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The Federal Reserve and the Economic Recovery

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During the financial crisis of 2007–09, the Federal Reserve took extraordinary steps to stem financial panic. Since then, the Fed has also taken extraordinary action to boost economic growth. The Fed continues to do its level best to achieve its congressionally mandated goals of maximum employment and stable prices. The following is adapted from a speech by the president and CEO of the Federal Reserve Bank of San Francisco at The Columbian's Economic Forecast Breakfast January 10, 2012, in Vancouver, Washington.

The subject of my talk is the economy and what the Federal Reserve is doing to encourage economic growth while keeping inflation low. This morning, I'll review the events of recent years, with a special eye on how the boom and bust in housing affected the recession and the economic recovery. I'll talk about the measures the Federal Reserve has taken to combat the financial crisis and to bolster the economy. That leads naturally to the current economic situation and my forecast of where things are going from here. I'll focus on the progress we're making toward the two goals Congress has assigned the Fed: maximum employment and stable prices. I'll conclude with a few words about the current stance of Fed policy.

Looking back at the crisis

The U.S. economy has been growing for the past two-and-a-half years. Nonetheless, we are still suffering from the aftereffects of the worst recession of the post-World War II period. The economic recovery has been notably weak and the unemployment rate is still shockingly high. And, as I will explain in a few minutes, I expect the pace of economic growth to be frustratingly slow and the unemployment rate to remain very high for years to come.

So, why isn't our economy doing better? What's holding us back? To answer these questions, we need to roll back the clock to when our problems started. Let me take you back to the early 2000s. Back then, we were also in the midst of a sluggish recovery—from the recession that followed the dot-com crash. At the time, the housing market was starting to take off. The housing boom provided a welcome boost to the economy. As house prices rose, people felt wealthier and began spending money more freely.

Buyers rushed into the housing market, confident that prices would keep going up and up. Meanwhile, lenders became convinced that home prices would stay on the escalator up, and they thought the risk of a major housing downturn was remote. Mortgages became easier and easier to get, and the terms became more and more generous. Amidst all this, the subprime mortgage market mushroomed. After all, if prices are rising, even a loan to a borrower with less-than-sterling credit looks safe.

Financial engineers sliced and diced all these mortgages into securities that few could understand, and they sold those securities to investors around the world. Lenders threw caution to the wind, knowing

they could sell even the riskiest mortgages to investors hungry for slightly higher interest rates. Even people who lacked the income to make monthly payments could just sign their name and walk away with a mortgage. They didn't even have to make a down payment. Add to that a dash of fraud and a dollop of weak regulation, and you have a recipe for a bubble of historic proportions.

Everything appeared just dandy as long as house prices kept rising. And, indeed, prices were shooting up at double-digit rates every year. Ordinary folks found themselves sitting on tens or even hundreds of thousands of dollars in home equity. It was easy to convert that equity into cash to buy an SUV or a new dining room set. And, despite all the risky lending, home delinquencies were low. As long as home prices rose, everybody was happy. Financial institutions had plenty of capital and made lots of money.

Tragically though, the boom contained the seeds of its own destruction. By one measure, house prices were about 70% overvalued at their peak in 2006. Since then, of course, house prices have plunged—by about 30% nationwide, and even more in places such as Las Vegas, Phoenix, and Florida. As prices tumbled, many borrowers behaved exactly the way you would expect—they stopped making payments. Foreclosures surged, and home sales plummeted. It turned into a free fall of catastrophic dimensions.

Problems first surfaced in subprime mortgages, but they soon spread far beyond. At one point, nearly 10% of all mortgages were in serious trouble or in foreclosure. As foreclosures and delinquencies skyrocketed, lenders and other financial institutions that had placed big bets on the mortgage market posted massive losses. Investors in U.S. mortgages were spread all over the world. No one was sure who was left holding the bag. Financial institutions became afraid to lend money to anybody, including other financial institutions. That choked off the routine flow of funds that financial institutions depend on to finance their day-to-day operations. It culminated in 2008 in an enormous financial panic that destroyed some of the biggest players in the financial industry and came close to bringing down the global financial system.

