

Ben S Bernanke: Current economic and financial conditions

Speech by Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the National Association for Business Economics 50th Annual Meeting, Washington DC, 7 October 2008.

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Good afternoon. I am pleased to have once again the opportunity to address the National Association for Business Economics. My remarks today will focus on recent developments in the financial sector and the economy and on the challenges we face.

As you know, financial systems in the United States and in much of the rest of the world are under extraordinary stress, particularly the credit and money markets. The losses suffered by many banks and nonbank financial firms have both constrained their ability to lend and reduced the willingness of other market participants to deal with them. Great uncertainty about the values of financial assets, particularly more complex and opaque assets, has made investors extremely reluctant to bear credit risk, resulting in further declines in asset prices and a drying up of liquidity in a number of funding markets. Even secured funding has become expensive and difficult to obtain, as lenders worry about their ability to sell collateral in illiquid markets in the event of default. In addition, many securitization markets, such as the secondary market for private-label mortgage-backed securities, remain closed or impaired.

Considerable experience in both industrialized and emerging economies has shown that severe financial instability, together with the associated declines in asset prices and disruptions in credit markets, can take a heavy toll on the broader economy if left unchecked. For this reason, the Federal Reserve, the Treasury, and other agencies are committed to restoring market stability and are working assiduously to ensure that the financial system is able to perform its critical economic functions. Recent actions by the Congress have given the Treasury new tools and resources to address the stressed conditions of our financial markets and institutions. The Federal Reserve has also been granted a new authority, the ability to pay interest on bank reserves, which will allow us to expand our lending as needed to support the system while better managing the federal funds rate. These tools will provide important additional support for the government's efforts to strengthen financial markets and the economy.

Let me briefly review recent financial developments. On the heels of nearly a year of stress in credit markets, investors' and creditors' concerns about funding and credit risks at financial firms intensified over the summer as mortgage-related assets deteriorated further, economic growth slowed, and uncertainty about the 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. Among the companies that experienced this dynamic most forcefully were 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, such difficulties 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 threatened, however, intervention to protect the public interest may well be justified.

Fannie Mae and Freddie Mac present cases in point. The Federal Reserve had long warned about the systemic risks posed by these companies' large portfolios of mortgages and mortgage-backed securities, as well as the problems arising from the conflict between shareholders' objectives and the government's goals for the two firms. Given the scale of losses in their portfolios, raising enough new capital from private investors was infeasible. The firms' size and their government-sponsored status precluded a merger with, or acquisition by, another company. To avoid unacceptably large dislocations in the mortgage markets, the financial sector, and the economy as a whole, the Federal Housing Finance Agency (FHFA) put Fannie and Freddie into conservatorship and the Treasury, drawing on authorities recently granted by the Congress, made financial support available. The Federal Reserve, acting in a consultative role, worked closely with FHFA in evaluating the GSE portfolios and capital positions. Based on the joint findings of the agencies, we supported FHFA's decision to place the companies into conservatorship as necessary and appropriate, given their conditions and systemic importance. The government's actions appear to have stabilized the GSEs, although like virtually all other firms they are experiencing effects of the current crisis. Nonetheless, we already have seen benefits of their stabilization in the form of lower mortgage rates, which should help the housing market.

The difficulties at Lehman and AIG raised somewhat different issues. Like the GSEs, both companies were large and complex and deeply embedded in our financial system. In both cases, as the firms approached default, the Treasury and the Federal Reserve sought private-sector solutions, but none was forthcoming. Attempts to organize a consortium of private firms to purchase or recapitalize Lehman were unsuccessful. With respect to public-sector solutions, we determined that either facilitating a sale of Lehman or maintaining the company as a free-standing entity would have required a very sizable injection of public funds – much larger than in the case of Bear Stearns – and would have involved the assumption by taxpayers of billions of dollars of expected losses. Even if assuming these costs could be justified on public policy grounds, neither the Treasury nor the Federal Reserve had the authority to commit public money in that way; in particular, the Federal Reserve's loans must be sufficiently secured to provide reasonable assurance that the loan will be fully repaid. Such collateral was not available in this case. Recognizing that Lehman's potential failure posed risks to market functioning, the Federal Reserve sought to cushion the effects by implementing a number of measures, including substantially broadening the collateral accepted by the Fed's Primary Dealer Credit Facility (PDCF) and Term Securities Lending Facility (TSLF) to ensure that the remaining primary dealers would have uninterrupted access to funding.

In the case of AIG, the Federal Reserve and the Treasury judged that a disorderly failure of AIG would have severely threatened global financial stability and the performance of the U.S. economy. That judgment reflected our assessment of prevailing market conditions, AIG's central role in a number of markets other firms use to manage risks, and the size and composition of AIG's balance sheet. To avoid the default of AIG, the Federal Reserve was able to provide emergency credit that was judged to be adequately secured by the assets of the company. 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 further 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. housing sector and economy, contributed to extraordinarily turbulent conditions in global financial markets in recent weeks. Equity prices have fallen sharply, the cost of short-term credit, where such credit has been available, has spiked, and liquidity has dried up in many markets. One money market fund's losses forced it to "break the buck" – that is, the value of its assets fell below par – an event that triggered extensive withdrawals from a number of money market funds. Those funds responded to the surge in redemptions by attempting to reduce their holdings of commercial paper and large certificates of deposit issued by banks.

