Financial Conditions and the Economic Outlook
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After gradually weakening through most of the first three quarters of 2008, the economy has taken a dramatic turn downward in the last few months. We find ourselves in the midst of a deep recession that is stretching into its second year. This contraction is more severe than we have seen for some time – in fact, you have not lived through an economic contraction this severe as an adult unless you came of age before disco.

South Carolina, with its relatively heavy concentration of manufacturing activity, has felt the full force of this downturn. The state's unemployment rate has now reached into the double digits and firms have shed jobs on balance for eight consecutive months. In the past year, these job losses have been felt beyond manufacturing, extending across most sectors of the economy in South Carolina.

This recession has coincided with a period of severe financial stress, as many major financial institutions in the United States and around the world have taken large losses, especially on assets related to mortgage finance. To many, financial conditions have become the defining characteristic of this business cycle, and the distressed condition of our financial institutions a key factor inhibiting a return to economic growth.

In my remarks today, I will argue that financial and economic conditions both stem from the same fundamental sources, and that financial and credit market developments are largely the result, rather than the cause, of the economic slowdown. As always, the views I express will be my own, and may not coincide precisely with the views of all of my Federal Reserve System colleagues.[1]

The proximate cause of the financial market turbulence, of course, is the home mortgages made from late 2005 through early 2007, near the end of long U.S. housing boom that began in 1995. Because of the decline in home prices, and thus home equity, since the peak in activity in 2005, mortgages made near the peak of the boom, especially the subprime and non-traditional categories, are experiencing much larger losses than expected.

There is a long list of suspects for the cause of the boom in home prices and construction, including public policy to promote home ownership, financial innovation and low interest rates.[2] I have emphasized the possibility that risk-taking incentives, in financial markets, have been distorted by actual and perceived government financial safety net protection. I also have emphasized that much future research will be required before economists can confidently gauge the relative contributions of various causal factors.

Whatever its causes, however, the housing finance boom set the stage for the turmoil that has plagued financial markets since the middle of 2007, when the potential scale of the home mortgage problem became more widely appreciated. The turmoil intensified in mid-September of last year, and volatility has been elevated since. This stress has shown up in the form of large losses to financial institutions, increased interest spreads for a wide array of credit market instruments, and a broad pull-back from the securitization of mortgages and other forms of credit.

The general sense of caution in financial markets has been the result of three major categories of uncertainty faced by market participants. The first concerns the aggregate amount of losses on mortgage lending, and some uncertainty still remains on this score, since the ultimate losses will depend importantly on the as yet unknown extent of the decline in home values.

Second, financial market participants have faced uncertainty about where the losses will turn up since mortgage risks were split up and spread widely, both within the United States and abroad, through securitization and use of the insurance capabilities provided by credit derivative contracts.

Third, market participants have at times faced uncertainty about prospective public sector intervention.[3] The disparate responses to potential failures at several high-profile organizations last year may have made it difficult for market participants to forecast whether official support would be forthcoming for any given counterparty. Speculation this year about the structure of possible government rescue programs may also be contributing to financial market uncertainty.

Most of what has been observed in financial markets since the summer of 2007 is fairly intelligible in light of these sources of uncertainty facing market participants. Apprehension about potential losses caused lenders to demand higher risk premia in interbank credit markets for institutions with at least some presumed mortgage-related exposure. Some borrowers were unwilling to pay higher premia for term loans, and shortened the tenor of their funding. Others were willing to pay the unusually high premia in order to “lock in” funding and protect themselves against an erosion in counterparties’ perception of their creditworthiness. Thus, observing that a particular credit market is “frozen,” “clogged,” or “dried up” may not indicate dysfunction, per se, but may instead indicate just a portfolio reallocation in response to a shift in risk assessments.

While the most common reading of these events is that the disruptions to credit channels have pulled the economy into deeper decline, assessing the effects of the financial market turmoil on real economic growth is not as straightforward as it might seem. One popular notion is that the credit market disruptions we have seen over the last year or so impede the financial sector's ability and willingness to extend credit to households and business firms, thereby creating an additional drag on spending. But causation can flow in the opposite direction as well. When overall economic activity seems poised to contract, the outlook for household income and business revenues deteriorates as well, and borrowers become less creditworthy, all else constant. Moreover, consumer and business demand for lending declines when they cut back on discretionary outlays. My reading of current conditions is that the economy is holding back credit markets much more than credit markets are holding back the economy.

