Board of Governors of the Federal Reserve System

Speech

Chairman Ben S. Bernanke

Remarks on the economic outlook

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As you know, financial markets in the United States and in a number of other industrialized countries have been under considerable strain since late last summer. Financial market conditions have in turn affected economic prospects, most notably by affecting the cost and availability of new credit.

Much discussion of the turmoil has focused on problems that have arisen with respect to specific financial markets and financial instruments. Understanding these institutional details is, of course, essential to the task of restoring more normal functioning to the financial system. Stepping back, however, one can see--at least in retrospect--that the turmoil has been some time in the making and reflects the combined influence of several powerful, longer-term developments.

Today, I will briefly discuss some longer-term factors that underlie recent developments; trace how these factors, individually and in combination, have affected both the financial markets and the economy; and describe how the Federal Reserve has responded to the challenges we face.

The Sources of the Financial Turmoil: A Longer-Term Perspective
Although the severity of the financial stresses became apparent only in August, several longer-term developments served as prologue for the recent turmoil and helped bring us to the current situation.

The first of these was the U.S. housing boom, which began in the mid-1990s and picked up steam around 2000. Between 1996 and 2005, house prices nationwide increased about 90 percent. During the years from 2000 to 2005 alone, house prices increased by roughly 60 percent--far outstripping the increases in incomes and general prices--and single-family home construction increased by about 40 percent. But, as you know, starting in 2006, the boom turned to bust. Over the past two years, building activity has fallen by more than half and now is well below where it was in 2000. House prices have shown significant declines in many areas of the country.

A second critical development was an even broader credit boom, in which lenders and investors aggressively sought out new opportunities to take credit risk even as market risk premiums contracted. Aspects of the credit boom included rapid growth in the volumes of private equity deals and leveraged lending and the increased use of complex and often opaque investment vehicles, including structured credit products. The explosive growth of subprime mortgage lending in recent years was yet another facet of the broader credit boom. Expanding access to homeownership is an important social goal, and responsible subprime lending is beneficial for both borrowers and lenders. But, clearly, much of the subprime lending that took place during the latter stages of the credit boom in 2005 and 2006 was done very poorly.

A third longer-term factor contributing to recent financial and economic developments is the unprecedented growth in developing and emerging market economies. From the U.S. perspective, this growth has been a double-edged sword. On the one hand, low-cost imports from emerging markets for many years increased U.S. living standards and made the Fed's job of managing inflation easier. Moreover, currently, the demand for U.S. exports arising from strong global growth has been an important offset to the factors restraining domestic demand, including housing and tight credit. On the other hand, the rapid growth in the emerging markets and the associated sharp rise in their

demand for raw materials have been--together with a variety of constraints on supply--a major cause of the escalation in the relative prices of oil and other commodities, which has placed intense economic pressure on many U.S. households and businesses.

In the financial sphere, the three longer-term developments I have identified are linked by the fact that a substantial increase in the net supply of saving in emerging market economies contributed to both the U.S. housing boom and the broader credit boom.[1] The sources of this increase in net saving included rapid growth in high-saving East Asian countries and, outside of China, reduced investment rates in that region; large buildups in foreign exchange reserves in a number of emerging markets; and the enormous increases in the revenues received by exporters of oil and other commodities. The pressure of these net savings flows led to lower long-term real interest rates around the world, stimulated asset prices (including house prices), and pushed current accounts toward deficit in the industrial countries--notably the United States--that received these flows.