Some firms that could not roll over maturing commercial paper drew on back-up lines of credit with banks just as the banks were finding it even more difficult to raise cash in the money markets. At the same time, a marked increase in the demand for safe assets – a flight to quality and liquidity – resulted in a further drop in the value of mortgage-related assets and sent the yield on Treasury bills down to a few hundredths of a percent.

Developments during the summer pressured not only nonbank financial firms, but also a number of depository institutions, including Washington Mutual (WaMu) and Wachovia. In recent weeks, these two institutions suffered deposit outflows and reduced access to wholesale funding. The Office of Thrift Supervision, WaMu's regulator, closed that company and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver; the FDIC immediately sold the institution to JPMorgan Chase. In the case of Wachovia, to avoid serious adverse effects on economic conditions and financial stability, the Secretary of the Treasury, in consultation with the President and on the recommendation of the Federal Reserve and FDIC, authorized the FDIC to use its funds to facilitate the sale of that company's banking operations without loss to creditors. Both Citicorp and Wells Fargo have offered to buy the company and negotiations are continuing. Most importantly, however, in either case all depositors and creditors of Wachovia are fully protected, and depositors and other customers will experience no interruption in banking services.

By potentially restricting future flows of credit to households and businesses, the developments in financial markets pose a significant threat to economic growth. The Treasury and the Fed have taken a range of actions to address the very tight funding conditions that now prevail. For example, the Treasury implemented a temporary guarantee program for balances held in money market mutual funds, helping to stem the outflows from these funds and thus reducing their need to sell assets into already distressed markets. The Federal Reserve has taken a number of steps, including putting in place a temporary lending facility that provides financing for banks to purchase high-quality asset-backed commercial paper from money market funds. The Fed has also significantly increased the quantity of funds it auctions to banks and has accommodated heightened demands for funding from banks and primary dealers; as of last Wednesday, our various lending facilities, including our securities lending program, were providing more than \$800 billion of liquidity to the financial system. To address dollar funding pressures worldwide, we have significantly expanded reciprocal currency arrangements (so-called swap agreements) with foreign central banks. These agreements enable the foreign central banks to provide dollar funding to financial institutions in their jurisdictions, which helps to improve the functioning of dollar funding markets globally. In addition, this morning the Federal Reserve announced a new facility that will help provide liquidity to term funding markets by purchasing three-month commercial paper and asset-backed commercial paper directly from eligible issuers.

The expansion of Federal Reserve lending is helping financial firms cope with reduced access to their usual sources of funding. Recently, however, our liquidity provision had begun to run ahead of our ability to absorb excess reserves held by the banking system, leading the effective funds rate, on many days, to fall below the target set by the Federal Open Market Committee. This problem has largely been addressed by a provision of the legislation the Congress passed last week, which gives the Federal Reserve the authority to pay interest on balances that depository institutions hold in their accounts at the Federal Reserve Banks. The Federal Reserve announced yesterday that it will pay interest on required reserve balances at 10 basis points below the target federal funds rate, and pay interest on excess reserves, initially at 75 basis points below the target. Paying interest on reserves should allow us to better control the federal funds rate, as banks are unlikely to lend overnight balances at a rate lower than they can receive from the Fed; thus, the payment of interest on reserves should set a floor for the funds rate over the day. With this step, our lending facilities may be more easily expanded as necessary. So long as financial conditions warrant, we will continue to look for ways to reduce funding pressures in key markets.

Economic activity had shown signs of decelerating even before the recent upsurge in financial-market tensions. As has been the case for some time, the housing market continues to be a primary source of weakness in the real economy as well as in the financial markets. However, the slowdown in economic activity has spread outside the housing sector. Private payrolls have continued to contract, and the declines in employment, together with earlier increases in food and energy prices, have eroded the purchasing power of households. This sluggishness of real incomes, together with tighter credit and declining household wealth, is now showing through more clearly to consumer spending. Indeed, since May, real consumer outlays have contracted significantly. Meanwhile, in the business sector, worsening sales prospects and a heightened sense of uncertainty have begun to weigh more heavily on investment spending as well.

The intensification of financial turmoil and the further impairment of the functioning of credit markets seem likely to increase the restraint on economic activity in the period ahead. Even households with good credit histories are now facing difficulties obtaining mortgage loans or home equity lines of credit. Banks are also reducing credit card limits, and denial rates on automobile loan applications reportedly are rising. Businesses, too, are confronting diminished access to credit. For example, disruptions in the commercial paper market and tightening of bank lending standards have made it more difficult for businesses to obtain the working capital they need to meet everyday operating expenses such as payrolls and inventories.

