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Policies to Bring Us Out of the Financial Crisis and Recession

I am glad to be back at Wooster. As I know from my time here, a strength of a small liberal arts school like Wooster is its ability to draw on the diverse perspectives of people of different disciplines and backgrounds to work closely with students in examining important issues, and I'm pleased to be part of such an effort today.

My role today is to discuss the actions the government is taking to address our current financial and economic difficulties. Although my fellow panelists will be discussing how we got here and the regulatory policies we should adopt to prevent a recurrence, I won't be able to fulfill my task without impinging a bit on their topics. The choice of policies follows by necessity from the diagnosis of the causes of the problems being addressed. And, as we address the challenges of the here and now, we cannot lose sight of the longer-term policy adjustments that we will have to make to avoid similar crises in the future.[1]

I should say at the outset that I will focus today on the economic and financial problems and policy responses in the United States. However, because capital markets and financial institutions are linked globally, financial dislocations and their consequences have been felt around the world. Moreover, other countries have taken policy steps similar to those taken here, including traditional and nontraditional monetary policy, programs to support banking institutions, and fiscal stimulus. This is truly a global crisis, and it is a hopeful sign that the need for forceful policy responses to the serious challenges we face is broadly recognized.

Characteristics of the Crisis

A defining characteristic of the crisis has been a deepening adverse feedback loop in which financial strains have caused economic weakness, which has in turn led to credit losses and heightened financial strains, which then contribute to further economic weakness, and so on.

The trigger for the crisis when it broke in the summer of 2007 was a weakening of the housing market and a sharp rise in delinquencies on subprime mortgages. These delinquencies were importantly the result of a breakdown in underwriting standards that reflected, in part, incentive problems in the securitization process. Lenders did not see a need to underwrite carefully because they did not intend to hold the loans themselves. Moreover, based on experience over recent years, investors expected property prices to rise; they did not appreciate the extent of the bubble in housing prices, and so they did not focus as much as they should have on the ability of the borrowers to repay the loans--or pieces of loans--they were purchasing. Complex and opaque securitizations of loans made due diligence on the underlying credits nearly impossible.

As losses on subprime loans mounted, investors realized that even highly rated securities backed by subprime mortgages could face large write-downs, and the prices of such securities declined sharply. Uncertainty about the extent of banks' mortgage-related losses and their potential liquidity needs to support off-balance-sheet entities led banks to become much less willing to lend to each other and to other financial institutions. The result was a sharp widening of risk spreads in key funding markets. Leverage in the financial sector, which had contributed to higher profits during the financial boom, was now seen to be excessive. As financial firms moved to reduce their exposures, they became less willing to make markets, and the liquidity of many securities declined.

Although housing was the trigger and the largest single source of problems, as time went on it became clear that problems in financial institutions and markets were more broadly based. Risk on a variety of assets had not been priced appropriately, and risk spreads in a range of markets increased, as did the equity risk premium. Markets for private asset-backed securities (ABS) were hit especially hard. Reflecting the deterioration in funding conditions, as well as efforts to conserve capital and liquidity, banks tightened lending standards and terms on loans to both businesses and households.

With both financial markets and intermediaries under considerable strain, credit became more expensive and, in some cases, unobtainable, causing spending to be reduced. The weaker economy in turn contributed to further deterioration in asset quality and concerns about greater losses to come. As a result, banks and other lenders tightened their lending stance further, which put additional downward pressure on spending.

This adverse feedback loop, which was already visible from late 2007, intensified considerably last fall. Failures and near-failures of some major financial institutions greatly undermined confidence in financial institutions and severely disrupted financial markets, leading to a further sharp tightening of credit conditions. Risk spreads, which were already elevated, escalated further and equity prices fell. In addition, the financial turmoil contributed to a sharp decline in consumer and business confidence. The result was a major pullback in spending as consumers responded to decreases in wealth and the deterioration in their future employment prospects and as businesses, worried about the demand for their products, cut back on capital spending and sharply reduced production to avoid an accumulation of unsold stocks. A gradual decline in economic activity through most of 2008 took a decided turn for the worse late in the year.