To be sure, the large inflows of savings and low global interest rates presented a valuable opportunity to the recipient countries, provided they invested the inflows wisely. Unfortunately, this did not always occur, as an increased appetite for risk-taking--a "reaching for yield"--stimulated some financial innovations and lending practices that proved imprudent or otherwise questionable. Regulators identified some of these issues in real time; for example, federal banking regulators issued new guidance on nontraditional mortgage lending and on commercial real estate lending. The Federal Reserve, in cooperation with the other supervisors, encouraged improvements in market infrastructure and conducted a series of targeted reviews designed to improve risk-management practice with respect to derivatives, exposures to hedge funds, leveraged lending, and other areas. And, in preparation for the new Basel II capital regulations, supervisors required more-demanding standards for the measurement and management of risk. Despite these efforts, however, the risk-management systems of many financial institutions proved inadequate in the face of a major housing downturn and substantial disruptions in market liquidity.

The current economic and financial situation reflects, in significant part, the unwinding of two of these longer-term developments--the housing boom and the credit boom--and the continuation of the pressure of global demand on commodity prices.

The housing boom came to an end because rising prices made housing increasingly unaffordable. The end of rapid house price increases in turn undermined a basic premise of many adjustable-rate subprime loans--that home price appreciation alone would always generate enough equity to permit the borrower to refinance and thereby avoid ever having to pay the fully-indexed interest rate. When that premise was shown to be false and defaults on subprime mortgages rose sharply, investors quickly backpedaled from mortgage-related securities. The reduced availability of mortgage credit caused housing to weaken further.

The losses from subprime mortgages have been significant in themselves, but their greater impact was to trigger the end of the broader credit boom. Notably, as subprime losses forced the credit rating agencies to downgrade what had been highly rated mortgage-backed securities, investors also came to doubt the reliability of ratings that had been awarded to other highly complex securities. As a result, investors became much more cautious and reversed their aggressive risk-taking of the credit boom period. The resulting pullback affected a much broader range of securities, including leveraged and syndicated loans, asset-backed commercial paper, commercial mortgage-backed securities, and a variety of structured credit products. Large financial institutions, especially in the United States and Europe, were particularly affected by these events, having reported a total of roughly $300 billion in writedowns and credit losses. These institutions have also been forced to bring onto their balance sheets the assets of sponsored investment vehicles that can no longer be financed on a standalone basis. Fortunately, most financial institutions entered this episode with strong capital positions, and many have raised substantial amounts of new capital. Still, balance sheet pressures and the relatively high cost of new bank capital have reduced the willingness and ability of these institutions to make markets and extend new credit. Prospectively, financial conditions seem likely to be closely tied to both domestic and global economic developments, including the course of the prices of oil and other commodities.

This brief overview makes clear that both global and domestic factors have played important roles in recent developments in the United States. The housing and credit booms were driven to some extent by global savings flows, but they also reflected domestic factors, such as weaknesses in risk measurement and management and lax standards in subprime lending. Higher commodity prices are for the most part a global phenomenon, but U.S. dependence on oil imports makes this country quite vulnerable on that score.

The Outlook

With this broader perspective as background, I turn now to a brief discussion of the current situation and outlook. Broadly speaking, the functioning of financial markets has improved of late, but conditions remain strained and some key funding and securitization markets have shown only tentative signs of recovery. Some borrowers, such as highly-rated corporations, retain good access to credit, but credit conditions generally remain restrictive in areas related to residential or commercial real estate.

Residential construction continues to contract, and the overhang of unsold new homes remains large, although it has declined some in absolute terms. Consumer spending has thus far held up a bit better than expected, but households continue to face significant headwinds, including falling house prices, a softer job market, tighter credit, and higher energy prices, and consumer sentiment has declined sharply since the fall. Businesses are also facing challenges, including rapidly escalating costs of raw materials and weaker domestic demand. However, the strength of foreign demand for U.S. goods and services has offset, to some extent, the slowing of domestic sales.

Overall economic growth was quite slow but apparently positive in both the fourth quarter of 2007 and the first quarter of this year. Activity during the current quarter is also likely to be relatively weak. We may see somewhat better economic conditions during the second half of 2008, reflecting the effects of monetary and fiscal stimulus, reduced drag from residential construction, further progress in the repair of financial and credit markets, and still solid demand from abroad. This baseline forecast is consistent with our recently released projections, which also see growth picking up further in 2009. However, until the housing market, and particularly house prices, shows clearer signs of stabilization, growth risks will remain to the downside. Recent increases in oil prices pose additional downside risks to growth.

