Donald L Kohn: Economic outlook

Speech by Mr Donald L Kohn, Vice Chairman of the Board of Governors of the US Federal Reserve System, at the Georgetown University Wall Street Alliance, New York, 15 October 2008.

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We gather in difficult times for our financial markets and our economy. Recent weeks have seen a sharp intensification of the turmoil in financial markets: There has been a broad-based pullback in risk-taking and a virtual seizing up of term lending to many banks and other financial institutions; interest rates have risen for many borrowers, and credit availability has significantly diminished; and equity prices have fallen sharply, on net. The authorities have responded with a series of forceful and innovative measures that promise to rebuild confidence and free up lending. Tonight I will try to put these developments in the context of the recent course of our economy and its prospects for the future.[1]

Before commenting on the current situation and its economic implications, I thought it might be useful to begin by giving you my perspective on where the economy stood prior to the recent intensification of financial turmoil. Overall economic activity – as measured by the growth of real gross domestic product (GDP) – held up surprisingly well over the first half of 2008 given the ongoing stresses in broader financial markets and the further rise in oil prices. At the same time, however, a number of disquieting signs lay underneath the surface of the aggregate growth figures. Conditions in housing markets, as had been widely expected, were continuing to deteriorate, with further declines in home sales, new construction, and house prices in most markets. And, while consumer spending posted moderate gains during the spring, it seemed likely that much of that strength stemmed from the sizable tax rebate checks that began to go out to households at the end of April. Meanwhile, on the business side, employers had been reducing payrolls since the turn of the year, industrial production fell from February through May, and many corporations were seeing their profits squeezed by rising costs and weak demand.

During the summer, it became increasingly clear that a downshifting in the pace of economic activity was in train. In particular, the long list of negative factors weighing on domestic demand – including high prices for oil and other commodities, tight credit conditions, and the housing downturn – were beginning to take a significant toll on the economy.

The deterioration was led by a noticeable retrenchment in consumer spending. Although rebate checks continued to provide a boost to incomes in June and July, households were facing some stiff headwinds. Ongoing job losses and sharp increases in energy and food prices subtracted from household purchasing power, declining home prices and falling equity values led to a further drop in household wealth, and consumers remained extremely downbeat about prospects for jobs and income. At the same time, credit became more difficult to obtain as lenders became increasingly concerned about the prospects for loan performance in a softening economy. Many banks and other creditors tightened standards for credit cards and other consumer loans, and some lenders either reduced borrowing limits on or eliminated home equity lines of credit. As a result of all these influences, real consumer outlays fell from June through August, putting real consumer spending for the third quarter as a whole on track to decline for the first time since 1991.

[1] The views expressed are my own and do not necessarily represent the views of other members of the Board or the Federal Open Market Committee. William Wascher, of the Board’s staff, contributed to these remarks.

Business investment also appears to have slowed over the summer. Orders and shipments for nondefense capital goods have weakened, on net, in recent months, pointing to a decline in real outlays for new business equipment. Similarly, outlays for nonresidential construction projects edged lower in July and August after rising at a robust pace over the first half of this year. Although the deteriorating sales outlook and increased uncertainty about the economy undoubtedly played a role, the softening in business outlays also appeared to reflect reduced credit availability from banks and other lenders.

In addition, conditions in housing markets have remained on a downward trajectory. Sales and construction of new homes continued to decline over the summer, and while existing home sales showed signs of stabilizing at low levels, many of the sales that did occur appear to have been stimulated by sharp price reductions for distressed properties. National indexes of house prices continued to post sizable declines.

Unfortunately, our trading partners have proven not to be immune from financial turmoil and economic weakness. Incoming data indicate that the pace of activity in many foreign economies slowed in recent quarters, reflecting many of the same forces of credit contraction, rising energy prices, and housing market decelerations that have affected the U.S. economy. This weakening in foreign activity suggests that the support to domestic production from net exports that was evident in the first half of this year is likely diminishing. We can see evidence of this in manufacturing production outside of motor vehicles, which had benefited from the earlier decline in the dollar and strong foreign growth; it fell for a third consecutive month in August, and indications for September suggest a further decline last month, even after excluding the effects of the recent hurricanes and the strike at Boeing.

Meanwhile, inflation remained uncomfortably high through much of the summer. The sharp increases in the prices of oil and many agricultural commodities showed through to consumer food and energy prices, and producers passed through some of their higher input costs into retail prices for "core" goods and services. More recently, however, the prices of oil and other commodities have posted substantial declines, non-oil import prices have edged down, and the prospect of greater slack in resource markets and weak demand seems likely to restrain labor cost pressures and pricing power. Reflecting these developments, inflation expectations appear to have eased a bit.

The weakening U.S. economy and ongoing declines in house prices, with their implications for credit performance, put further pressure on exposed financial institutions over the summer. Investors lost confidence in some of these institutions, which then saw their access to liquidity dry up, causing some to fail and others to require government assistance or to consolidate via their acquisition by healthier institutions.

