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The Federal Reserve and the Economic Recovery

Good morning. I want to thank Alex and all of you for coming to the forum this morning. I get to travel all over the world to give talks, but I'll admit it's nice to be able to just jump in my car and not have to go through airport security and delays to be with you today.

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. I should stress that I'm expressing my own views and not those of anybody else in the Federal Reserve System.

The good news is that the U.S. economy has been growing for the past two-and-a-half years. The unemployment rate has fallen about three-quarters of a percentage point in the past four months, and is now at its lowest level in nearly three years. Nonetheless, we are still suffering from the aftereffects of the worst recession of the post-World War II period. Compared to the pattern seen in past recessions, the economic recovery has been weak. And, despite relatively strong job gains in recent months, the unemployment rate remains very high. 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 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 look back at events during the housing boom when the problems plaguing us today got started. Let me take you back to the early 2000s, when the housing market took off. 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, lending 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 rise they did. Ordinary folks found themselves sitting on tens or even hundreds of thousands of dollars in home equity, which could be turned into cash to buy an SUV or a new dining room set. Despite all the risky lending, home loan delinquencies were low. As long as home prices rose, everybody was happy. Financial institutions had plenty of capital—at least on paper—and made lots of money.

Tragically though, the boom contained the seeds of its own destruction. By one measure, house prices were about 70 percent overvalued at their peak in 2006. Since then, of course, house prices have plunged—by about 30 percent 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 percent of all mortgages were in serious trouble or in foreclosure. As delinquencies and foreclosures skyrocketed, lenders and other financial institutions that had placed big bets on the mortgage market posted massive losses. Financial institutions became fearful of lending money to anybody, including other financial institutions. That choked off the 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, 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 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 run for cover 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 19^{th} and the early 20^{th} centuries, financial panics wiped out banks and other financial institutions, large and small. Credit is the lifeblood of our economy. During those repeated panics, loans became almost entirely unavailable to households and businesses. Those 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 percent of the workforce was out of work.

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 a few 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. In fact, 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 books are subject to a stringent reporting process and regularly reviewed by Congress.[1]

The Fed's actions, along with those of the U.S. Treasury and other agencies, succeeded in stemming the 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. Almost 13 million Americans are still out of work. It's astonishing that nearly a third of them have been without a job for a year or more.

I'd like to turn 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

[1] For more information on audits of the Federal Reserve, see the website http://www.federalreserve.gov/faqs/about_12784.htm.

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 historic 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, about one in four home 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 can still be 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 businesspeople that these uncertainties are prompting them to slow investment and hiring.

Yet, even in the face of these obstacles, the economy continues to grow. 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 about 2¼ percent this year and 2¾ percent in 2013. That's an improvement from 2011, when GDP grew only a little over 1½ percent. Unfortunately, such moderate growth will not be enough to keep taking big bites out of unemployment. The unemployment rate is currently 8.3 percent. I expect it to remain over 8 percent well into next year and still be well over 7 percent at the end of 2014.

But, that's a forecast, and things could obviously turn out differently than I expect. One risk in particular could cause the economy to perform much worse than this forecast. 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 what might be 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.

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

The Fed sets policy with an eye on the two goals Congress has assigned it: maximum employment and stable prices. Clearly, with unemployment at 8.3 percent, we are very far from maximum employment. And I expect inflation to run somewhat below the 2 percent level that we at the Fed are aiming for. 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, like today, we lower 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.

The Fed's monetary policy body is called the Federal Open Market Committee, or FOMC. Back in December 2008, in response to the deepening recession, the FOMC lowered the federal funds rate close to zero. The Committee has kept the funds rate near zero since then. In fact, given the weakness in the economy, standard monetary policy benchmarks indicate that the federal funds rate should have gone deep into negative territory. But, of course, it's not possible for interest rates to go much below zero.

So the Fed has had to look for alternative or "unconventional" ways to stimulate the economy. For example, we've purchased over one-and-three-quarters 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, which causes their prices to rise. This translates into 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 at least through late 2014. This guidance has helped lower longer-term interest rates, like those on home mortgages, car loans, and corporate bonds, by letting investors know that short-term interest rates are likely to stay low for a long time. It's important to emphasize that this is not a promise or commitment to keep rates near zero. Instead, it's our best collective judgment about the likely future course of policy. And, of course, it will change if the economic outlook changes.

In addition to these policy actions, we have been hard at work on improving our communication of the Fed's monetary policy strategy and plans. We've recently taken a number of steps in this direction. First, we released a statement of our longer-run goals and strategies—essentially, a statement of our monetary policy principles.[2] That statement noted that we view a 2 percent inflation rate as most consistent with our mandates. It also emphasized that we will continue to carefully balance our dual goals of maximum employment and price stability in making our policy decisions. This statement is the latest in a series of Fed initiatives toward greater openness and accountability.

Second, we now regularly report our views about the probable course of short-term interest rates over the next few years. Unemployment is high, of course, and it's likely that inflation will be below our 2 percent objective for years to come. In those circumstances, most Fed policymakers expect that we will keep short-term interest rates at their current very low levels into 2014 or later. Releasing the views of policymakers in this fashion should reduce public uncertainty about our plans for monetary policy. And that, in turn, improves the effectiveness of our policies.

We at the Fed are doing everything we can to move the economy forward. We recognize that monetary policy cannot perform 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. Looking ahead, we may still need to provide more policy accommodation if the economy loses momentum or inflation remains well below 2 percent. Should that occur, restarting our program of purchasing mortgage-backed securities would likely be the best way to provide a boost to the economy.

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[2] For more information, see http://www.federalreserve.gov/newsevents/press/monetary/20120125c.htm.

The policy actions the Fed takes from here will depend on how economic conditions develop, and they will change as economic circumstances change. I want to assure you that the Fed will do its level best to achieve the goals of maximum employment and stable prices. Thank you very much.