Inflation has remained high, largely reflecting continued sharp increases in the prices of globally traded commodities. Thus far, the pass-through of high raw materials costs to domestic labor costs and the prices of most other products has been limited, in part because of softening domestic demand. However, the continuation of this pattern is not guaranteed and will bear close attention. Futures markets continue to predict--albeit with a great range of uncertainty--that commodity prices will level out, a forecast consistent with our expectation of some overall slowing in the global economy and thus in the demand for raw materials. A rough stabilization of commodity prices, even at high levels, would result in a relatively rapid moderation of inflation, consistent with the projections of Federal Reserve governors and Reserve Bank presidents for 2009 and 2010. Unfortunately, the prices of a number of commodities, most notably oil, have continued upward recently, even as expectations of future policy rates and the foreign exchange value of the dollar have remained generally stable in the past few months. The possibility that commodity prices will continue to rise is an important risk to the inflation forecast. Another significant upside risk to inflation is that high headline inflation, if sustained, might lead the public to expect higher long-term inflation rates, an expectation that could ultimately become self-confirming.

The Federal Reserve's Policy Response

The Federal Reserve's mandate is to foster maximum sustainable employment and price stability. To achieve these goals, we must also support the return of financial markets to more normal functioning.

The Federal Reserve is pursuing its objectives through several means. First, we have eased monetary policy substantially and proactively to address the sharp deterioration in financial conditions and to forestall some of the potential adverse effects on the broader economy. Our decisive policy actions were premised on the view that a more gradual reduction in short-term rates could well have failed to

contain the financial and economic problems confronting us. For now, policy seems well positioned to promote moderate growth and price stability over time. We will, of course, be watching the evolving situation closely and are prepared to act as needed to meet our dual mandate.

In collaboration with our colleagues at the Treasury, we continue to carefully monitor developments in foreign exchange markets. The challenges that our economy has faced over the past year or so have generated some downward pressures on the foreign exchange value of the dollar, which have contributed to the unwelcome rise in import prices and consumer price inflation. We are attentive to the implications of changes in the value of the dollar for inflation and inflation expectations and will continue to formulate policy to guard against risks to both parts of our dual mandate, including the risk of an erosion in longer-term inflation expectations. Over time, the Federal Reserve's commitment to both price stability and maximum sustainable employment and the underlying strengths of the U.S. economy--including flexible markets and robust innovation and productivity--will be key factors ensuring that the dollar remains a strong and stable currency.

Second, to improve market liquidity and functioning, we have taken a range of measures to ensure that financial institutions have adequate access to central bank liquidity.[2] The resulting reductions in funding pressures, together with the increased confidence created by the assurance that backstop liquidity is available to eligible institutions, should help to promote an orderly resolution of current market dislocations. In recognition of the global nature of financial markets, we have also cooperated with other major central banks to ensure that central bank liquidity is deployed where needed.

Finally, we are taking action in our role as regulators. We have worked with lenders and servicers to encourage appropriate modifications of distressed mortgage loans, and we have proposed new rules to improve disclosure and to ban unfair or deceptive acts and practices in mortgage lending. We are also collaborating with other regulators, both domestically and abroad, to put in place changes that will help make the financial system less vulnerable in the future. Among the changes we expect to see are strengthening of capital and liquidity rules, greater disclosure requirements, an increased emphasis on the measurement and management of firmwide risks, and further steps to increase the transparency and resilience of the financial infrastructure. Our goal is to emerge from this difficult period with a financial system that will be more stable without being less innovative, with a more effective balance between market discipline and regulation.

References

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Footnotes

1. Bernanke (2005). Return to text

2. Bernanke (2008). Return to text

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