The Policy Response

Because the threat to economic stability in the current episode has been so closely related to problems in the financial sector, most of the policy responses have been focused on financial institutions and markets and the flow of credit to households and businesses. Many of these policies have been aimed at countering the tightening of financial conditions that occurred as lenders became more risk averse and took steps to conserve capital and liquidity. To that end, the Federal Reserve has lowered interest rates, made backup sources of liquidity available to private lenders, and used its own lending capacity to try to revive a variety of financial markets. In addition, the Federal Reserve, the Treasury, and the Federal Deposit Insurance Corporation (FDIC) have taken a number of steps to stabilize and repair financial institutions in order to limit the tendency of those institutions to pull back from lending and thereby intensify the decline in spending.

Other government policies operate at the intersection of the financial and real sectors. Foreclosure mitigation, for example, not only serves to keep people in their homes, but also should reduce downward pressures on house prices and hold down loan losses at lenders. Finally, fiscal stimulus works directly on demand, in effect bypassing the financial sector in its first-round effects; by strengthening aggregate demand, it too should help alleviate strains on lenders and contribute to stemming the vicious cycle.

Although I'll be discussing each of these policy initiatives separately, it is important to keep their interactions in mind. They all attempt to break into that adverse feedback loop we've been talking about at different points in the chain of cause and effect and then cause again. The expectation of recovery rests importantly on the natural recuperative powers of the economy, but it also depends on the effects of the various policy efforts reinforcing each other: A stable financial system is critical to realizing the positive effects of monetary and fiscal policies; the financial system won't stabilize very quickly without monetary and fiscal stimulus to help support spending and ease credit problems.

Monetary Policy
In response to the rise in credit spreads and tightening of credit conditions, the Federal Reserve has aggressively eased monetary policy, as conventionally defined by the target for the federal funds rate. In the second half of 2007 and into the spring of 2008, the federal funds rate target was cut rapidly, and, as the financial turbulence intensified last fall and the economic outlook deteriorated, the Federal Open Market Committee (FOMC) responded by cutting the target further, setting a range of 0 to 1/4 percent by the end of last year.

With the federal funds rate already near zero, the FOMC noted, in the statement after its March meeting, "that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period." By communicating this expectation, the Committee reinforced market beliefs that policy is likely to remain on hold, and so put downward pressure on longer-term rates. Because it is these longer-term rates that have the largest effects on spending behavior, this sort of communication can be very useful in stimulating borrowing and spending by businesses and households.

In addition to easing the traditional interest rate instrument of monetary policy, the Federal Reserve has taken a range of other policy steps to ease credit conditions and support the broader economy. From the onset of the crisis in the summer of 2007, we could see that widening spreads in interbank funding markets were putting upward pressure on the interest rates paid and charged by banks. To combat the strains in these markets, the Federal Reserve provided credit to banks on more generous terms and at longer maturities than usual. The Federal Reserve subsequently introduced the Term Auction Facility, under which it holds auctions of fixed amounts of term credit to banks on a regular schedule. By providing banks with a more assured source of liquidity, these changes limited banks' need to bolster liquidity through fire sales of assets and so made them more willing to lend and to make markets.

The Federal Reserve also expanded its provision of liquidity beyond U.S. banking institutions to other financial institutions and market participants. Because foreign dollar funding markets affect U.S. markets, swap lines were established with foreign central banks in late 2007 (and have since been expanded significantly), allowing them to obtain dollars so that they could meet the dollar liquidity needs of banks in their jurisdictions. As some large investment banks came increasingly under pressure in early 2008, the Federal Reserve, consistent with its role as lender of last resort and in light of the key roles these institutions play in a range of financial markets, introduced programs under which it could provide liquidity to primary dealers.[2] And, as the financial situation deteriorated last fall, the Federal Reserve established liquidity facilities for money market mutual funds and introduced programs to provide liquidity directly to borrowers and investors in key credit markets, including the commercial paper market, where strains threatened the ability of many financial and nonfinancial firms to place their paper.

More recently, the Federal Reserve and the Treasury have teamed up to try to restart the markets in which loans had been securitized to be sold to final investors. Until the crisis, ABS issuance was a key source of funding for consumer loans, small business loans, student loans, and other types of household and business credit. However, after the substantial losses on residential mortgage-backed securities, and with the economy weakening, investors became wary of all structured securities; spreads on ABS rose sharply and issuance tailed off last fall. Under the Term Asset-Backed Securities Loan Facility (TALF), the Federal Reserve will provide loans against a variety of ABS while the private sector and the Treasury take most of the risk.

