Policy and the Economy in the Wake of the Shock

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Introduction

In the economic realm, the past 14 months have been characterized first and foremost by a severe and extensive financial shock, which has provoked, among other things, an extraordinary response from the Federal Reserve and from other policymakers as well. I want to spend some time this evening describing this response, the implications of financial developments for the economy, and the role of fluctuations in asset prices in our recent experience. This is a lot of ground to cover, and so necessarily many details and nuances will be skipped. These, hopefully, can be addressed in the subsequent question and answer session. And the usual caveat applies: I am speaking only for myself and not for others in the Federal Reserve.

The Federal Reserve Response

The financial disruptions we have witnessed for more than a year now began in the market for subprime mortgages but ultimately engulfed much of the credit system, with the turmoil intensifying over the summer and through early fall. Against this background, the Federal Reserve has undertaken a wide range of significant actions intended to restore stability. Given the tools available to the Federal Reserve and our mission, we have largely focused our efforts on increasing the availability of liquidity to financial institutions. Without trying to be comprehensive, I would note the following:

We have added liquidity by easing the terms of our discount window lending to traditional borrowers, including reducing prices and lengthening maturities, for example. We have also rolled out new ways to provide this credit, including auctioning it off. In addition we have allowed certain securities firms, the so-called primary dealers, to access our credit facilities. Finally, in two cases, we used our lending powers to facilitate the orderly resolution of financial firms whose failure otherwise posed systemic risk.

I could point to other actions, such as increasing our coordinated lending of dollars with other central banks and prospective entry into the commercial paper market, but suffice it to say the Federal Reserve has responded to unprecedented times with equally unprecedented actions. And, of course, we have reduced the Federal funds rate target from 5 ¼ percent in September ’07 to 1 ½ percent today.

Despite these initiatives, financial markets remain unsettled, and some institutions continue to experience funding pressures. Restoration of stability has not yet been achieved and, to add to the challenge, the too-big-to-fail (TBTF) problem, with which I have long been concerned, has been exacerbated by some of the actions taken to foster stability. These actions were fully appropriate against the background of the risks at hand, and it is critical that they succeed; nevertheless, at some point policymakers will have to turn their attention to reining in TBTF because, if left unchecked, it is likely to contribute to future instability.

I have proposed, and I have spoken previously at some length about, a program called "systemic focused supervision" (SFS) to begin to accomplish this objective. That is a topic for another day, except for two points that I want to reiterate here: First, at the end of the day SFS is all about preparation and timely action. The underlying idea is, before severe problems arise, to identify potential vulnerabilities and spillovers – that is, to try to determine how the weakness of one large or systemically important financial institution will affect other financial firms and the real economy before the former actually gets into difficulty. SFS would also have regulators close financial institutions early, before they can impose too large a loss on peers, by enhancing the so-called prompt corrective action regime with more forward-looking market data. And specific, regular communication is also a necessary component of SFS, in order to prepare creditors for the change in regime and to encourage changes in their expectations and behavior. Second, policies with the ingredients of SFS are likely to be essential if we are to restore a stable, market-driven financial system.

Financial Conditions and the Economy

For now, let me consider the implications of the financial disruptions, and the response to them, for the economy. Despite the deterioration in financial conditions, the economy grew better than 2 percent last year and about 1 ¾ percent (at an annual rate) over the first half of this year. But these numbers for real GDP do not tell the whole story. Nationwide, employment has dropped every month this year. Housing construction and prices of residential units continue to decline, and the inventory of unsold, unoccupied properties remains substantial. The sharp drop in equity values, along with the course of home prices, has reduced household wealth, and marked deterioration in credit market conditions has added to the cost and difficulty of obtaining funding.

In this environment, consumer spending, which has softened in recent months, seems likely to remain subdued. As I have suggested on other occasions, there are discernible similarities between current circumstances and those prevailing in the early 1990s, during the so-called financial “headwinds” episode. In that period, credit became expensive and in some cases, unavailable, even for relatively high quality borrowers. Indeed, in view of the scope and severity of the recent financial shock, the restraint on economic activity stemming from credit market headwinds could exceed the experience of the 1990s.