Think back to the fall of 2008. Fannie Mae and Freddie Mac, institutions central to the American system of home finance, had become insolvent and were taken over by the government. A major investment bank, Lehman Brothers, went bankrupt. WaMu, the nation's largest savings and loan, and an institution you Washingtonians knew well, failed. AIG, the nation's largest insurance company, was on the brink of failure because of bets it had made on the mortgage market. Money market funds, a symbol of safety for tens of millions of Americans, were threatening to impose losses on customers who had thought their investments were rock solid. No one knew how big the problem was or which companies would survive. The result was panic, with everyone trying to take cover from risk at the same time.

This kind of massive financial panic could have ushered in a major depression. Indeed, it was for just this reason that the Federal Reserve System was created nearly 100 years ago. Back in the second half of the 19th and the early 20th centuries, financial panics wiped out banks and other financial institutions, large and small. During those repeated panics, credit, the lifeblood of our economy, became almost entirely unavailable to households and businesses. These episodes were marked by widespread bankruptcy and economic depression.

In late 2008, we were facing just such a panic, teetering on the edge of an abyss. If the panic had been left unchecked, we could well have seen an economic cataclysm as bad as the Great Depression, when 25% of the workforce was out of work.

Fed actions: Dispelling the myths

Why then didn't we fall into that abyss in 2008 and 2009? The answer is that a financial collapse was *not*—I repeat, *not*—left unchecked. The Federal Reserve did what it was supposed to do. The Fed is the nation's government-chartered central bank, charged by law with safeguarding the financial system. Among other things, that means acting as lender of last resort during periods of panic. One of the Fed's jobs is to supply emergency loans to financial institutions when normal funding isn't available. At the same time, the Fed and other federal agencies set up an array of special programs to support vital financial markets. For example, the Fed backstopped the market that corporations use to get short-term funding to finance payrolls, inventories, and the like.

Now there are many myths associated with these emergency programs. I would like to take this opportunity to dispel some of them. First, these programs were not "secret." The fact is that all of these programs were publicly announced and reported on regularly. Indeed, the amounts lent in each program were shown on Fed financial documents made public every week. The only thing that wasn't disclosed at the time was the names of specific borrowers and the amounts lent to them. Second, this lending did not put taxpayer money at significant risk. All of the lending was backed by good collateral and the vast majority of it has been fully repaid. Indeed, these emergency lending programs alone generated an estimated \$20 billion in interest income. That income, like all the net income the Fed generates after its expenses, went to the U.S. Treasury. Third, borrowers did not get below-market interest rates. Many of our programs charged penalty rates so that borrowers would want to go back to the private markets as soon as they opened up again. Fourth, the Fed is audited. Our financial books are subject to a stringent reporting process and regularly reviewed by Congress (see Board of Governors 2011).

The Fed's actions, along with those of the U.S. Treasury and other agencies, succeeded in stemming the global financial panic. I recognize that some of these actions have not been popular, especially at a time when so many people are suffering. But, in the midst of a financial panic, they were essential to stabilizing the financial system and saving the economy.

There's no doubt that these programs helped us avert a depression. But the damage done by a burst housing bubble and a financial crisis was great, and we couldn't escape a very painful recession. The lingering effects of those dramatic events are still with us today in the form of a recovery that's unusually slow and weak. More than 13 million Americans remain out of work. It's astonishing that nearly a third of them have been without a job for a year or more. The level of unemployment is a national calamity that demands our attention.

Causes of the weak recovery

I'd like to turn now to why the recovery has been so weak. The answer is that the bursting of the housing bubble and the resulting financial crisis unleashed at least four powerful forces that have sapped the recovery of its vigor: First, it destroyed household wealth. Second, it left the housing market in a deep depression. Third, it made credit hard to get. And, fourth, it left a legacy of uncertainty that clouds the future. Let's consider those in order.

