Ben S Bernanke: Stabilizing the financial markets and the economy

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Economic Club of New York, New York, 15 October 2008.

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Good afternoon. I am pleased once again to share a meal and some thoughts with the Economic Club of New York. I will focus today on the economic and financial challenges we face and why I believe we are well positioned to move forward. The problems now evident in the markets and in the economy are large and complex, but, in my judgment, our government now has the tools it needs to confront and solve them. Our strategy will continue to evolve and be refined as we adapt to new developments and the inevitable setbacks. But we will not stand down until we have achieved our goals of repairing and reforming our financial system and restoring prosperity.

The crisis we face in the financial markets has many novel aspects, largely arising from the complexity and sophistication of today's financial institutions and instruments and the remarkable degree of global financial integration that allows financial shocks to be transmitted around the world at the speed of light. However, as a long-time student of banking and financial crises, I can attest that the current situation also has much in common with past experiences. As in all past crises, at the root of the problem is a loss of confidence by investors and the public in the strength of key financial institutions and markets. The crisis will end when comprehensive responses by political and financial leaders restore that trust, bringing investors back into the market and allowing the normal business of extending credit to households and firms to resume. In that regard, we are, in one respect at least, better off than those who dealt with earlier financial crises: Generally, during past crises, broad-based government engagement came late, usually at a point at which most financial institutions were insolvent or nearly so. Waiting too long to respond has usually led to much greater direct costs of the intervention itself and, more importantly, magnified the painful effects of financial turmoil on households and businesses. That is not the situation we face today. Fortunately, the Congress and the Administration have acted at a time when the great majority of financial institutions, though stressed by highly volatile and difficult market conditions, remain strong and capable of fulfilling their critical function of providing new credit for our economy. This prompt and decisive action by our political leaders will allow us to restore more normal market functioning much more quickly and at lower ultimate cost than would otherwise have been the case. Moreover, we are seeing not just a national response but a global response to the crisis, commensurate with its global nature.

This financial crisis has been with us for more than a year. It was sparked by the end of the U.S. housing boom, which revealed the weaknesses and excesses that had occurred in subprime mortgage lending. However, as subsequent events have demonstrated, the problem was much broader than subprime lending. Large inflows of capital into the United States and other countries stimulated a reaching for yield, an underpricing of risk, excessive leverage, and the development of complex and opaque financial instruments that seemed to work well during the credit boom but have been shown to be fragile under stress. The unwinding of these developments, including a sharp deleveraging and a headlong retreat from credit risk, led to highly strained conditions in financial markets and a tightening of credit that has hamstrung economic growth.

The Federal Reserve responded to these developments in two broad ways. First, following classic tenets of central banking, the Fed has provided large amounts of liquidity to the financial system to cushion the effects of tight conditions in short-term funding markets. Second, to reduce the downside risks to growth emanating from the tightening of credit, the Fed, in a series of moves that began last September, has significantly lowered its target for the federal funds rate. Indeed, last week, in an unprecedented joint action with five other major central banks and in response to the adverse implications of the deepening crisis for the economic outlook, the Federal Reserve again eased the stance of monetary policy. We will continue to use all the tools at our disposal to improve market functioning and liquidity, to reduce pressures in key credit and funding markets, and to complement the steps the Treasury and foreign governments will be taking to strengthen the financial system.

Notwithstanding our efforts and those of other policymakers, the financial crisis intensified over the summer as mortgage-related assets deteriorated further, economic growth slowed, and uncertainty about the financial and economic outlook increased. As investors and creditors lost confidence in the ability of certain firms to meet their obligations, their access to capital markets as well as to short-term funding markets became increasingly impaired, and their stock prices fell sharply. Prominent companies that experienced this dynamic most acutely included the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, the investment bank Lehman Brothers, and the insurance company American International Group (AIG).

The Federal Reserve believes that, whenever possible, the difficulties experienced by firms in financial distress should be addressed through private-sector arrangements – for example, by raising new equity capital, as many firms have done; by negotiations leading to a merger or acquisition; or by an orderly wind-down. Government assistance should be provided with the greatest reluctance and only when the stability of the financial system, and thus the health of the broader economy, is at risk. In those cases when financial stability is broadly threatened, however, intervention to protect the public interest is not only justified but must be undertaken forcefully and without hesitation.

Fannie Mae and Freddie Mac present cases in point. To avoid unacceptably large dislocations in the mortgage markets, the financial sector, and the economy as a whole, the Federal Housing Finance Agency put Fannie and Freddie into conservatorship, and the Treasury, drawing on authorities recently granted by the Congress, made financial support available. The government's actions appear to have stabilized the GSEs, although, like virtually all other firms, they are experiencing effects of the current crisis. We have already seen benefits of their stabilization in the form of lower mortgage rates, which will help the housing market.

