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The Economic Outlook for 2009 and Community Banks[1]

Good afternoon and thank you for asking me to speak at your assembly. I'm glad to appear before bank directors because—as you know all too well—your industry is at the center of the turbulence now swirling around our economy. I look forward to your insights and questions.

I don't need to tell you that our financial system has, in many important areas, broken down, and this has precipitated a very serious credit crunch. Banks have played a role in the credit crunch by tightening their terms and standards for lending. Tighter credit terms are a natural response by banks to the losses they have suffered and the deterioration in the economic climate. But diminished access to credit for households and businesses is intensifying the economic contraction and, in turn, exacerbating financial distress. These negative dynamics are creating the perception of intense uncertainty about the future, prompting a loss in confidence that has left households and firms extremely wary about spending. In this environment, government policies to restore confidence, create jobs by boosting the demand for goods and services, and improve the functioning of our financial system, represent our main hope of avoiding a very severe economic contraction. Fortunately, many innovative and bold policy steps have already been implemented, or are being considered, by the Federal Reserve and the

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federal government, and this provides me with a measure of optimism that we may avoid the significant downside risks that we face.

Today, I will give you my perspective on financial and economic conditions, and discuss the implications for community banks. As always, my comments represent my own views and not necessarily those of my colleagues in the Federal Reserve System.

Economic conditions

Let me turn to the current economic situation. Unfortunately, there is not much good news to report. Over a year into the recession, the U.S. economy is contracting sharply, and that weakness is evident in every sector.

Let's begin with the largest sector—consumer spending, which represents about 70 percent of gross domestic product. It fell sharply in the third and fourth quarters of last year. As a consequence, retailers experienced a dreadful holiday season and many are now shuttering stores and even declaring bankruptcy. Such retrenchment in consumer spending is understandable, given the truly tough conditions that households face. This morning's dismal employment data show that nonfarm jobs have declined for 13 months in a row. Since peaking in December 2007, some 3.6 million jobs have been lost. The unemployment rate now stands at 7.6 percent, up from just under 5 percent a year ago. With respect to wealth, the combined impact of falling equity and house prices has been staggering. Household wealth has declined by an estimated $10 trillion. Nor can households easily borrow to fund spending—consumer credit is both costlier and harder to get. Not surprisingly, consumer confidence is at a 30-year low. The recent plunge in vehicle sales, in spite of lower gas prices and huge price incentives, reflects this lack of confidence, as well as the difficulty of getting auto loans. These negative factors far outweigh the boost to consumer spending from the sharp decline in energy prices since the middle of last year.

Households are hunkering down. The personal saving rate has jumped from around zero early last year to about 3½ percent recently, as people have tried to rebuild lost wealth and some cushion to weather adversities, including possible job loss. While more personal saving strengthens household balance sheets and makes sense for individual families, in current circumstances it is magnifying the depth of the economic contraction.

The steep decline in residential investment that began three years ago was the leading edge of our current economic and financial problems. Unfortunately, there is no end in sight. Housing starts have plummeted over the past year, falling by nearly one-half. It's hard to see when starts will bottom out, since inventories of unsold new and existing homes remain at high levels relative to sales. Indeed, the possibility of ongoing contraction in this sector is intensified by the economic downturn, the loss in jobs, and the reduced availability of mortgage credit. With the demise of the market for private-label mortgage-backed securities, Fannie Mae and Freddie Mac are now the main sources of funding for conventional conforming mortgages. Virtually the only piece of good news for housing is that interest rates on these mortgages have come down recently in response to a new Federal Reserve program to purchase agency debt and agency-guaranteed mortgage-backed securities. However, the spreads above Treasury rates charged to borrowers seeking nonconforming jumbos have risen sharply, and mortgages are all but unavailable to borrowers with imperfect credit histories or those who can't make large down payments.

Even beyond its negative implications for the pace of home construction, the ongoing decline in house prices is a concern because it poses downside risks to future consumer spending and the health of the financial system. House prices in some of the largest metropolitan areas are down by as much as 35 to 40 percent from their 2006 peak. Unfortunately, futures contracts for house prices suggest that further declines are likely this year and next. The correction in house prices has contributed to delinquencies and foreclosures on subprime and other mortgages. With an estimated 15 to 20 percent of homeowners underwater on their mortgages, it is likely that foreclosures will continue at a rapid pace throughout this year. The associated losses are seriously weakening banks and the financial system more broadly. And, of course, foreclosures are extremely painful for homeowners and create negative spillovers for neighbors and afflicted communities.