The unprecedented response by the Fed and the government to financial market developments is by now a well-known story.[4] The alphabet soup of new lending programs and capital injections for large banks, as well as the targeted assistance for specific institutions, have supported market segments at the heart of turmoil. They also have limited the losses born by many market participants. While equity holders in large financial institutions have seen the value of their shares erode dramatically, government and Fed actions have shielded many debt holders from loss. This is the effect of federal financial safety net protection that I believe raises the greatest concerns about moral hazard. Our response has extended well beyond what were perceived in the past to be the bounds of such protection, and this raises important questions about how markets will expect us to act in the future.

As we emerge from this extraordinary episode and look to restructure our regulatory framework, I believe that it is of paramount importance that we also clearly define the boundaries of future safety net support. Ambiguity about who is or is not "too big to fail" contributed significantly, in my view, to the incentives of large financial institutions to pursue strategies focused on leveraged growth and off-balance-sheet risks, which ultimately added to the instability of markets. Redesigning our financial regulatory system before establishing clear boundaries around the financial safety net would be like putting the cart before the horse.[5] I believe we should seek to scale back the boundaries of the safety net, because the cost of containing the moral hazard effects of widespread government support exceed the benefits of avoiding financial firm failures. But in any case, our choices of whom and how to regulate in the future will need to be commensurate with the status of implicit as well as explicit safety net guarantees.

I have been discussing the effects on credit markets of the decline in residential construction activity over the last three years. That decline also has had a large impact on overall economic activity. At first, it seemed as if the weakness was isolated in the housing market, and GDP expanded at a reasonably satisfactory rate of 2.4 percent in 2006 and 2.3 percent in 2007. But strains became increasingly evident in 2007. Manufacturing production peaked in July. Real disposable personal income peaked in September of 2007 and consumer spending growth then slowed, dampened as well by the decline in household wealth due to falling house prices. Payroll employment ultimately peaked in December of 2007, a date the National Bureau of Economic Research later named as the transition point between expansion and recession.

At first, the recession seemed rather mild, similar to the last two recessions. Payroll employment, for example, fell by 137,000 jobs per month in the first eight months of 2008. But in September the recession intensified. We've lost 3.25 million jobs since then, and all other major gauges of economic activity have been dismal since then as well. With jobs, income, and wealth declining, it is no surprise that consumer spending weakened further last year, with real expenditure falling 1 ½ percent. As conditions deteriorated for many businesses, capital budgets were slashed. New investment in equipment and software fell 11 percent last year in inflation-adjusted terms. And while a number of large construction projects were under way when the economy turned, new commercial construction activity also began to decline last quarter. Based on such indicators as the steep decline in activity at architectural and engineering firms last year, we are likely to see a continuing fall in construction of offices, stores, and other types of nonresidential buildings throughout this year.

At this point, then, it's safe to say that this recession will be at least as severe as the recessions of 1973-75 and 1981-82. Despite the abundance of bad news, however, prominent forecasters expect the economy to bottom out at some point later this year and then gradually regain forward momentum, and I think that is a reasonable expectation. First, I believe that we have already received the bulk of the bad news from the housing sector. New single-family housing starts have fallen 80 percent over three years, and there is little room for further decline. With new construction activity low, population growth will gradually absorb the excess supply of housing that exists in many localities. Similarly, auto sales have fallen by more than 40 percent in the recession and are now well below the rate at which cars and trucks wear out or are totaled in accidents. Simple replacement demand will put a floor on auto sales going forward.

With this bad news behind us, are there any favorable signs? The answer is yes. First, economic history teaches one to not underestimate the power of monetary stimulus, and monetary policy has been highly stimulative since the recession began. The federal funds rate is five percentage points below its peak, and the size of our balance sheet has doubled in the last six months. This stimulative policy stance is likely to begin to show its effects on overall activity by year's end. I also would note that one source of economic stress last year was the extraordinary run-up in gasoline and other energy prices in the first part of the year. That shock has now been reversed, and lower gasoline prices have given a welcome boost to consumer buying power. Moreover, despite the weak labor markets, wages have not been slashed and as a result, total wage and salary income has held up remarkably well. In nominal terms there has actually been a slight increase in wage income since the recession began, and total personal income – after adjusting for taxes, transfer payments and inflation – has risen almost 3 percent during the recession.

Last, but certainly not least, one can now point to a couple of positive economic reports. To cite one example, retail sales of goods and services to consumers increased 1.7

percent in the first two months of this year. This may be a sign that consumers are responding in the manner suggested by economic theory and basing their immediate consumption plans on less adverse longer-run income prospects. This is a key element in the case for the economy bottoming out this year, because most forecasters expect improvements in consumer spending to lead private demand growth this year, and for investment spending to turn somewhat later.