The collapse of house prices contributed to a decline in the wealth of households of some six-and-a-half trillion—that's trillion with a "T"—dollars. And, with the financial system and economy on the brink, the stock market plummeted. This one-two punch deprived households of both the means and the will to spend. So it's hardly surprising that consumer spending has been subdued.

What about housing? Past recoveries typically got a jump-start from home construction and spending on household goods, such as furniture, appliances, and the like. This time though the housing market is mired in a historical state of depression. We still see millions of homes in foreclosure, and millions more on the verge. With the housing market so distressed, there's little sign that prices are poised to rise. Meanwhile, nearly 30% of all mortgages are currently under water, meaning that borrowers owe more than the homes are worth. No wonder that construction and new home sales are still near the lowest levels recorded since the early 1960s.

Weak consumer spending and depressed housing are closely related to a third powerful force holding back the recovery—tight credit. It's the nature of a financial crisis that the pendulum swings from loose credit, when it's easy to borrow, to tight credit, when loans are hard to get. This time, that swing was breathtaking. In today's mortgage market, customers without excellent credit scores and cash for a hefty down payment find it tough to borrow. Likewise, many small businesses are shut out of the loan market because they may not be able to use residential or commercial real estate as collateral. Anecdotal reports and surveys suggest that credit conditions have been easing. Indeed, corporations that can sell securities in the financial markets have great access to capital. But, for households, the going is still tough. And small businesses find that many of the community banks they relied on are too weak to open the credit spigots.

The final force I want to mention is the depressing effect on spending and investment caused by uncertainty. By almost any measure, uncertainty is high. Businesses are uncertain about the economic environment and the direction of economic policy. Households are uncertain about job prospects and future incomes. Political gridlock in Washington, D.C., and the crisis in Europe add to a sense of foreboding. I repeatedly hear from my business contacts that these uncertainties are prompting them to slow investment and hiring. As one of them put it, uncertainty is causing firms to “step back from the playing field.” Economists at the San Francisco Fed calculate that uncertainty has reduced consumer and business spending so much that it has potentially added a full percentage point to the unemployment rate.

Economic prospects brightening

Yet, even in the face of these obstacles, the economy is growing at a moderate pace. Prospects are that it will continue to do so. This is a testament to the natural resilience of our economic system. As I mentioned, credit conditions are slowly improving. Little by little, households are repairing their finances. Businesses are gradually increasing production and hiring extra hands. The housing market is no longer falling, and home construction eventually will recover to levels consistent with a growing population.

The broadest barometer of economic conditions is gross domestic product, which measures the nation's total output of goods and services. My forecast calls for GDP to rise nearly 2½% this year and about 3% in 2013. That's an improvement from 2011, when I estimate GDP grew about 1¾%. Unfortunately, such moderate growth will not be enough to take a big bite out of unemployment. The unemployment rate is currently 8.5%. I expect it to remain over 8% well into next year and still be around 7% at the end of 2014.

I should mention one risk that would cause the economy to perform much worse. That's the situation in Europe. The governments of several countries that use the euro as their currency have been struggling to

pay their debts. Greece in particular appears unable to meet its obligations. At the same time, countries such as Italy have been forced to pay unsustainably high interest rates. This has raised questions about the health of European financial institutions that invest in government bonds.

European leaders have been working to solve this problem and they may be able to muddle through. But, if they fail, all bets are off. The agreement binding together the countries that use the euro could break up, sending shock waves through financial markets around the world. Under such circumstances, the United States could hardly escape unscathed.

