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REMARKS

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Introduction

Good afternoon. It is a distinct pleasure to be back in Helena, to have another opportunity to share some thoughts about the state of and prospects for our economy, about risks to economic progress going forward, and about proposals for reform of the regulatory and supervisory apparatus governing financial institutions. By way of preview, my principal conclusions with regard to these matters are: 1) while this has been a long, broad, and deep recession, the first stage of recovery of the economy is close at hand; 2) although there are concerns about a potential burst of inflation, owing to considerable liquidity provision by the Federal Reserve during the recession and financial crisis, this is not likely in my judgment to pose a major threat to the economy. More worrisome in the longer-term is the possibility of renewed volatility in asset prices; 3) finally, while regulatory reform is essential and the Treasury's recent proposal is a start, the document fails to deal adequately with the too-big-to-fail problem and therefore, unless strengthened, will leave the financial system susceptible to future bouts of resource misallocation and serious instability.

Having, I hope, piqued your curiosity, I will devote the remainder of my remarks to describing the basis for these conclusions. But before proceeding, I will remind you that as always I am speaking only for myself and not for others in the Federal Reserve.

The Economy

As you are no doubt well aware, the national economy has experienced a serious recession which began over a year and a half ago, in December 2007. The downturn in business activity has been broad, deep, and prolonged. Most industries and virtually every region of the country have been affected; the recession has, moreover, been global in nature. In this country, employment has declined appreciably during the contraction (by more than 6 million jobs), and unemployment has climbed to 9.5 percent of the labor force, the highest level since 1983.

Despite a fairly continuous stream of negative news, I continue to think that improvement in the economy is close at hand. At economic turning points – when activity moves from recession to positive growth, for example – the data are inevitably mixed, and there now are in fact positive signs of stabilization in consumer spending, manufacturing activity, and various measures of residential real estate activity, including the volume of home sales and starts of single-family units. Moreover, adjustments which typically occur in a contraction ultimately help to lay the foundation for renewed growth. For example, as business reduces output and employment, at some point aggregate supply falls below even the subdued level of demand, inventories shrink, and the reduction in stocks leads ultimately to increases in hours worked, new hiring, and a general pickup in the economy. This inventory adjustment process is well under way.

Perhaps more fundamentally, considerable fiscal policy stimulus is in train and monetary policy has been aggressively expansionary as well. Interest rates are low, and financial conditions have demonstrably improved. While it is difficult to judge these things with precision, it now appears that credit expansion is being constrained roughly as much by subdued demand as by tight supply. In any event, credit is more readily available to households and businesses today than it was just a few months ago.

Once the economic recovery begins, its pace is likely to be quite modest for a time. There is historical precedent for this, as evidenced by the first stages of both the expansion of the 1990s and the one earlier this decade. In view of the negative wealth effects stemming from declines in home and equity values, still strained credit conditions, considerable excess capacity across the economy, and sizable job losses to date, it seems a reasonable bet that it will take time for momentum to build. It is also likely to take a considerable period for the labor market to recover, as employment may well continue to decrease in finance, autos, and construction, for example, even as it picks up elsewhere. It is worth recalling in this regard that the unemployment rate peaked 15 months into the expansion of the 1990s and 19 months into this decade's expansion. In any event, with the passage of time – as we move into the middle of next year and beyond – I would expect to see a resumption of healthy growth.

Inflation and Asset Prices

Numerous analysts have recently been expressing the concern that, notwithstanding the large amount of slack in the economy, there is the threat of a serious burst of inflation owing to the huge expansion of the Federal Reserve's balance sheet, from about $1 trillion in size last September to more than $2 trillion today. This is to be sure an impressive and, I might add, justified increase in liquidity, but there is nothing inevitable about a surge in prices. The Federal Reserve is fully capable of shrinking its balance sheet and withdrawing liquidity when it is appropriate to do so. Without question, it will be difficult to know both when to begin such action and how rapidly to proceed, but this is always the case. That is, in my experience it is always a challenge for policymakers to know when to begin to tighten policy and by how much to do so.

This challenge, however, is not a cause for despair. If one examines the inflation record of the United States, and of many other industrial economies for that matter, since the early 1980s, it appears that central banks have largely succeeded in delivering diminishing and, ultimately, low inflation. I can think of no reason why this cannot continue.