The speed with which these developments occurred, along with worries about losses throughout the financial system, led banks and other lenders to pull back from extending credit except at the very shortest maturities. As a result, conditions in funding markets deteriorated substantially further in September and early October, with interbank lending rates moving up sharply from already-high levels and spreads over comparable-maturity overnight index swaps widening to unprecedented levels.

In addition, the commercial paper market became severely disrupted as money market mutual funds, the largest investors in that market, substantially reduced their demand in response to outflows and the difficulty of liquidating commercial paper in secondary markets. As a result, yields on commercial paper skyrocketed for most issuers, and funding became increasingly concentrated in paper with overnight maturities. Similarly, interest rates on longer-term corporate bonds rose sharply even for investment-grade firms, and bond markets were closed off to many issuers. These developments quickly led to sharp declines in equity prices more generally, as well as to widespread disruptions in other markets, including the markets for municipal bonds. Market distress fed on itself, as efforts by lenders to protect themselves triggered calls for increased margins, sales of assets that accentuated price declines, large increases in volatility in an uncertain and unfamiliar environment, and a sharp cutback in the willingness to extend credit. Financial stresses have intensified in major foreign economies as well, with many also experiencing a drying up of liquidity in financial markets, sharp increases in the cost of short-term credit, and steep declines in equity prices.

The net result of the erosion of confidence, declines in asset prices, and freezing up of many financial markets has been a marked deterioration in the outlook for economic growth both here and abroad. Already, the latest readings on the U.S. economy have become more downbeat. In the labor market, private payroll employment fell 170,000 in September, a faster pace of decline than had been evident in preceding months, and the Institute for Supply Management survey of conditions in the manufacturing sector turned down sharply. In addition, motor vehicle sales fell to a 12-1/2 million unit pace in September, and today's report on retail sales indicated that purchases of other goods also dropped sharply last month. Meanwhile, pressures in financial markets have undoubtedly further restricted the availability of credit to households and businesses. Indeed, many of our contacts for the Beige Book, which was published today, highlighted tight and tightening credit conditions, and, in increasing numbers, indicated that a lack of credit availability is negatively affecting their customers' ability to spend or impairing their own ability to maintain the normal working capital they need to manage their day-to-day operations.

To combat the increased stresses in financial markets and their effects on the economy, the U.S. authorities, as well as those of many foreign governments, have taken a number of forceful and innovative steps in recent weeks. Of greatest consequence was the passage of the Emergency Economic Stabilization Act (EESA) with its authority for the government to use up to $700 billion to support financial markets. Importantly, the U.S. Treasury has indicated that a significant share of this authority will be used to inject capital into financial institutions. As the turmoil has persisted and deepened, it has become increasingly clear that the fear and uncertainty gripping markets stems from questions about the exposure of many financial intermediaries to losses on mortgages and other loans. Banks and other lenders need greater capital cushions to reassure their counterparties that they will be able to meet their obligations, and they need it soon. The capital purchase plan announced by the Treasury yesterday is a start on building capital and confidence, and, by strengthening lenders, should make it easier for them to access the private capital they also require. In addition, the troubled asset purchase program should help by counteracting the effect of forced sales and impaired market liquidity on asset prices.

Although capital is the bedrock of confidence, it probably will take some time for enough to be raised to completely reassure those who extend funds to many intermediaries. In the meantime, the inability of lenders to fund themselves beyond the very near term creates vulnerability in the financial system and impedes their capacity to make loans to households and businesses to finance the purchases of cars, houses, and business capital. To bridge the gap to stronger capital, the Federal Deposit Insurance Corporation (FDIC) is offering banks and their holding companies an opportunity to issue guaranteed obligations for the next nine months. This guarantee covers the obligations most likely to be withdrawn when confidence erodes, but it is also structured to encourage banks to lengthen the maturity of their borrowing to provide stability, rebuild confidence, and stimulate lending. The FDIC program will operate alongside the earlier Treasury guarantee of money market fund balances designed to stabilize investments in those accounts and hence reduce the need for these funds to liquidate assets.

For its part, the Federal Reserve has greatly expanded its provision of liquidity to banks here and abroad and to other borrowers. We could do so in part because the EESA accelerated the authority for the Federal Reserve to pay interest on reserves. With that power, we can expand our lending and still maintain the federal funds rate target established by the Federal Open Market Committee (FOMC). Under normal circumstances, we face no tension between supplying liquidity and achieving our interest rate objective, because we supply a relatively small amount of funds to the private sector through our open market operations with primary dealers and discount window lending to banks. Over the past 15 months, however, as lenders have become increasingly reluctant to lend to each other, the Federal Reserve has had to take on a much greater role in the financial system to carry out its public policy responsibilities to provide a backstop source of liquidity. At first, we did this by expanding the amount and lengthening the maturity of our lending to banks at the discount window and through our traditional open market operations with dealers. Then, we found that we needed to supply credit against a greater variety of collateral to primary dealers so we opened the discount window to them and expanded our securities lending facilities. And just within the past few weeks we determined that, with normal intermediation increasingly disrupted, economic and financial stability required us to lend to firms that issued commercial paper. At the same time, we have greatly expanded our dollar swaps with foreign central banks to help them meet the dollar funding needs of their domestic banks – needs that have been adding to pressures on our markets here at home.

