

Embargoed until Tuesday, May 19 at 1:20 p.m. Eastern Time

Financial Conditions and the Economic Outlook

Gary H. Stern
President
Federal Reserve Bank of Minneapolis

Willmar Lakes Area Chamber of Commerce
Willmar, MN
May 19, 2009

Introduction

About two weeks ago, I had the opportunity to testify before the Senate Banking Committee on policies to address the too-big-to-fail (TBTF) problem. TBTF is a critical public policy issue, and I will offer further comments on the topic shortly. Indeed, my plan this afternoon is to cover a broad range of issues, including progress toward restoration of financial stability, policies essential to reducing the probability of future financial crises, the current state of the economy, and the economic outlook. There should be time for questions and discussion, and I will remind you that, as always, I am speaking only for myself and not for others in the Federal Reserve.

Financial Institutions and Markets

Beginning about 21 months ago, financial markets were rocked by a series of shocks which ultimately had global implications and whose repercussions remain significant to this day. While conditions in credit markets generally have improved over the past several months, perceptible strains persist. The improvement we have witnessed 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. Reflecting the scale of these actions, the Federal Reserve balance sheet has increased from about \$1 trillion last September to something in excess of \$2 trillion now. While it is still too early to fully tally results, there has been progress, and I anticipate further improvement in credit conditions as select programs become fully operational, participation increases, and confidence picks up.

The Role of the Financial System

A healthy, smoothly functioning financial system is essential to sustained economic growth, because 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 remains 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, and it is important to recognize that the demand for credit from some sectors appears to have diminished, and its composition has shifted as well.

Besides a role in financing investment, there are other compelling reasons why restoration of sound financial institutions and markets is of the highest priority. Markets that are impaired obviously do not provide robust prices for 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 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 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. 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 many of my speeches of the past eight months – let me instead speculate a bit about the possible course of action with regard to the risk-taking of large, complex financial institutions. I would think that such institutions may well, in the future, be subject to higher capital requirements, “taxes” on activities that pose systemic risk, and a bank-like resolution regime to help contain spillovers. Among other things, such steps would help to level the playing field between TBTF firms and community-oriented financial organizations. However, I am deeply concerned that proposals which purport to address TBTF, but which fail to correct incentives, will prove to be less than fully successful. 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.

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 8.9 percent nationwide.

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 far off. Interest rates are low and financial conditions are improving; the improvement is gradually becoming more broadly based. Major fiscal policy stimulus is 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 decline during the second half of last year; 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 and the decline in the value of equities and homes, 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 and the concomitant increase in excess capacity.

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, although to be sure, policymakers will have to be acutely sensitive to acting as soon as appropriate.

Asset Prices

A few moments ago, I alluded to the decrease in home and equity values and its implications for near-term business activity. Changes in home and equity prices, 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 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.

Conclusion

Let me reiterate just a few points, in wrapping up these remarks. First, appreciable financial strains persist, 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 several more months, 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. And policymakers also should begin to reconsider their attitude toward excesses in asset prices because it has proven exceedingly difficult and costly to deal with the aftermath of such excesses.