose repercussions remain severe to this day. While conditions in credit markets have improved over the past several months, in general appreciable strains persist. The improvement appears to be due, in part, to the aggressive policy response of the Federal Reserve as well as programs introduced by the Treasury and FDIC.

The Federal Reserve, in particular, has reduced short-term interest rates significantly, worked to improve liquidity both in important markets and for a

range of financial institutions, and purchased longer-term debt instruments in volume in order to decrease those rates as well. While it is still too early to fully tally results, there has been progress, and I anticipate more to come as select programs become fully operational, participation increases, and confidence improves.

The Role of the Financial System

A healthy, smoothly functioning financial system is essential to sustained economic growth, for businesses and households alike require the ability to finance projects at competitive terms and conditions, be they investment in plant and equipment or purchases of homes and durable goods. Right now, the financial system is impaired, and there is considerable rhetoric about a so-called credit crunch. To be sure, some borrowers are encountering substantial difficulty in obtaining funding, but conversations with numerous bankers and their customers reveal a diverse set of circumstances, ranging from "business as usual" on the one hand to appreciable credit restriction on the other. One size clearly does not fit all.

Besides its role in investment, there are other compelling reasons why restoration of sound financial institutions and markets is of the highest priority. Markets that are closed obviously fail to price the financial instruments that normally trade on them, and such pricing is critical to resource allocation and reallocation. In particular, the reallocation of resources that should occur in a recession and that is fundamental to economic recovery is inhibited when financial markets are not functioning or are functioning poorly. Unless conditions improve, such market failures threaten to prolong the recession.

Further, the commercial banking system has long been thought of, and indeed has served as, a principal backup source of liquidity for many other financial institutions and markets. Banks continue to play this role but, for a

variety of reasons, it has become more challenging to do so. For one thing, the so-called shadow banking system grew rapidly relative to the traditional banking sector over the past two decades or so. And now the demands on the banks from these nonbank financial institutions are that much greater, making it difficult for banks to respond adequately to all customers. Restoration of a healthy banking system would help to mitigate this problem.

Too-Big-to-Fail

In view of the severity of the financial disruptions of the past 21 months, it is essential that we begin immediately to give serious thought to avoiding a recurrence of these events and to addressing the too-big-to-fail (TBTF) issue, now widely if belatedly acknowledged as an exceedingly costly problem. While not constituting "proof," it is striking that most of the losses suffered to date during the financial crisis have been at the largest institutions operating in the country.

I have in fact spoken and written extensively – some might say obsessively – about TBTF over the past five years. In 2004, I co-authored (with my colleague Ron Feldman) a book on the subject titled *Too-Big-to-Fail: The Hazards of Bank Bailouts*, just released in paperback by the Brookings Institution. I think it fair to say that Feldman and I, unlike most other policymakers and analysts, recognized in a timely way that TBTF was a severe and growing problem, that it had not been addressed effectively by the FDICIA legislation of 1991, and that it would eventually and inevitably lead to excessive risk-taking, turmoil in financial markets, and disruption in the economy.

Further, I think an important question is: How is it that we put high priority on the growing TBTF problem and its ramifications when others did not? The short and direct answer to this question is that we focused on understanding the incentives of uninsured creditors of large, complex financial institutions, the

incentives of management of such institutions, and the incentives of policymakers responsible for economic and financial stability. And we understood the implications of such incentives.

The bottom line of our analysis is that creditors of such complex financial institutions expected, on the basis of relatively well-established precedents and on an understanding of policymakers' motivations, protection if failure threatened. As a consequence, they had at most modest incentive to be concerned about the condition and prospects of these large institutions, leading to underpricing of risk-taking. With risk underpriced, these institutions took on excessive amounts of it, leading eventually to the precarious position of some of them. And policymakers, fearing massive, negative spillover effects to other institutions, financial markets more generally, and the economy itself, provided protection and validated creditor expectations.

This emphasis on incentives is not merely historical background. To the contrary, I am convinced that just as incentives were at the heart of the TBTF problem, they necessarily must be at the heart of the solution. Our proposal to correct TBTF, called "systemic focused supervision" (SFS) is designed to better align incentives so as to significantly reduce both the TBTF problem and the probability of future episodes of major instability. The keys to this are, in fact, reforms which make policymakers confident that they need not intervene if a large institution encounters difficulty and to put creditors on notice that they are likely to experience losses in such circumstances.