More worrisome to me is the potential – I would emphasize that at some point in the future – for further, sharp volatility in asset prices, where the Federal Reserve does not have a track record of success in curbing excesses. In my view, asset prices should play a greater role in policy deliberations and decisions than currently is the case. While policymakers have acknowledged that asset price excesses and their subsequent correction can potentially have meaningful consequences for the economy, they generally have preferred to try to cushion the repercussions of an asset price collapse rather than to address an asset price run-up in its early stages. There are in fact good reasons for this attitude, having to do with the difficulty of identifying asset "bubbles" in a timely way, the need to build public support for action, and the challenge of weighing the costs and benefits of action for the broad economy. Nevertheless, in view of the damage resulting from the decline in housing values, as well as the aftermath of the collapse of prices of technology stocks earlier this decade, I think it essential to revisit these issues.

Identification of excesses in asset prices, although challenging, does not appear to be beyond the realm of possibility. There is some work in academic circles, and at least some practitioners agree, that when common ratios (the ratio of stock prices to earnings or dividends, for example, or the ratio of housing values to rents) exceed the bounds of historical experience, it is likely that a price correction will follow, although its timing is unpredictable. It would seem likely that misidentification will occur occasionally and, in particular, that some events may be classified as bubbles when they are not. The implication of this possibility is, in my view, to ensure that the policy response to a perceived excess in asset prices is measured, so that even if in error the ramifications for the economy will be modest.

This consideration illustrates, perhaps, the critical issue in addressing asset price excesses. When all is said and done, will the benefits outweigh the costs, assuming policymakers have made the correct identification? Monetary policy, for which we in the Federal Reserve are responsible, is a blunt instrument with economywide effects. We should not pretend that actions taken to rein in those asset price increases which seemingly outstrip economic fundamentals won't in the short run curtail to some extent economic growth and employment; after all, such actions are likely to require raising interest rates earlier and probably more than otherwise would be the case. There is a trade-off here, involving short-run costs in exchange for the benefits of greater stability and growth in the long run. Before taking action, policymakers need to weigh these elements carefully.

Further, monetary policy is not made in a vacuum; the central bank must have public support for the actions it pursues, and it is easy to imagine resistance to concerns about asset price levels. Nevertheless, as the anti-inflation experience of 1979-82, for example, illustrates, it is possible to build considerable support (as Paul Volcker did), or at least tolerance, for policies that some considered risky and unappealing.

Regulatory Reform

The Treasury has recently come forward with an ambitious proposal to reform the regulatory and supervisory apparatus governing much of the financial services industry. I will not attempt a comprehensive review of the proposal here; instead, let me concentrate on a critical public policy issue and provide an assessment of the Treasury's response to this matter.

The issue in question is too-big-to-fail (TBTF), 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 Federal Reserve colleague Ron Feldman) a book on the subject titled *Too-Big-to-Fail: The Hazards of Bank Bailouts*, just rereleased 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. It is also revealing that there is considerable overlap between the 19 large banking organizations just put through the “stress test” and the list of TBTF institutions Feldman and I identified in 2004.

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 in the market place. 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 accidental. 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. That is, any proposal which purports to correct TBTF must address the incentives which lead to the problem. The program that Feldman and I have advocated, which is called systemic focused supervision and is described in detail in several previous speeches, is intended to do precisely that.

The Treasury proposal, on the other hand, largely fails in this regard. In fact, I would describe the Treasury plan as it pertains specifically to TBTF as "status quo plus" – more capital, more liquidity, better supervision, far-reaching resolution authority for the largest institutions. There is little reason to think that these steps will, individually or collectively, succeed in reining in TBTF effectively over time because they do not change the incentives which create the problem. In fact, there is nothing in the Treasury proposal designed to put creditors of large, systemically important financial institutions at risk of loss.

Conclusion

Let me reiterate just a few points, in concluding these remarks. First, although the labor market continues to deteriorate, I think that the first stage of economic recovery is close at hand, largely because the inventory liquidation process is proceeding as anticipated and because there are signs of stabilization in consumer spending, manufacturing, and some measures of housing activity. Second, while some have expressed considerable concern about inflation prospects in view of the expansion of the Federal Reserve's balance sheet, a more likely threat at some future point is renewed volatility in asset prices, where the Federal Reserve lacks a record of success in providing stability. And finally, while regulatory reform is appropriate at this juncture, the Treasury proposal fails to come to grips with TBTF and therefore leaves the financial system considerably more vulnerable than it needs to be to future bouts of instability.