I'd like to say a brief word about inflation. Some observers feared that the Fed's aggressive actions to boost the economy would cause inflation to jump. That simply hasn't happened. The prices of oil and other commodities did jump last year in the face of strong global demand. But commodity prices have retreated notably since then and so has the overall inflation rate. And there's no sign that the public or financial markets expect inflation to rise much. I expect inflation to come in under 1½% this year and next, down from about 2½% in 2011. That would put inflation a bit below the rate of about 2% that most Fed policymakers consider healthiest.

Federal Reserve policies and improving communication

So what does the story I've told mean for Federal Reserve policy? The Fed has taken extraordinary action to boost growth. That effort is ongoing.

The Fed sets policy with an eye on the two goals Congress has assigned it: maximum employment and stable prices. Inflation is likely to fall a bit below what I consider the level most consistent with the stable-prices mandate. And clearly, with unemployment at 8.5%, we are very far from maximum employment. During the recession, Congress and the White House used the federal budget to stimulate the economy by raising spending and trimming taxes. Now, the agenda in Washington, D.C., is to control spending and cut the federal budget deficit. Those are essential goals in the long run. But, in the short run, such government austerity is damping the economy, not boosting it. And it's being reinforced as state and local governments also pare spending. In this situation, it's vital that the Fed use all the tools at its disposal to achieve its mandated employment and price stability goals.

The Fed influences the economy through its ability to affect interest rates. When the economy is overheating, we raise interest rates, which dampens economic activity. When the economy is not performing well, we cut interest rates, which stimulates activity. Our usual tool is the federal funds rate, which is what banks pay to borrow from each other on overnight loans. The federal funds rate serves as a benchmark for other short-term interest rates and it indirectly influences longer-term rates as well. In this way, the Fed has a broad ability to affect the level of interest rates throughout the economy.

We at the Fed have guidelines that allow us to set interest rate targets based on the levels of unemployment, inflation, and other economic indicators. So what do those guidelines tell us now? With inflation under control and unemployment so high, those guidelines tell us something most unusual: the federal funds rate should actually be in negative territory.

Of course, it's not possible for the federal funds rate to go below zero, which is about where we've put it for the past three years. But that doesn't mean that we are out of ammunition. We've created new ways to stimulate the economy. For example, we've purchased over one-and-a-half trillion dollars of longer-term securities issued by the U.S. government and mortgage agencies.

This policy works through the law of supply and demand. When we buy large quantities of securities, we increase demand for those securities. Higher demand equals lower interest rates. As the yields on longer-term Treasury securities come down, other longer-term interest rates also tend to fall. That reduces the cost of borrowing on everything from mortgages to corporate debt. Our securities purchases are an important reason why longer-term interest rates are at or near post-World War II lows.

In addition, we've publicly stated that we expect to keep the federal funds rate exceptionally low through at least mid-2013. That kind of statement can lower interest rates today by letting investors know that rates are likely to stay low for a long time.

My message this morning is that we at the Fed are doing everything we can to move the economy forward. We've pushed short-term interest rates about as far down as they can go. And our unconventional programs have pushed longer-term rates down as well. These are not magic. Lower interest rates alone can't fix all the economy's problems. But they do help. Conditions are far better today than they would be if the Fed hadn't administered such strong medicine. What's also needed are tax and spending policies that work together with Federal Reserve programs to stimulate the economy. For example, I'd like to see federal programs that support the housing market (see Board of Governors 2012). Housing has been at the center of the crisis and is one of the big impediments to recovery.

One thing we are hard at work on now is improving our communication of the Fed's monetary policy strategy and plans. Our moves toward greater openness in recent years have made our policies more effective and helped the public understand the Fed's actions better. Just last month, we decided to start reporting our expectations for the likely future course of short-term interest rates. This should reduce public uncertainty and confusion about our thinking and our plans regarding monetary policy. Another step toward more transparency and accountability could include laying out more explicitly our policy strategy and our longer-run goals.

The policy actions the Fed takes from here on out will depend on how economic conditions develop. I want to assure you that the Fed will do its level best to achieve the goals of maximum employment and stable prices.

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