Business capital investment is also dropping sharply, as firms face weak demand for their products, a higher cost of capital, restricted credit, and a high level of uncertainty about the future. With regard to credit, many companies, especially those with lower credit ratings, must now pay extraordinarily high rates in the bond market. Bank lines of credit are more difficult to negotiate, trade credit is being restricted, and many firms have become cautious in managing liquidity and in committing to capital spending projects. Some companies are drawing down existing credit lines to have cash on hand in case these lines are capped by their banks. It is not surprising that many of my business contacts report cancelling or delaying capital investment plans and paring back on their workforces in order to avoid being locked into commitments that might prove burdensome.

Nonresidential construction declined modestly at the end of last year but, surprisingly enough, has not yet shown the steep declines that have been expected for some time. However, such declines are almost surely imminent. With business activity slowing and new buildings coming on line, vacancy rates on office, industrial, and retail space are all on the rise. For developers, financing is indeed extremely hard to get. The market for commercial mortgage-backed securities has all but dried up. Banks and other traditional lenders have also become less willing to extend funding. It's no wonder that my contacts are talking about substantial cutbacks on new projects and planned capital improvements on existing buildings. I know that this sector is of special interest to many community banks, and I will have more to say about this later in my presentation.

The budgets of many state and local governments have been thrown into crisis by the financial and economic mess. The downturns in housing, the stock market, and incomes have bitten into tax collections at the same time that financial market turmoil has made it harder to issue bonds. The aggregate budget deficit for the 50 states as a whole is growing. In response, many states are cutting spending. Of course, the Obama administration's plans for fiscal stimulus include a large dose of funding for state and local projects, and this should provide considerable support to this sector.

Unfortunately, the economic downturn is hardly confined to the United States. Economic growth in the rest of the world—including Europe and Japan—has weakened sharply for a number of reasons, including spillovers from the U.S. recession and the financial meltdown that now has spread globally. For these reasons, the world economy appears to have entered recession in late 2008, and it seems likely that this contraction may last for some time, especially in some important industrial countries. Moreover, the dollar has appreciated over the past year, especially against the euro and the British pound, making U.S. exports more expensive. It is apparent that we cannot count on strong foreign demand for our exports to offset weakness in domestic demand. Indeed, real exports fell sharply in the final quarter of last year after years of strong growth.

Now, let me to turn to inflation. Not so long ago soaring commodity prices were pushing inflation to unacceptably high rates. However, things have changed dramatically, as weaker economic activity around the world has reduced the demand for commodities, pushing their prices, and inflationary pressures, down substantially. At the same time, rising unemployment and unused industrial capacity are also putting downward pressure on inflation. Thus, in the final quarter of last year, our main measure of consumer inflation—the personal consumption expenditures price index—fell at a 5½-percent rate; and when excluding food and energy prices, this measure rose at only a ½-percent rate, the slowest pace since early 1961. With slack in labor and product markets likely to build significantly over the next couple of years, it seems likely that inflation will remain, for some time, below levels that are consistent with price stability.

As I have indicated, the economy is in the midst of a downward spiral, and that calls for strong policy responses. Economic weakness and a shortage of credit are inducing increasingly cautious households and businesses to spend less to strengthen their balance sheets and "weather the storm." These spending cuts serve to spread the pain, triggering additional job losses that damage spending and intensifying the distress that weakens the financial system. The case for policy actions—by both the monetary and fiscal authorities—to arrest this cycle and reverse the downward spiral is exceptionally strong. There's no question that the spiral presents extraordinary challenges for policymakers—challenges that, in my view, are the most significant and complex since the Great Depression. However, I am encouraged that bold actions are being taken both here and abroad.

To address the crisis, the Federal Reserve has taken a panoply of strong actions. In particular, the Federal Open Market Committee (FOMC) has cut its federal funds rate target by roughly 5 full percentage points, establishing a target range of 0 to ¼ percent at its December meeting. Although, for all practical purposes, this interest rate cannot be pushed any lower, the Fed also announced after both its December and January meetings that an exceptionally low level of the federal funds rate would likely be warranted for some time due to weak economic conditions. By offering guidance about the likely course of future short-term interest rates, conditional on the Committee's economic forecast, the Committee hopes to influence longer-term interest rates and asset prices, which in turn affect the spending decisions of households and firms.

