

The U.S. Economic Outlook:
The Aftermath of Leverage

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I am pleased to once again be at the Central Exchange to share my outlook for the economy. It doesn't seem possible that it has been a year since I last spoke here and suggested that though the economy was going to slow, there was still the possibility of avoiding a recession. I thought we might avoid the recession if the housing market stabilized and the financial sector avoided further shocks.

The sad truth is that over the past year, the economy has been affected by several shocks – the further decline in housing, the turmoil in financial markets, and a sharp drop in consumer and business confidence. With the benefit of hindsight, we should not be all that surprised by the onset of these shocks. They are a consequence of excessive leverage accumulated over a decade, about which many of us expressed concerns.

The remedy to what we now face will require a rebalancing of domestic savings and investment within the U.S. economy. This rebalancing process and the length and depth of the recession itself will be determined importantly by how quickly financial firms, businesses and the consumer rebuild their diminished wealth and regain their confidence. It will be influenced also by the Federal Reserve's unprecedented actions and funding programs and forthcoming fiscal initiatives.

These are challenging times to say the least, and for the next few minutes, I want to share with you my perspective on them. I will start with some background on what led to this recession and then describe for you my outlook for 2009. I also will provide what information I can on the policy actions being taken to influence this outlook. And let me say at the outset that though I agree we must do all we reasonably can to revive the economy, I caution, based on my years of experience, that in our haste to mitigate this recession's effects, we not attempt shortcuts that put at risk future stability and growth.

The U.S. Economy is in Recession

The U.S. recession, we are told by the NBER, officially began more than a year ago in December 2007. In the third quarter of 2008, real GDP growth was -0.5 percent, and recent data suggests that the economy contracted at a much sharper rate in the fourth quarter.

Labor markets have weakened considerably throughout the year. The unemployment rate has risen from 4.9 percent in January 2008 to 6.7 percent in November, and total employment has fallen by 1.8 million jobs. And, as evidenced by the November employment report and recent layoff announcements, the deterioration in labor markets has intensified.

Worse yet, economic growth has slowed sharply in the rest of the world. Several European countries along with Japan appear to be in recession. As growth in the rest of the world slows, so does demand for U.S. exports, which was the one bright spot in the U.S. economy in 2008.

Finally, as is usually the case with recession, inflation has moderated considerably in recent months. After surging in the earlier half of 2008, the headline price indexes fell sharply in October and November due to the steep fall in energy prices. Core inflation also moderated following weak consumer demand and declining production costs from lower energy and commodity prices. But while inflation is receding for the moment, I must remind you that monetary policy is extremely accommodative, and if it remains so too long, as history suggests it may, inflation pressures could re-emerge as the economy recovers.

Financial Leverage

It seems so clear now, doesn't it, that the key factor underlying the current economic downturn has been the behavior of financial institutions and consumers, who increased their borrowing to unprecedented and ultimately unsustainable levels in the excitement of the "boom" in housing. As the reality of this leverage finally emerged, its effects started to show most notably in August 2007. An asset-pricing crisis eventually widened into a confidence crisis that spread throughout the economy.

Between 2001 and 2007, in an environment of low and then slowly rising interest rates and easy credit availability, financial institutions dramatically increased their packaging and selling of mortgages in response to increased demand for these securitized assets. During this period of rapidly rising real estate prices, these assets were judged to be safe, profitable investments.

In addition, we saw a surge in debt. Financial firms increased the level of domestic financial debt from \$8.5 trillion to \$16 trillion, or by 90 percent. Mortgage debt increased from \$4.9 trillion to \$10.5 trillion, a 114 percent increase. And total public debt outstanding increased from \$3.4 trillion to \$5.2 trillion. The building of assets through the use of debt was the way to easy wealth, so it seemed.

When the rise in real estate prices stalled in late 2006, investors became increasingly concerned about the value of these securitized, leveraged assets. In August 2007, the financial crisis emerged, full force, as short-term lending began to seize up.

The firms most strongly affected by these events were, of course, those that "took advantage" of one of the most aggressive leveraging periods in financial history. The debt-to-capital ratios for the largest 10 bank holding companies in aggregate increased

over the past ten years from about 14 to 1 to over 21 to 1. The debt-to-capital ratios for the investment banks were even higher at over 30 to 1.

The crisis that emerged as the implications of this leverage became more apparent resembled an old-style bank run. As problems developed and confidence waned many of these institutions found themselves without funding. They were unable to sell their securities in the market given the concerns about the value of the underlying assets. These events caused a broad base of participants to pull out of the markets to the point where they no longer function properly.

The resolution of the crisis will occur when the deleveraging process hits bottom and financial institutions are able to resume their role as intermediaries. This I suspect is dependent on at least two factors.

First, a stable market price needs to be established for the currently illiquid assets sitting on the balance sheets of financial institutions. Until these assets can be adequately valued and losses absorbed and future losses stanchied, financial firms are going to have a difficult time raising capital and extending new loans.