Rather than review the specifics of SFS this afternoon – they are described in virtually all of my speeches of the past seven months – let me instead warn that proposals which purport to address TBTF but which fail to correct incentives are unlikely to succeed. In particular, proposals to "shrink" the largest financial institutions or to rely on heightened regulation and supervision of and increased

capital for such institutions do not address the fundamental problem and must therefore be viewed as unlikely to effectively curb TBTF.

The Economy

Let me turn now to the state of the economy and its prospects. As you are no doubt well aware, the national economy is in the midst of a serious recession which began about a year and a half ago, a downturn which has affected most industries and virtually every region of the country. The recession, moreover, is global in nature. In this country, employment has declined significantly during the contraction in activity, and the unemployment rate has climbed to 8.5 percent nationwide. This region of the country has not been immune from these problems, as the data as well as reports from our directors and other contacts reveal.

Given the breadth of the downturn, it is difficult at this stage to identify with conviction the engine, or engines, of expansion that will propel the recovery of the national economy. In my experience, this is always the case in the midst of recession.

Still, I continue to think that improvement in business activity is not too far off. Interest rates are low and financial conditions are improving, albeit unevenly. Major fiscal policy stimulus is now under way and should add to aggregate demand in a timely way unless consumers and businesses turn exceedingly cautious.

Moreover, adjustments which typically occur in a contraction ultimately help to lay the foundation for renewed growth. For example, as business continues to reduce output and employment, inventories shrink, and at some point aggregate supply falls below even the diminished level of demand, leading to increases in hours worked, net new hiring, and a general pickup in activity. There are, moreover, signs that consumer spending is in the process of stabilizing after its

sharp fourth-quarter decline; indeed, consumer spending increased in the first quarter, according to the recently released GDP report. And progress is under way in working off the inventory of unsold, unoccupied homes and condos.

Once the economic recovery begins, the pace of the expansion is likely to be subdued for a time. There is historical precedent for this, since the recovery of the early 1990s was initially quite modest, as was the recovery earlier this decade. More importantly, in view of the state of the credit markets, it seems a fair bet that it will take time for momentum to build. But with the passage of time – as we get into the middle of 2010 and beyond – I would expect to see a resumption of healthy growth.

It is also likely to take some time for labor market conditions to improve meaningfully. Again, there is ample precedent for this and, more fundamentally, employment may well continue to fall in industries which are contracting – finance, construction, autos – even as it picks up elsewhere.

What of the outlook for inflation? Concerns today appear to have coalesced around two competing perspectives, namely: (1) concern for future inflation, stemming from the Federal Reserve's provision of huge amounts of liquidity in response to the financial crisis; (2) deflation, resulting presumably from the downturn in global economic activity.

Neither concern can be readily dismissed but, if economic growth resumes in the United States as I expect, the threat of deflation should diminish commensurately. And, to date, there is scant evidence of deflation in so-called core measures of inflation. As for liquidity provision and inflation, it is important to emphasize that the relation between growth in the money supply and the path of prices holds in the long run, over periods of at least five and more likely 10 years. Thus, there is ample time for the Federal Reserve to withdraw excess liquidity as appropriate.

Research conducted by economists at our Bank over the past several decades reveals that, in general, the regional economy fluctuates with the national economy, and this is especially true if the agricultural sector is excluded from the analysis. Taking a step back, this result is unsurprising since in the aggregate the composition of the regional economy is similar to that of the nation as a whole. Thus, I would expect the regional economy to track the path of the national economy in the years ahead.

Conclusion

Let me reiterate just a few points, in wrapping up these remarks. First, many financial markets remain strained, and credit issues are likely to weigh on the economy for some time. Overall, it is essential to restore the health of financial institutions and markets, so that long-lived projects can be financed, so that resource reallocation is facilitated, and so that liquidity improves. In part as a consequence of the state of the credit markets, the recession is likely to persist for some time longer, and the initial stage of the recovery seems likely to be subdued. Nevertheless, in view of the policies already in place here and abroad, a resumption of growth should not be too far off, especially given the economy's fundamental resilience. Before long, attention will appropriately turn to banking issues and policies, and especially to addressing the vexing issue of TBTF. This effort should be among our highest priorities and should focus on correcting the incentives that contributed to the problem and the instability that followed from it. Proposals aimed at TBTF which fail to align incentives properly are not likely to succeed and should be avoided, else they waste valuable time and resources.