All told, economic activity is likely to be subdued during the remainder of this year and into next year. The heightened financial turmoil that we have experienced of late may well lengthen the period of weak economic performance and further increase the risks to growth. To support growth and reduce the downside risks, continued efforts to stabilize the financial markets are essential. The Federal Reserve will continue to use the tools at its disposal to improve market functioning and liquidity.

Inflation has been elevated, 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 to consumers of their higher costs of production. However, more recently, the prices of oil and other commodities, while remaining quite volatile, have fallen from their peaks, and prices of imports show signs of decelerating. In addition, expected inflation, as measured by consumer surveys and inflation-indexed Treasury securities, has held steady or eased. These recent developments, together with economic activity that is likely to fall short of potential for a time, should lead to rates of inflation more consistent with price stability. Still, the inflation outlook remains highly uncertain, in part because of the extraordinary volatility of commodity prices. We will need to continue to monitor price developments closely.

Overall, the combination of the incoming data and recent financial developments suggests that the outlook for economic growth has worsened and that the downside risks to growth have increased. At the same time, the outlook for inflation has improved somewhat, though it remains uncertain. In light of these developments, the Federal Reserve will need to consider whether the current stance of policy remains appropriate.

The intensification of the financial crisis in recent weeks made clear that a more powerful and comprehensive approach involving the fiscal authorities was needed to solve these problems. On that basis, the Secretary of the Treasury, with the support of the Federal Reserve, went to the Congress to ask for a substantial program aimed at stabilizing our financial markets. As you know, last week the Congress passed and the President signed the Emergency Economic Stabilization Act. This legislation provides important new tools for addressing the distress in financial markets and thus mitigating the risks to the economy. The act adds broad, flexible authorities to buy troubled assets, to provide guarantees, and to directly strengthen the balance sheets of individual institutions. Notably, the legislation establishes a new Troubled Asset Relief Program, or TARP, under which the Treasury is authorized to purchase as much as \$700 billion of troubled mortgages, mortgage-related

securities, and other financial instruments from financial firms that are regulated under U.S. law and have significant operations in the United States. The act also raises the limit on deposit insurance at banks and credit unions from \$100,000 to \$250,000 per account, a step that should reinforce depositors' confidence in the security of their funds and thus help to stabilize depository institutions. And, as I mentioned, the act provides the Federal Reserve the authority to pay interest on reserves, which will allow us to better manage the federal funds rate as we provide liquidity to the markets. We will begin exercising that authority this week.

The TARP's purchases of illiquid assets from banks and other financial institutions will create liquidity and promote price discovery in the markets for these assets. This in turn will reduce investor uncertainty about the current value and prospects of financial institutions, enabling banks and other institutions to raise capital and increasing the willingness of counterparties to engage. More generally, increased liquidity and transparency in pricing will help to restore confidence in our financial markets and promote more normal functioning. With time, strengthening our financial institutions and markets will allow credit to begin flowing again, supporting economic growth.

The interests of taxpayers are carefully protected under this program. First, the Congress has required extensive controls and oversight to ensure that the allotted funds are used appropriately and effectively. Second, the \$700 billion allocated by the legislation is not an authorization to spend but rather an authorization to purchase financial assets. The Treasury will be a patient investor and will likely hold these assets for an appreciable period of time. Eventually, however, some assets will mature, and the Treasury will choose to sell others to private investors. Financially, in the long run, the taxpayer may come out either ahead or behind in this process; in light of the many uncertainties, no assurances can be given. But the ultimate cost of the program to the taxpayer will certainly be far less than \$700 billion. Third, and most important, restoring the normal flow of credit is essential for economic recovery. If the TARP promotes financial stability, leading ultimately to stronger economic growth and job creation, it will have proved a very good investment indeed, to everyone's benefit.

To be sure, there are many challenges associated with the design and implementation of the TARP, including determining which assets will be purchased and how prices will be determined. The Treasury, with the advice and cooperation of the Federal Reserve, is working to address these challenges as quickly as possible. It is unlikely that a single method will be used for acquiring assets; inevitably, some experimentation will be necessary to determine which approaches are most effective. Importantly, the legislation that created the TARP does provide sufficient flexibility to allow for different approaches to solving the problem – subject, of course, to the close oversight that will ensure that the program's funds are used in ways that are in the interest of taxpayers.

These are momentous steps, but they are being taken to address a problem of historic dimensions. In one respect, however, we are fortunate. We have learned from historical experience with severe financial crises that if government intervention comes only at a point at which many or most financial institutions are insolvent or nearly so, the costs of restoring the system are greatly increased. This is not the situation we face today. The Congress and the Administration chose to act at a moment of great stress, but one at which the great majority of financial institutions have sufficient capital and liquidity to return to their critical function of providing new credit for our economy. The steps being taken now to restore confidence in our institutions and markets will go far to resolving the current dislocations in the markets. I believe that the bold actions taken by the Congress, the Treasury, the Federal Reserve, and other agencies, together with the natural recuperative powers of the financial markets, will lay the groundwork for financial and economic recovery.