Second, this will take time and will not be painless or simple to accomplish. It will require actions by both the monetary and fiscal authorities that are well thought out, well-defined, fully disclosed, and firmly and consistently executed across all financial firms. We have learned from events over this past year that this is no easy task.

Consumer Leverage

A related event having substantial negative repercussions for the U.S. economy is the fallout from the leveraging of U.S. consumers. Between 2001 and 2007, household debt increased from 97 percent of disposable personal income to 133 percent. This massive increase in borrowing was reflected most vividly through the increase of mortgage debt. The mortgage refinancing boom allowed homeowners to extract large quantities of equity from their homes at a time when house prices were appreciating rapidly. The overall result was that consumers spent at a rate roughly equal to their incomes, savings rates plunged to zero and borrowing soared.

Much of this borrowing was funded by foreigners. Between 2001 and 2007, the current account deficit increased by 56 percent as our demand for imports greatly exceeded exports. Foreign holdings of total U.S. Treasury debt increased sharply from 30 percent to 46 percent. Thus, while the United States spent, the rest of the world supported our habit. Now we're in withdrawal, and, yes, it is painful.

In the past two years, household wealth has fallen sharply with declines in house prices and equity values. For example, homeowners' equity share of household real estate has dropped from 55 percent to 45 percent, the lowest value on record. To rebalance and rebuild wealth, consumers are now increasing savings and decreasing spending. As I said, this is a difficult process, and without offsetting adjustments in other sectors of the economy, the effect of this rebalancing is slower growth in real GDP.

The Aftermath of Leverage

In the first half of 2008, the necessary structural adjustment began gradually. Real GDP grew at an annual rate of 1.8 percent while consumption grew at the slower rate of 1.0 percent. Over the last several years export growth was strong and the real net export deficit decreased. For a while at least it seemed we might come through the adjustment relatively well. I certainly thought it was possible.

But, then, mortgage foreclosure problems worsened. In early 2008, Bear Stearns collapsed, followed later by a series of liquidity and solvency crises involving the GSEs, Lehman Brothers, Merrill Lynch and AIG. For investors, there was confusion regarding how each was handled and how future problems might finally be resolved. The TARP was introduced and changed several times as it was being implemented.

These events added to uncertainty across the economy, and the financial turmoil worsened. In September and October, credit conditions tightened further, and businesses' and consumers' confidence seemed to collapse. Indeed, although the early attempts to staunch the recession were well-intentioned, it will be a subject of debate for some time on whether the rush to action might have contributed to the worsening of conditions.

In the meantime, these developments contributed to the sharp decline of 3.8 percent in consumption in the third quarter. And for the first time ever, the level of household debt declined. Based on recent indicators, this decline in consumption continued into the fourth quarter and has served to deepen the recession.

The Outlook

The process of absorbing financial loss, increasing savings and decreasing consumption, the pain of deleveraging, sets the context for the economic outlook. The hard fact is that the sharp deterioration of banking and credit conditions, the deepening slump in consumer and business confidence, and the ongoing housing correction must work its way through the economy. While we must do what we can to mitigate the effects of this deleveraging process, to attempt to avoid its effects entirely is to repeat past mistakes and may sow the seeds for the next crisis.

Accordingly, my outlook calls for the economy to contract further through much of 2009 until later in the year when the effects of policy actions begin to stimulate GDP growth.

Starting with consumption, we will most likely see a contraction at least into the second quarter. Improvements in both consumption and savings will be hampered by declines in disposable incomes as firms continue to cut costs through layoffs, reductions of hours and pay cuts. This will be particularly hard felt by households this month when the seasonal jobs during the holiday shopping season come to an end.

The outlook for business spending is also weak. Conditions in the manufacturing sector have worsened, and with this, the decline in corporate profits makes it unlikely that firms will expand equipment spending until they see a rebound in consumer demand. Spending on structures is expected to contract markedly due to tight credit conditions and waning demand for commercial building space.

Of course, the outlook for residential investment remains weak as well. Housing starts have fallen by 60 percent from peak levels in 2006, and the inventory of existing

single-family homes remains unusually high at an 11.5-month supply. The increase in foreclosure rates in the near term is likely to contribute to additional housing price declines.

Even the one recent source of strength for the economy, net exports, is expected to slow in 2009. After a robust expansion of U.S. exports in the first half of 2008, a rapid appreciation of the dollar combined with weakening world demand likely halted the expansion of exports in the second half of the year. The recent decline in the dollar should reverse this somewhat, but world demand is likely to be weak over the next several quarters.

Government spending at the state and local level is expected to slow as budgets are cut in response to a decline in tax revenues during this downturn. Government spending at the national level will provide a boost to the economy, depending on the size and content of the forthcoming stimulus package.

Putting all of the pieces of the outlook together, the picture for the last quarter of 2008 and at least the first half of this year is grim. The magnitude of the downturn is likely to surpass that of the 1990 and 2001 recessions.