Beyond interest-rate policy, the Fed is using other tools to improve the functioning of financial markets and to lower longer-term interest rates in support of private spending. A variety of new nonconventional programs rely on the Fed's balance sheet. These programs serve two basic purposes. First, they provide a reliable source of liquidity to financial institutions and markets so that they are more willing to extend credit. Second, these programs directly augment the flow of credit to the private sector.

To fulfill our role in providing liquidity, we have crossed traditional boundaries by extending the maturity of loans, the range of acceptable collateral, and the range of eligible borrowing institutions. As one example, we introduced a new auction system—called the Term Auction Facility (TAF)—to distribute discount window loans more effectively. We also have greatly expanded the size of the auctions and the maturity of the allowable loans to address a persistent shortage of term funding in the money markets. In addition, we established a discount window facility for primary dealers and new facilities to provide liquidity to money market mutual funds and the commercial paper market. We have also supported the provision of dollar liquidity beyond our own shores through a vast expansion of our network of swap lines with foreign central banks. Interest rates in a number of key money markets have come down in recent months, and in my judgment, the suite of facilities that the Fed has created to improve money market conditions is working.

To directly improve the flow of credit to the private sector, the Fed announced several new programs in November. In support of the housing sector, the Fed created a $600 billion program to purchase agency debt and agency-insured mortgage-backed securities. Yields on mortgage-backed securities and 30-year fixed-rate mortgages fell substantially right after the program was announced, and these rates fell again when the first purchases were made in January. The Fed has developed another very promising program jointly with the Treasury to help restore functioning in other impaired financial markets, called the Term Asset-Backed Securities Loan Facility (TALF). It will support the issuance of securities collateralized by auto, student, credit card, and SBA, or Small Business Administration loans—sectors where the issuance of new securities has slowed to a trickle. This approach has the potential to be expanded substantially, with higher lending volumes and additional asset classes, such as commercial mortgage-backed securities.

Now I'd like to say a few words about the role of fiscal policy in the current crisis. Fiscal policy must play two distinct roles. First, it is needed to help restore the financial system to better health. Much has been done already in this arena through the TARP, which has provided capital to the banking system to stabilize it and encourage more lending, as well as funding for the TALF program with the Federal Reserve, and guarantees against losses for several systemically important financial institutions including Citigroup, Bank of America and AIG.

Further actions are still needed, however, to get credit flowing. The Administration is expected to soon propose a comprehensive program to help banks address the bad assets on their balance sheets and assist homeowners in avoiding preventable foreclosures. A lesson from past experience with banking crises around the globe is that the removal of bad assets from bank balance sheets, along with the injection of new capital, is needed to restore health to the banking system. As long as hard-to-value, troubled assets clog their balance sheets, banks find it difficult to attract private capital and to focus on new lending.

The second role for fiscal policy is to provide stimulus to the economy through higher spending and tax cuts. In ordinary circumstances, there are good reasons why monetary, rather than fiscal, policy should be used to stabilize the economy. An important argument against using fiscal policy to fight recessions is that it often takes a long time to implement due to the complexity of executive and legislative decision-making processes and the lags involved in spending the money that Congress appropriates. The result is that fiscal stimulus sometimes kicks in only after the need has passed. However, the current situation is extraordinary, making the case for fiscal action very strong.

Of course, a fiscal stimulus package, involving a combination of tax cuts and spending increases, is a top priority for the new Obama administration and is now moving through Congress. There is—and there should be—vigorous debate about the form it should take and about the likely effectiveness of particular fiscal strategies. However, it is critical that decisions on these matters be made on a timely basis so that the economy's downward spiral is not allowed to deepen.

Policy actions by the Fed and federal government that have already been taken, and that seem to be in train, offer the prospect that we may be able to avoid dire outcomes for the economy. My best guess is that we may see economic activity begin to grow late this year as housing construction stabilizes and the financial sector begins to heal. But substantial downside risks remain.

Banking conditions

You are all well aware that current circumstances create formidable problems for banking organizations. For some time now, institutions have been taking losses on their holdings of residential mortgages and securities, and on their residential construction and development loans. In addition, losses have been incurred because of exposure to other financial institutions and off-balance-sheet vehicles that were damaged by those same housing-related assets. Moreover, as the recession has deepened, we have seen rising credit problems in traditional commercial and consumer loan portfolios. As a result, many banks are taking large provisions for expected losses. Judging from the data so far, it appears likely that the commercial banking industry will incur a significant loss in the fourth quarter, and that the results for 2008 as a whole will be the weakest since at least the banking crisis of the early 1990s.

