

EMBARGOED UNTIL PRESENTATION AT 12:30 P.M. MT

An Economy at Risk: The Tough Decisions Ahead

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Sheridan, Wyo.
June 3, 2009

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Thank you for allowing me the opportunity to speak with you here in Sheridan today. It is a pleasure to be here, and it has been a genuine opportunity for the directors and staff of the Federal Reserve Bank of Kansas City to learn first hand what is happening in this part of our region.

In thinking about the long run while contemplating the current economic situation, I would humbly amend the famous observation of economist John Maynard Keynes. In the long run, we are all dead but our children will be left to pick up the tab. With that in mind, today I will focus on some of the longer-run challenges we face as we emerge from the current financial and economic crisis. These challenges can most certainly be dealt with, but they require that we begin now to address them genuinely and systematically or we risk repeating past mistakes and creating an environment that leads to our next set of crises.

Near-term outlook

I'll begin my remarks by stating that my view of the more immediate outlook for the U.S. economy is that we will emerge from this recession – perhaps as soon as the second half of this year, but most likely in early 2010, as many economists project. If for no other reason, the economy should respond positively to the significant degree of monetary and fiscal stimulus that has been directed into the economy over the past several months. Let me briefly describe those actions.

Monetary policy is enormously accommodative, with the fed funds rate being near zero. The Federal Reserve's lending programs and support of the housing market provides significant additional liquidity and stimulus to our financial markets and economy. The Federal Reserve is in the process of purchasing longer-term assets including Treasury securities, which adds

significant stimulus. In total, these actions will increase the Federal Reserve Banks' combined balance sheets to more than \$3 trillion from less than \$1 trillion less than two years ago.

Fiscal policy also has been highly expansionary and will provide trillions in stimulus over the coming quarters and years. For example, the Troubled Asset Relief Program (TARP) placed \$700 billion into the financial industry and parts of the auto industry just within the past eight months. The fiscal stimulus package recently implemented into law provides nearly \$800 billion in tax cuts, grants to state governments, expanded jobless benefits and significant infrastructure spending on highways and other transportation enhancements, and on clean energy initiatives that are unprecedented in size and scope. Frankly, it would be surprising if the economy failed to recover based on the magnitude of these monetary and fiscal programs.

Despite these actions, I expect the recovery to be more modest than some economists project. The U.S. economy is working through a series of difficult structural adjustments, as are many of our trading partners. Our financial institutions remain fragile and will require significant additional amounts of capital to regain their stability. How we choose to do this will affect the public's confidence in these institutions and their ability to support the recovery. The housing market continues to struggle as it downsizes from past financial and speculative excesses and the associated misallocation of resources. Consumers are adjusting to a significant loss in wealth associated with the declining housing and stock markets, and job losses. Recovery in these circumstances will take time and require patience if we are to avoid mistakes in our efforts to bring the economy forward.

Thus, while I am convinced that the economic recovery we all want will develop, it will be slower and more fragile than we hope for.

Fixes for the long run

This recession is often described as the worst in post-World War II history, and that may very well be correct. From it will flow a host of policy issues that will require careful review and hard choices if we are to assure our national economy's long-term strength and vitality. In this regard, I would like to direct the remainder of my remarks to three policy issues: the need to address fundamental weaknesses within our financial system; the need to address significant imbalances within the U.S. economy; and the need to act to avoid an inflationary outbreak that could come with current fiscal and monetary policy.

The financial system

Over the past year, we have seen the U.S. financial system nearly collapse. Financial institution failures have included Bear Stearns, Fannie and Freddie, and Lehman Brothers. Meanwhile, billions of dollars in taxpayer money have been needed by CitiGroup, Bank of America and AIG. The panic that followed these events affected the broader economy, worsening the current recession. It is apparent that we need a better set of incentives within the industry and better oversight by the regulatory authorities if we are to avoid a repeat of these events in the future. Moreover, if we hesitate to make needed changes, we will perpetuate an oligarchy of interests that will fail to serve the best interest of business, the consumer and the U.S. economy.