The difficulties at Lehman and AIG raised different issues. Like the GSEs, both companies were large, complex, and deeply embedded in our financial system. In both cases, the Treasury and the Federal Reserve sought private-sector solutions, but none was forthcoming. A public-sector solution for Lehman proved infeasible, as the firm could not post sufficient collateral to provide reasonable assurance that a loan from the Federal Reserve would be repaid, and the Treasury did not have the authority to absorb billions of dollars of expected losses to facilitate Lehman's acquisition by another firm. Consequently, little could be done except to attempt to ameliorate the effects of Lehman's failure on the financial system. Importantly, the financial rescue legislation, which I will discuss later, will give us better choices. In the future, the Treasury will have greater resources available to prevent the failure of a financial institution when such a failure would pose unacceptable risks to the financial system as a whole. The Federal Reserve will work closely and actively with the Treasury and other authorities to minimize systemic risk.

In the case of AIG, the Federal Reserve and the Treasury judged that a disorderly failure would have severely threatened global financial stability and the performance of the U.S. economy. We also judged that emergency Federal Reserve credit to AIG would be adequately secured by AIG's assets. To protect U.S. taxpayers and to mitigate the possibility that lending to AIG would encourage inappropriate risk-taking by financial firms in the future, the Federal Reserve ensured that the terms of the credit extended to AIG imposed significant costs and constraints on the firm's owners, managers, and creditors.

AIG's difficulties and Lehman's failure, along with growing concerns about the U.S. economy and other economies, contributed to extraordinarily turbulent conditions in global financial markets in recent weeks. Equity prices fell sharply. Withdrawals from prime money market mutual funds led them to reduce their holdings of commercial paper – an important source of financing for the nation's nonfinancial businesses as well as for many financial firms. The cost of short-term credit, where such credit has been available, jumped for virtually all firms, and liquidity dried up in many markets. By restricting flows of credit to households, businesses, and state and local governments, the turmoil in financial markets and the funding pressures on financial firms pose a significant threat to economic growth.

The Treasury and the Fed have taken a range of actions to address financial problems. To address illiquidity and impaired functioning in commercial paper markets, the Treasury implemented a temporary guarantee program for balances held in money market mutual funds to help stem the outflows from these funds. The Federal Reserve put in place a temporary lending facility that provides financing for banks to purchase high-quality asset-backed commercial paper from money market funds, thus reducing their need to sell the commercial paper into already distressed markets. Moreover, we soon will implement a new, temporary Commercial Paper Funding Facility that will provide a backstop to commercial paper markets by purchasing highly rated commercial paper directly from issuers at a term of three months when those markets are illiquid.

To address ongoing problems in interbank funding markets, the Federal Reserve has significantly increased the quantity of term funds it auctions to banks and accommodated heightened demands for temporary funding from banks and primary dealers. Also, to try to mitigate dollar funding pressures worldwide, we have greatly expanded reciprocal currency arrangements (so-called swap agreements) with other central banks. Indeed, this week we agreed to extend unlimited dollar funding to the European Central Bank, the Bank of England, the Bank of Japan, and the Swiss National Bank. These agreements enable foreign central banks to provide dollars to financial institutions in their jurisdictions, which helps improve the functioning of dollar funding markets globally and relieve pressures on U.S. funding markets. It bears noting that these arrangements carry no risk to the U.S. taxpayer, as our loans are to the foreign central banks themselves, who take responsibility for the extension of dollar credit within their jurisdictions.

The expansion of Federal Reserve lending is helping financial firms cope with reduced access to their usual sources of funding and thus is supporting their lending to nonfinancial firms and households. Nonetheless, the intensification of the financial crisis over the past month or so made clear that a more powerful, comprehensive approach involving the fiscal authorities was needed to address these problems more effectively. On that basis, the Administration, with the support of the Federal Reserve, asked the Congress for a new program aimed at stabilizing our financial markets. The resulting legislation, the Emergency Economic Stabilization Act, provides important new tools for addressing the distress in financial markets and thus mitigating the risks to the economy. The act allows Treasury to buy troubled assets, to provide guarantees, and to inject capital to strengthen the balance sheets of financial institutions. The act also raises the limit on deposit insurance from $100,000 to $250,000 per account, effectively immediately.

The Troubled Asset Relief Program (TARP) authorized by the legislation will allow the Treasury, under the supervision of an oversight board that I will head, to undertake two highly complementary activities. First, the Treasury will use the TARP funds to help recapitalize our banking system by purchasing non-voting equity in financial institutions. Details of this program were announced yesterday. Initially, the Treasury will dedicate $250 billion toward purchases of preferred shares in banks and thrifts of all sizes. The program is voluntary and designed both to encourage participation by healthy institutions and to make it attractive for private capital to come in along with public capital. We look to strong institutions to participate in this capital program, because today even strong institutions are reluctant to expand their balance sheets to extend credit; with fresh capital, that constraint will be eased. The terms offered under the TARP include the acquisition by the Treasury of warrants to ensure that taxpayers receive a share of the upside as the financial system recovers.