Finally, the Federal Reserve has begun making substantial purchases of longer-term securities in order to support market functioning and reduce interest rates in the mortgage and private credit markets. As recently as our March meeting, the FOMC increased the total planned amount of purchases of agencyguaranteed mortgage-backed securities and initiated a program of buying longer-term Treasury securities.[3]

I believe these efforts have been somewhat successful at addressing the "tightening in financial conditions" side of the adverse feedback loop. Short-term interest rates are much lower than they were when the crisis began, and so are mortgage rates--at least those on mortgages eligible to be guaranteed by Fannie Mae and Freddie Mac. Functioning of the commercial paper market has greatly improved. Banks, investment banks, and money market mutual funds tell us that without the liquidity backstops we have provided, they would have had to shrink and deleverage much more rapidly, which would have put downward pressure on asset prices and would have further reduced credit availability for households and businesses.

But we are not out of the woods yet. For many borrowers, credit remains much harder to get and far more expensive than it was in the summer of 2007. Some reductions in leverage and tightening of credit conditions relative to earlier this decade clearly were needed, and I expect that lower leverage and tighter lending standards and terms will be enduring features of the financial landscape. But current credit conditions are far tighter than these adjustments would seem to justify. Many financial markets remain under considerable stress, asset prices have been reduced by the lack of liquidity in markets, and credit spreads and availability still reflect very high aversion to risk. These conditions are not conducive to a substantial and sustained economic rebound, and the Federal Reserve will continue to be alert to ways that monetary policy can contribute to economic recovery.

We are also conscious of a potential adverse feedback loop between persistent economic weakness and a continuing decline in inflation and inflation expectations. With the federal funds rate about as low as it can go, significant further decreases in inflation as a result of the substantial slack in resources, lower import prices, and declines in the prices of oil and other commodities could imply an increase in the real federal funds rate. Indeed, if such a process continued for some time, we could fall into deflation, much as Japan did for a time in the 1990s and earlier this decade. Then again, the substantial increase in the size of the Federal Reserve's balance sheet as a result of the credit programs that have been implemented have led some to worry that inflation could rise sharply when the economy recovers unless the Federal Reserve moves quickly when the time comes to unwind the programs and limit the growth in credit.

Because inflation expectations play a key role in the setting of prices and wages, firmly anchored inflation expectations can help avoid both of these outcomes. To help anchor inflation expectations, the FOMC is now providing extended projections of inflation--along with growth and unemployment--in its quarterly economic projections.

To address concerns about its ability to rein in its balance sheet, the Federal Reserve must be prepared to exit from its various programs when the time is right. We have designed many of our facilities to discourage use when markets are functioning more normally, and securities that have been accumulated can be sold when such sales are judged to be appropriate. However, given very large purchases of long-term assets and substantial long-term lending for the TALF and other purposes, the Federal Reserve would benefit from new tools that would allow it to drain reserves from the banking system. We are working with the Treasury and the Congress to obtain such tools.

Financial Repair

In addition to the Federal Reserve's monetary policy actions, which broadly support the financial sector and the economy, the government--including the Treasury, the Federal Reserve, and the FDIC--has been working to provide more direct support to financial firms.[4]

In part, this effort has involved targeted actions to prevent the failure or substantial weakening of specific systemically important institutions, including Bear Stearns, Fannie Mae, Freddie Mac, AIG (American International Group, Inc.), Citigroup, and Bank of America. These actions were not taken to protect the affected firms' managers or shareholders from the costs of past mistakes. Indeed, managers have been replaced in some cases, and shareholders of the weakest firms have experienced massive losses. Instead, our actions have been driven by concerns that the disorderly failure of a large, complex, interconnected firm would impose significant losses on creditors, including other financial firms, dislocate a range of financial markets, and impede the flow of credit to households and businesses. Losses sustained by other financial firms could erode their financial strength, limiting their ability to play their intermediation role, or even cause them to fail, reinforcing financial pressures. Moreover, the disorderly failure of a large, complex interconnected firm could undermine confidence in the U.S. financial sector more broadly, potentially triggering a widespread withdrawal of funding by investors and an additional tightening of credit conditions, which would, in turn, cause a further reduction in economic activity.