Having said all that, it bears emphasizing that uncertainty about the economic outlook is particularly acute right now, and that while there are indications consistent with the emergence of positive momentum by the end of the year, we are likely to see quite negative economic reports in the meantime.

You may have noticed that I have not mentioned so far the recently enacted fiscal stimulus program. While there is a fair amount of uncertainty about the effects of such efforts to boost economic growth, I believe many popular accounts overstate the effects of fiscal policy actions. You may recall that we had fiscal stimulus last year, and the evidence indicates that it failed to keep the recession from intensifying. Such disappointing results are actually quite frequent. Keep in mind that today's stimulus will have to be paid for at some point in the future, and the prospect of higher taxes can restrain activity as well. Moreover, some spending diverts workers and firms from other uses instead of drawing in unemployed resources. My sense is that the stimulus is likely to have only a marginal effect on the broad contours of the economic recovery.

You also may have noticed that I have not yet mentioned inflation. Overall inflation was below 2 percent earlier in this decade, but began to trend higher back in 2004 and reached 4.5 percent by the middle of last year, as measured by the 12-month change in the price index for consumer spending. Much of that acceleration reflected energy prices, and with oil prices down, inflation began to subside last August. For the 12 months ending in January, inflation has been a low 0.7 percent.

Looking ahead, some economists are forecasting that inflation will persist at that low level for several years, on the grounds that substantial economic slack is generally associated with declining price pressures. I would be cautious about relying on this correlation as a causal relationship, however, even though it is detectable in many datasets.[6] And I am confident that we can prevent outright deflation by expanding our expansive monetary policy stimulus if need be. But at the same time, it is not premature to be concerned with the behavior of inflation when the recession is over and the recovery has begun. We have engineered a tremendous expansion in the monetary base over the last six months, and the statement issued by the Federal Open Market Committee last week announced that further rapid expansion lies ahead. This is an extraordinary policy response, and I believe it is appropriate. But such a large increase in the monetary base cannot be left in place indefinitely without creating quite sizeable inflation pressures. Choosing the right time to withdraw that stimulus will be a challenge, and I believe it will be very important to avoid the risk of waiting too long.

The monetary liabilities of the Federal Reserve Banks have more than doubled over the last several months, from around $940 billion the week ending September 10, to around $1.7 trillion the week ending March 18. Virtually all of this increase was in the form of bank reserves – the deposit balances that banks hold at their Federal Reserve Banks – which went from $8 billion to around $780 billion over that period. (The rest of the monetary base consists of paper currency.) This increase in the Fed's money supply was a direct consequence of the collection of credit programs initiated last fall. Prior to October, the Fed was able to "sterilize" new lending through offsetting asset sales that soaked up the additional bank reserves, which otherwise would have increased the monetary base. After October, the cumulative amount lent became too large to sterilize, and further lending added to the monetary base. Luckily, the implementation of these large credit programs coincided with a time in which additional monetary stimulus was warranted.

But monetary policy and credit programs do two different things. Monetary policy stabilizes the purchasing power of money over time by keeping the price level stable and relatively predictable, and by doing so, contributes to maximum sustainable economic growth. Credit policy is also aimed at promoting growth, but it is more a form of fiscal policy in that it uses the public sector's balance sheet to alter the allocation of resources. In this instance, credit market interventions have been financed to a large degree by the issue of new monetary liabilities, but they could just as well be financed with non-monetary liabilities, such as U.S. Treasury securities.

The debate about whether the economy is more in need of credit policy or traditional monetary policy actions at this time is based on competing understandings of the relationship between credit markets and aggregate economic performance. There's no debate that the dire economic conditions we now face warrant a strong policy response. But the best type of response – credit versus money – depends on which of these competing theories is a better understanding of how our economy works. While this could complicate policy choices as a general matter, the good news right now is that the credit and monetary views yield complementary policy implications, because policies that provide targeted Fed credit also add reserves to the monetary base. The more difficult choices will come down the road, if improvements in credit market conditions and the overall economy do not coincide.

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[1] I am grateful to John Weinberg and Roy Webb for assistance in preparing this address.
[2] January speech in Columbia
[3] Jeffrey M. Lacker, "Financial Stability and Central Banks," Speech to European Economics and Financial Centre, London, June 5, 2008.
[4] January speech in Columbia
[5] John Kareken, "Deposit Insurance Reform or Deregulation is the Cart, Not the Horse," *Federal Reserve Bank of Minneapolis Quarterly Review*, vol. 7, no. 2, 1983.
[6] Jeffrey M. Lacker and John A. Weinberg, "Inflation and Unemployment: A Layperson's Guide to the Phillips Curve," Federal Reserve Bank of Richmond 2006 Annual Report.