By opening and expanding these facilities, we are trying to assure banks, dealers, and commercial paper issuers that they can extend credit without worrying about whether they will be able to borrow to fund those loans. We are also trying to assure those who lend to these firms that the borrowers will have a source of funding to pay them back. Clearly, the willingness of the Federal Reserve to lend substantial amounts to more counterparties over longer periods has not, by itself, been sufficient to unlock private credit flows; but Federal Reserve credit has been a critical ingredient in the mix of policy tools.

As I noted earlier, the troubles in the financial markets have spilled over to the economy. Indeed, fear of economic weakness and the associated deterioration in credit quality contributed to the adverse dynamics in credit markets. To counter this dynamic and adjust its policy to the evolving economic outlook, the FOMC reduced the target federal funds rate 50 basis points last week. To be sure, the effects of the easier stance of policy on the cost and availability of credit were overwhelmed last week by the further erosion in confidence. But, over time, lower rates will help to support asset prices and reduce the cost of capital to encourage spending, economic expansion, and job creation.

Importantly, this easing action was taken alongside similar actions by many other central banks. Financial markets are connected around the world by the free flow of capital, and the freezing up of credit has occurred, to one degree or another, in many foreign economies as well as our own. In these circumstances, measures to address financial market problems within each country are likely to be more effective if other countries are also taking similar steps, as they are doing not only in monetary policy but also in their efforts to recapitalize banks, guarantee bank obligations, and shore up the confidence of lenders.

I am optimistic that this multipronged approach is laying the groundwork for a return to more normal functioning in financial markets and a restoration of vigorous economic growth. The initial reaction has been positive, but it will take some time before we know to what extent the current stresses in the financial sector are being resolved. Over time, financial firms will need to bolster profits to offset losses and attract capital, to delever by reducing debt relative to equity, and in many cases to consolidate through mergers and acquisitions. All of this points to a prolonged period of cautious lending and a high cost of capital relative to benchmark interest rates like the federal funds rate, even as market functioning improves.

Similarly, although the adjustment in housing markets is well under way, it likely still has further to go. House prices will probably continue to fall for a while, and inventories of unsold homes, while decreasing, will remain elevated. At some point, however, house prices will begin to stabilize, demand will be bolstered by the lower level of prices and low interest rates, and inventories will come into better alignment with sales. To be sure, any rebound in housing activity will likely be modest, but even a stabilization in housing markets will remove what has been a significant drag on the U.S. economy.

Given the likely drawn-out nature of the prospective adjustments in housing and financial markets, I see the most probable scenario as one in which the performance of the economy remains subpar well into next year and then gradually improves in late 2009 and 2010. As credit restraint abates, the low level of policy interest rates will begin to show through into more accommodative financial conditions. This improvement in financial conditions, together with the gradual stabilization of housing markets and the stimulative effects of lower oil and commodity prices, should lead to a pickup in jobs and income, contributing to a broad recovery in the U.S. economy.

At the same time, inflation seems likely to move onto a downward track. If sustained, the recent declines in commodity prices should soon lead to a sharp reduction in headline inflation. In addition, I expect core inflation to slow from current levels as lower commodity prices and greater economic slack moderate upward pressures on costs. Similar reductions in inflation abroad, as well as the recent appreciation of the dollar, should restrain increases in the prices of imported goods.

I would caution, however, that the uncertainty around my forecast is substantial. The path of the economy will depend critically on how quickly the current stresses in financial markets abate. But these events have few if any precedents, and thus we can have even less confidence than usual in our economic forecasts.

Here's what I do know: The authorities around the world have brought to bear on this situation an array of actions that are unprecedented in scope and force; these actions show every promise of being successful in restoring confidence in lending institutions and freeing the flow of credit to households and businesses; and governments in the United States and elsewhere have shown themselves able to work across political parties and across international boundaries to craft new approaches to problems. As Chairman Bernanke has often remarked, at the Federal Reserve we will utilize all the tools at our disposal to meet our responsibilities for fostering high employment and stable prices. I also know that the U.S. economy has proven itself over the years to be flexible and resilient as well as innovative and productive, qualities which enable it to rebound from serious economic shocks. I am confident that we will emerge from this episode with a stronger and more robust financial system and with a restoration of solid and sustainable economic growth.