In our efforts to fix the oversight process for our financial system, we should not misdiagnose the patient. Unfortunately, I'm afraid we are witnessing some regulatory malpractice now. The emphasis on reform at this moment is to change the structure of the regulatory system rather than address the fundamental weakness of that system. Leading to this crisis were a series of steps that eliminated or compromised financial standards that had served to

support sound financial practices for generations. For the most part, these rules were simple in form, understandable and enforceable. They served to constrain excessive leverage and undisciplined growth using simple leverage ratios, and they focused on fundamental underwriting standards such as limits on loan-to-value. Accordingly, I am convinced that before we spend time and energy restructuring the regulatory system, we should first determine which rules of conduct should be reintroduced and enforced to provide for better outcomes. Perhaps in the end there will be consensus to change our oversight structure, but I suspect reestablishing and then enforcing rules that have proven effective over time will do more than the make-work exercise of regulatory restructuring. After all, England has one regulator and has fared no better in the current financial crisis.

In discussing any aspect of financial reform, one of the most significant changes that must be accomplished is the end of “Too Big To Fail.” If nothing else, this current financial crisis has confirmed its existence. Capitalism is a process of success, failure and renewal, and for it to work properly, institutions must be allowed to fail, no matter their size or political influence. Institutions that are considered too big to fail have an implied subsidy. Research suggests that these firms are thought to have a lower cost of funds and a competitive advantage over their less “systemically important” competitors. Too big to fail introduces a “moral hazard” problem for society where creditors of these firms lessen their due-diligence programs knowing that they will be bailed out by the government should the institutions fail. The effect is to lower the costs to these firms and significantly raise costs to the taxpayer and, ultimately, to fundamentally weaken our financial system.

Finally, ending too big to fail is not the same as endorsing a disorderly liquidation process for institutions. Rather it demands a market-oriented solution to poor performance. It requires a resolution process that holds management and investors accountable for their actions

and, properly structured, it provides for an orderly transition to new ownership or the closing of the institution with the least disruption to the market and economy. I have previously outlined various examples of how this might be done based on what has worked in our financial history and in other countries. It is imperative that we learn from these examples. If we do not address this issue, we will certainly invite a repeat of the recent financial turmoil and its devastating effect on our economy.

Imbalances and economic stability

Over the past two decades, the U.S. has created for itself a set of economic imbalances that, in my judgment, have significantly increased uncertainty and placed economic growth at risk for future generations of Americans. That is a serious statement to make, so let me set out a few facts to illustrate my point. As a nation, the U.S. has been living beyond its means for many years. The U.S. current account balance since 1990 has declined steadily from approximately in balance to a deficit of 6.5 percent of our GDP in 2005, and it remains at nearly 4 percent of GDP today. At its peak, this equates to almost \$900 billion that the U.S. has borrowed from the rest of the world on an annual basis. If this were being used to finance productive investment, I would not be overly concerned because the returns we earn could finance the cost of borrowing. Unfortunately, however, a large share of U.S. imports is for consumption.

The reality of this imbalance is brought further into focus when we realize that U.S. consumption as a percent of GDP has increased from an already relatively high 66 percent in 1990 to 70 percent in 2006 and remains near this level even today. Just as significant is the fact that U.S. aggregate personal savings had fallen from an already low rate of 5 percent of GDP in 1990 to near zero in 2006. More significant still is the fact that for the same period, consumer debt to income increased from a high of 84 percent to nearly 135 percent.

Finally, our federal government has, except for a short period at the end of the '90s, run its own chronic annual deficit, which is projected to approach \$2 trillion this fiscal year and will remain large for years to come. Moreover, these projections do not include the effects of additional trillions of dollars of unfunded promises we have made to ourselves to provide Social Security and Medicare benefits for decades to come.