Traditionally, the crest of bank credit losses has extended for some time beyond the end of recessions. This is not surprising, given that the unemployment rate typically peaks well after business cycle troughs. As a result, and given the outlook for the economy, I would expect to see more deterioration in corporate, commercial real estate, and consumer portfolios over the course of this year and into next year. How well any individual bank fares during this especially difficult credit cycle will depend on the quality of its past and present underwriting; ongoing risk management practices; and the profitability of its core lending, deposit-taking, and fee-generating operations.

Many community banks have significant commercial real estate concentrations, and these loans are a particular concern in the current environment. At present, the performance of such loans has deteriorated only mildly. But, as I suggested earlier, we can't count on that situation to continue, since the downturn in commercial real estate construction is just getting started and is likely to be quite challenging.

One saving grace is that many commercial real estate loans currently do not have the same characteristics that infected the residential real estate boom or the commercial real estate cycles in the early 1980s and 1990s. In recent years, underwriting standards on commercial real estate loans generally have been fairly conservative. By and large, lenders have focused on making loans supported by significant cash flow and have required relatively conservative loan-to-value ratios. The equity cushions on many of these loans, coupled with low interest rates, should give borrowers quite a bit of "breathing room." Still, as commercial real estate loans and related securities are refinanced amid rising vacancies, falling collateral values, and an economic recession, we can expect higher delinquencies, defaults, and losses.

This situation represents an obvious challenge to risk-management practices, putting a premium on active monitoring and stress-testing. These stress tests can provide bank management with advance warnings of the potential effects of higher-than-expected vacancies and falling collateral values on their borrowers' ability to perform and on the bank's potential losses. This analysis in turn can be used to evaluate the full effect of a commercial real estate concentration on the bank's earnings and capital, and lead to better decision-making throughout the cycle.

Large real estate losses could put pressure on capital levels and should therefore prompt banks to review their dividend policies. In this highly volatile period, when future, but currently unidentified, losses are highly likely and capital markets are still not functioning well, capital maintenance is critical.

In addition, banks must be attentive to liquidity. Over the past year, we have seen that large and small banks alike can be extremely vulnerable to losses in confidence, and that past choices in funding a bank's operations may severely constrain efforts to take corrective action. Even multiple sources of liquidity can dry up at the same time, undermining the effectiveness of contingency plans for maintaining access to funding. Many community banks have relied significantly on Federal Home Loan Bank advances and brokered deposits. While these sources of funds can be managed, they do pose risks. For example, the amount of a bank's borrowing capacity can quickly decline when Home Loan Bank collateral margin requirements tighten. Similarly, institutions whose capital ratios fall from the well-capitalized category to the adequately capitalized category may not be permitted to acquire or roll over brokered deposits, resulting in liquidity strains.

As I have indicated, the work of public officials to stabilize the financial system and improve the flow of credit should help banks meet challenges in these tougher economic times. The measures taken by the Fed, Treasury, and the FDIC have buttressed public confidence, provided new sources of liquidity, and helped cushion banks from losses. All of these special measures reflect a recognition that banking organizations play a unique and essential role in the U.S. economy.

It’s also important to acknowledge that banking organizations find themselves under intense scrutiny and are subject to conflicting pressures. At a time of nearly unparalleled challenges for financial institutions, you find yourselves called on simultaneously to preserve capital, avoid excessive risk, and step up your lending. Policymakers are mindful how difficult it can be to balance those mandates. In November, the Fed, the FDIC, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision issued a joint statement to help banks and thrifts navigate these waters. The statement noted that “at this critical time, it is imperative that all banking organizations and their regulators work together to ensure that the needs of creditworthy borrowers are met.” The statement also noted that “prudent bank lending practices” should be carried out “consistent with safety and soundness principles and existing supervisory standards.”

The policy objective has been to equip banking organizations to serve the needs of creditworthy borrowers by augmenting their capital, providing FDIC guarantees of debt, enhanced deposit insurance, and better access to liquidity. In the current circumstances, banks, like households and firms, may be tempted to hunker down. My hope is that, while avoiding imprudent practices that would put your institutions at risk, you will also resist extreme risk aversion, since it would undermine efforts to get the economy going again.

In sum, 2009 is shaping up to be, by many measures, the most challenging economic environment of the postwar period. At the same time though, the vigorous application of monetary and fiscal policy offer the prospect of improvement. I am hopeful that the steps policymakers are taking will stabilize the financial system and provide the broader economy with a foundation for renewed growth.