I would, however, be cautious about this conclusion, for several reasons. First, many “initial conditions” prevailing prior to the current financial shock were perceptibly better than in the early 1990s. Unemployment, interest rates, and inflation were all lower at the outset of the latest period of turmoil than in the previous headwinds episode. Equally important, the financial condition of both most banking and nonfinancial businesses was relatively healthier at the outset of recent problems.

Second, the policy response, including the Treasury program to purchase troubled assets from financial institutions and to inject capital into banking firms, as well as the extension of deposit insurance, is substantial and far-reaching. As I perceive the environment today, some financial assets are being traded infrequently if at all, implying that their price, and value as collateral, is highly uncertain. This circumstance calls into question the capital position and viability of those institutions that hold such assets in volume. Thus, market participants are unsure of the value of collateral and the financial condition of counterparties, completing a vicious circle which has contributed to the reluctance to trade and to fund firms except on a very short-term basis.

The Treasury program, properly implemented, will improve capital positions and help to establish values for assets currently locked up. And the actions the Federal Reserve has taken have aimed to ameliorate the funding issues which have arisen in this challenging environment.

It has long been presumed that the commercial banking system was, and would function as, the backup source of liquidity for other institutions – financial and nonfinancial alike – in times of stress. Banks are, to some extent at least, playing this role again; as former Federal Reserve Board Chairman Paul Volcker remarked recently, “Everybody is running back to Mother, the commercial banking system.” But the banking system’s capacity to fulfill this role is strained, in part because of losses some institutions sustained as a consequence of positions in the assets in question and in part because the so-called “shadow banking system” grew so large relative to traditional institutions.

All of this is to suggest that it likely will take time for confidence in collateral values, capital positions, and counterparties to be restored; from my perspective, the financial headwinds experience of the early 1990s remains relevant. With that reference point, it seems that for the near term we should anticipate further declines in employment and softness in most components of demand for goods and services, together with a diminution of inflation as the bulge in energy and other commodity prices is apparently behind us.

It is worth recalling that the economic recession of 1990-91 was brief but not especially mild: real GDP declined more than 2 percent (annual rate) over the three quarters ending in the first quarter of 1991 and consumer spending dropped perceptibly during that period. Depending on how one reads the data, financial headwinds restrained the pace of the ensuing expansion of the early 1990s for from 12 to 36 months. Something similar is certainly conceivable today. At the same time, we should bear in mind that, current travails notwithstanding, the underlying flexibility and resilience of the economy are intact, as are its human and physical capital, and these characteristics should ultimately prevail to restore solid growth.

Asset Prices

Early in these remarks, I noted in passing that the recent financial shock originated in the market for subprime mortgages. It will take some time to comprehensively analyze and to understand the underlying sources of the problem, and surely more than enough "culprits" contributed to the turmoil. But one significant factor appears to have been the (formerly) widely held conviction that house prices across the country would rise rapidly and uninterruptedly; many transactions would have worked out satisfactorily had this been the case. This observation brings us to the last issue I want to raise this evening, and which I have considered previously, namely the role of asset price fluctuations in economic performance and in policy formulation.

Changes in home prices and equity values, two principal items on the household balance sheet, exert so-called wealth effects on consumer spending, which is to say that while such spending depends mainly on after-tax income, wealth influences outlays as well. 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, to be sure, 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 economy-wide 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.

Conclusion

I have tried to cover a lot of ground this evening, in part because these are far from normal times. Before turning to your comments and questions, let me highlight just three points in concluding: 1) the financial disruptions we have experienced have important implications for the performance of the economy, and the headwinds episode of the early 1990s provides a useful reference point for thinking about what we might expect going forward; 2) the actions taken by the Treasury, Federal Reserve, FDIC, and others should, with time, improve market liquidity and the availability of credit; and 3) it has proven difficult and costly to deal with the aftermath of excesses in asset prices. As a consequence, it would seem wise to devote more resources both to the accurate identification of asset price bubbles and to consideration of appropriate policy actions upon such identification.