Because the U.S. economy is so large and, by historical standards, so successful, it has the capacity to carry such imbalances far longer than most economies would be permitted in today's global markets. However, such an advantage will eventually end and comes with its own costs. Over time, an ever-increasing amount of national and personal debt will raise the cost of capital. As these costs increase, investment will slow and cause lower productivity, yet an improving level of productivity is what is required to maintain a high standard of living. The decrease in economic growth will most likely come slowly and be modest, but its compounding effects over future generations will be significant. For example, over a 25-year period, a 25-basis-point reduction in real GDP growth would imply a difference of nearly 6 percent in the level of GDP, all else equal, as we economists like to say. In other words, seemingly small percentages can have an enormous impact on future generations.

The inflation challenge

It is one thing to outline the challenges we face, it is quite another to address them. To illustrate this point, I would direct you to an article by Martin Barnes, the managing editor of The Bank Credit Analyst, published this May. In estimating the effect on consumption growth if the annual savings rate steadily increased from zero toward 8 percent between now and the end of 2013, the article suggests that consumer spending would grow at an average rate of only 1.3 percent per year. This would be a significant reduction of consumption growth, the slowest since

the 1930s. There can be little doubt that such a growth rate would have a significant adjustment effect, even if only temporary, not only on the U.S., but also on the rest of the world. For the U.S., it most likely would imply the need to shift resources toward the export sector, and for our trading partners, it would mean relying less on sales to the U.S.

Starting from where we are today, it is clear that interest rates must rise. As the economy recovers, even at a modest pace, resource demands will begin to increase. At this point, the current level of monetary accommodation will need to be withdrawn to avoid introducing inflationary impulses. Also, with the almost certain adjustments that need to occur in consumption, savings and the rebalancing of imports and exports, I expect there would be additional pressure for interest rates to rise steadily over time. To the extent that these adjustments will require considerable time to complete, unemployment levels, for example, may decline more slowly than anyone wants.

If such a set of events occurs, then I also suspect there will be considerable pressure on the central bank to “help out” in easing this adjustment process by keeping interest rates low for an extended period. This happens because people often confuse the establishment of low interest rates – and therefore the creation of money – with the creation of wealth. Sadly, through history, it has been shown repeatedly that excessive reliance on monetary policy as a means to avoid fundamental economic policy choices leads to high inflation and an actual worsening of an economy’s long-term performance. I hope the U.S. can avoid the temptation to take policy short cuts as we emerge from this recession. We face difficult adjustments that must yet be made. The process will not be free of pain.

The Federal Reserve System over the past nearly two years has more than doubled its balance sheet as it has provided liquidity and monetary stimulus to the U.S. and world economy. In doing so, it has served to staunch the financial and economic panic. But it now must turn to the matter of carefully removing this stimulus at the very time that consumers, businesses and the government will need to fund pent-up demand for goods and services and to meet committed obligations. There is little doubt that such a “coincidence” of needs will place upward pressure on interest rates. Central banks will have little choice but to allow these increases to occur or risk the consequence of higher inflation, perhaps significantly higher. As I said, this process of removing past monetary accommodation will be resisted. However, in contemplating this process and the pain of adjustment, I often emphasize that inflation is the least fair, most regressive and most corrosive tax we can impose on ourselves. It is particularly harsh for low- to moderate-income citizens.

Finally, the markets won't be fooled by artificially low rates for long. Market participants realize that a period of high deficits and accommodative monetary policy are an invitation to increased inflationary pressure. I suspect we are experiencing the first signs of the markets' concerns in the rising rates and increased volatility in longer-term Treasury markets. I suggest strongly that we need to be alert to the markets' message and begin in earnest to bring monetary policy into better balance before inflation forces our hand.

Conclusion

As we emerge from this global financial crisis and recession, the United States must address a series of significant financial and economic imbalances and risks. In dealing with these challenges, the Federal Reserve must stay focused on our mission and make the tough – if

unpopular – decisions that will help guide our economy into better condition. A central bank’s mission remains that of holding the trust of the public by providing a stable currency that retains its purchasing power over time. It is for governments and businesses to allocate resources that address our economic challenges. These are not things that a central bank should address directly. No matter how well-intentioned, to attempt to do so goes beyond its mission and risks delaying and worsening the inevitable adjustment.