Moreover, as required by the legislation, institutions that receive capital will have to meet certain standards regarding executive compensation practices.

Second, the Treasury will use some of the resources provided under the bill to purchase troubled assets from banks and other financial institutions, in most cases using market-based mechanisms. Mortgage-related assets, including mortgage-backed securities and whole loans, will be the focus of the program, although the law permits flexibility in the types of assets purchased as needed to promote financial stability. Removing these assets from private balance sheets should increase liquidity and promote price discovery in the markets for these assets, thereby reducing investor uncertainty about the current value and prospects of financial institutions. Unclogging the markets for mortgage-related assets should put banks and other institutions in a better position to raise capital from the private sector and increase the willingness of counterparties to engage. With time, the provision of equity capital to the banking system and the purchase of troubled assets will help credit flow more freely, thus supporting economic growth.

These measures will lead to a much stronger financial system over time, but steps are also necessary to address the immediate problem of lack of trust and confidence. Accordingly, also announced yesterday was a plan by the Federal Deposit Insurance Corporation (FDIC) to provide a broad range of guarantees of the liabilities of FDIC-insured depository institutions, including their associated holding companies. The guarantee covers all newly issued senior unsecured debt, including commercial paper and interbank funding, and it will also cover all funds held in non-interest-bearing transactions accounts, such as payroll accounts. This broad guarantee will be effectively immediately, and fees for coverage will be waived for 30 days. After the 30-day grace period, banks may continue to participate in the guarantee program by paying reasonable fees.

I would like to stress once again that the taxpayers' interests were very much in our minds and those of the Congress when these programs were designed. The costs of the FDIC guarantee are expected to be covered by fees and assessments on the banking system, not by the taxpayer. In the case of the TARP program, the funds allocated are not simple expenditures, but rather acquisitions of assets or equity positions, which the Treasury will be able to sell or redeem down the road. Indeed, it is possible that taxpayers could turn a profit from the program, although, given the great uncertainties, no assurances can be provided. Moreover, the program is subject to extensive controls and to oversight by several bodies. The larger point, though, is that the economic benefit of these programs to taxpayers will not be determined primarily by the financial return to TARP funds, but rather by the impact of the program on the financial markets and the economy. If the TARP, together with the other measures that have been taken, is successful in promoting financial stability and, consequently, in supporting stronger economic growth and job creation, it will have proved itself a very good investment indeed, to everyone's benefit.

Stabilization of the financial markets is a critical first step, but even if they stabilize as we hope they will, broader economic recovery will not happen right away. Economic activity had been decelerating even before the recent intensification of the crisis. The housing market continues to be a primary source of weakness in the real economy as well as in the financial markets, and we have seen marked slowdowns in consumer spending, business investment, and the labor market. Credit markets will take some time to unfreeze. And with the economies of our trading partners slowing, our export sales, which have been a source of strength, very probably will slow as well. These restraining influences on economic activity, however, will be offset somewhat by the favorable effects of lower prices for oil and other commodities on household purchasing power. Ultimately, the trajectory of economic activity beyond the next few quarters will depend greatly on the extent to which financial and credit markets return to more normal functioning.

Inflation has been elevated recently, reflecting the steep increases in the prices of oil, other commodities, and imports that occurred earlier this year, as well as some pass-through by firms of their higher costs of production. However, expected inflation, as measured by consumer surveys and inflation-indexed Treasury securities, has held steady or eased, and prices of imports now appear to be decelerating. These developments, together with the recent declines in prices of oil and other commodities as well as the likelihood that economic activity will fall short of potential for a time, should lead to rates of inflation more consistent with price stability.

This past weekend, the finance ministers and central bank governors of the Group of Seven industrialized countries met in Washington. We committed to work together to stabilize financial markets and restore the flow of credit to support global economic growth. We agreed to use all available tools to prevent failures that pose systemic risk. We affirmed we will ensure our deposit insurance programs instill confidence in the safety of savings. We agreed to ensure that our banks and other major financial intermediaries, as needed, can raise capital from public as well as private sources. We further agreed that we would take all necessary steps to unfreeze interbank and money markets, and that we will act to restart the secondary markets for mortgages and other securitized assets. Finally, we recognized that we should take these actions in ways that protect taxpayers and avoid potentially damaging effects on other countries. I believe that these are the right principles for action, and I see the steps announced by our government yesterday as fully consistent with them.

I have laid out for you today an extraordinary series of actions taken by policymakers throughout our government and around the globe. Americans can be confident that every resource is being brought to bear to address the current crisis: historical understanding, technical expertise, economic analysis, financial insight, and political leadership. I am not suggesting the way forward will be easy, but I strongly believe that we now have the tools we need to respond with the necessary force to these challenges. Although much work remains and more difficulties surely lie ahead, I remain confident that the American economy, with its great intrinsic vitality and aided by the measures now available, will emerge from this period with renewed vigor.