While this immediate outlook is unsettling, over the longer horizon there is reason to expect that we can move through these difficulties and be a stronger economy when we emerge from recession. If we pursue systematic policies with the right balance of monetary and fiscal stimulus, the early signs of economic recovery could show themselves as early as the third quarter of 2009. It would be foolish to attempt to pinpoint the exact spark for the recovery, but there are important factors that should contribute to this result.

First, the recent sharp decline in oil and gasoline prices does increase consumer disposable income by billions of dollars, improve their financial position and serve to restore confidence. Second, while the housing market will continue to struggle, low mortgage rates and some decline in inventory will serve to stabilize home prices and moderate housing's extended drag on the economy. Third, a gradual improvement in financial conditions will increase the supply of credit and encourage demand. And finally, expansive monetary and fiscal policy will stimulate the economy and serve to offset some of those factors pulling it down.

Inflation will remain moderate over 2009 and much of 2010. Lower energy and commodity prices along with moderate improvement in demand for goods and services will keep price pressures temporarily contained. How prices behave beyond the immediate horizon depends most critically on how the Federal Reserve conducts policy and manages its expanding balance sheet in a strengthening economy. This is no doubt the central bank's most difficult longer-run challenge.

Monetary Policy

As I already have suggested, the FOMC has responded to the financial and economic crisis by steadily cutting the federal funds target rate from 5¼ percent in September 2007 to its current range between 0 and ¼ percent.

In addition, to provide continued support for the functioning of financial markets and to stimulate the economy, the Board of Governors, under provisions of the Federal Reserve Act, has authorized the creation of several new liquidity facilities and the FOMC has authorized the purchase of large quantities of additional assets for the Reserve Banks

to hold. The Federal Reserve has stated that with near-term inflation pressures diminished, it is prepared to provide expanded liquidity to the markets as needed. Plans include implementing a loan program to facilitate the extension of credit to consumers and small businesses.

These actions are unprecedented and are a powerful stimulus to the economy for 2009, but they come with their own set of risks. First, they are not designed to fix the problems within the financial industry but to go around the problem. They were taken because the intermediation process is broken, and financial institutions are thought to be in such a state that they are unable to expand their lending sufficiently to drive the economic recovery forward.

As a result, the Federal Reserve is not only providing liquidity to the financial industry, it is also taking on the financial industry's role as intermediary to business firms. This is a dramatic expansion of the central bank's role in the economy. It is reflected most vividly in the combined balance sheet of the 12 Reserve Banks, which has increased from \$900 billion in mostly Treasury securities in the fall of 2007 to \$2.3 trillion in other assets today, and this will increase still further in the months ahead.

The Federal Reserve must now manage its balance sheet in a manner that not only places liquidity into the economy but also in a manner that does not undermine the long-term functioning of markets. It must design an exit strategy that at the appropriate time both removes excess liquidity from the economy and allows it to withdraw as a significant intermediary. Failure to have such a strategy risks undermining an efficient financial market system.

Some of these facilities will automatically dissipate as the market's intermediation process returns to a more normal state. But the Federal Reserve also will have to undertake specific, timely actions if we are to remove the accommodative policy in an effective manner. The importance of doing this correctly cannot be overemphasized. As I have suggested, we have sometimes been slow to remove our accommodative policy, and in doing so, we have invited the next round of inflation, excess and crisis.

Fiscal Policy

Finally, a critical element affecting the recovery in 2009 will be the introduction of additional fiscal stimulus into the economy. To this point, the current administration and Congress have taken actions to recapitalize banks, and the FDIC has greatly expanded its guarantees of bank liabilities. But these actions might be viewed best as holding actions, designed to keep the economy from deteriorating further and faster while other solutions are developed. The incoming administration's stimulus package appears to involve expenditures for both short-term and longer-term projects.

The cost of the proposed actions is expected to exceed \$700 billion and will almost certainly boost the economy in a time of recession. In the longer run, as we know, this too brings risks that cannot be ignored. It will add to our burden of managing a rapidly expanding national debt at the same time that we will be confronted with the looming obligations from rising Social Security, Medicare and defense expenditures. But for the moment, putting our economy back on its feet is the priority, and with the monetary and fiscal actions that are underway, we should see improvement as we enter the second half of 2009.

Concluding Comments

In the end, the greatest challenge that I see for the U.S. economy is not just the recession we are now suffering through but how we choose to address it. There are no shortcuts to stability, no painless methods to adjusting our saving-spending mix and returning to prosperity. We want to successfully get through this difficult deleveraging process, rebuild our national savings and wealth, and we want to do it in a fashion that does not sow the seeds of the next crisis. As we provide needed liquidity to the financial system to contain the crisis, we must be careful to build public confidence by assuring that our actions across financial firms are consistent, open, and understandable to the market and the public. We also must be patient and consider the long run. We must provide for an environment of stable prices and manageable debt levels so necessary for sustainable growth in our national income. If we fail to meet this mandate, we will only repeat the cycle of inflation, excess and crisis.