Besides this targeted support, the government has undertaken programs to inject capital more broadly into the banking system. Since last fall, nearly $200 billion has been distributed under a Treasury program that provides government capital investments to banks in good condition. More recently, the Treasury, in conjunction with the bank supervisory agencies, announced a new program to ensure that U.S. banking institutions are appropriately capitalized. Under this program, the capital needs of the major U.S. banking institutions are being evaluated relative to the losses that would be anticipated under a significantly more challenging economic environment than anticipated in the consensus of private forecasters. Should that assessment indicate that an additional temporary capital buffer is warranted, institutions will have an opportunity to raise the capital from private sources. If these efforts are unsuccessful, the temporary capital buffer will be made available from the government. By providing additional capital, the government can reduce concerns about the adequacy of bank capital, build investor confidence in U.S. banking institutions and the U.S. financial sector more generally, and so ease financial pressures and encourage new lending.

In addition to providing capital, the government, through the FDIC, has temporarily guaranteed selected liabilities of insured depository institutions and their holding companies. This program provides a stable source of funds for these institutions and so eases the pressures on funding that some of them faced.

Finally, the Treasury recently announced a program to assist banks and other lenders in reducing their "legacy assets"--that is, real estate loans held directly on their books ("legacy loans") and securities backed by loan portfolios ("legacy securities") that were accumulated during the housing boom and which have since declined in value and become relatively illiquid. Uncertainty about the value of legacy assets is weighing on confidence in banks, reflecting concerns that the assets will turn out to be worth much less than currently thought and so undermine the financial strength of the banks holding them. Moreover, the lack of liquid markets for legacy assets means that banks cannot readily manage the associated risks and cannot easily make room on their balance sheets for new loans if they have attractive lending opportunities. In part, buyers for these assets are scarce because credit is expensive and difficult to obtain and because investors are highly averse to risk.

Under the new program, the Treasury, with the participation of the FDIC and the Federal Reserve, is establishing public-private investment funds to purchase legacy assets. Capital for the funds will be provided jointly by private investors and the Treasury. In addition, the government will provide the funds with leverage (through Federal Reserve lending or FDIC guarantees) that currently cannot be raised from market sources, allowing the funds to increase their purchases of legacy assets. These facilities are structured to give the government a share of any gains in the value of assets purchased while protecting the private-sector investors from some of the downside risks inherent in real estate credit at present. By providing such protection along with leverage that is unavailable in markets today, the government hopes to bolster demand for these assets and restart markets in them.

Taken together, these financial repair programs are a comprehensive and substantial effort to help financial institutions resume lending and so support economic activity. Banks worried about the adequacy of their capital have been reassured by the capital provided by the Treasury, and they may also be more optimistic about their ability to raise private capital once they have shed legacy assets. At the same time, concerns about the availability of funding should be eased by access to government-guaranteed funding options. Moreover, as I noted at the outset, these programs need to be viewed as complementing the monetary, fiscal, and other policies put in place to alleviate financial strains and support aggregate demand. Indeed, when I think back to the exceedingly perilous financial situation last September and October, I judge the efforts at financial repair as at least a qualified success. Risk spreads in bank funding markets have narrowed, and the liquidity positions of many institutions have improved. Despite significant pressures on many financial firms, we have generally avoided fire sales of assets by institutions that were troubled or were anticipating trouble.

Despite this progress, financial markets remain very fragile, lenders are still very protective of their capital and liquidity, risk spreads remain elevated, and many segments--especially securitization markets--continue to be impaired. However, some of the government programs I have discussed--those to restart markets, provide additional capital buffers, and open outlets for legacy assets--are just now being implemented. While these programs are quite promising, we will not be able to judge their success at restarting lending for a time.

Foreclosure Mitigation
Another way that the government has intervened to limit the spillovers of financial problems to the real economy, and vice versa, is by taking steps to reduce unnecessary foreclosures. Most notably, the Treasury recently announced the Making Home Affordable program that will provide financial incentives to encourage lenders and servicers to refinance existing mortgages with new mortgages having lower payments, thereby helping at-risk homeowners to avoid foreclosure. The large supply of foreclosed-upon houses coming onto the market has placed added downward pressure on house prices, and clusters of vacant properties can lead to higher crime rates and strains on municipal budgets as well. Thus, in addition to helping homeowners stay in their houses, limiting foreclosures should benefit lenders, mitigate adverse impacts on affected communities, and, by limiting the decline in overall home prices, help support the macroeconomy.

Fiscal Policy
In addition to the wide range of policies to bolster financial firms and markets and so damp the adverse feedback loop of the past year and a half, the government has put in place fiscal stimulus that will support spending and economic activity directly. The fiscal package includes tax cuts to bolster household incomes, new infrastructure investments, and financial assistance to state and local governments, many of which would otherwise have had to cut spending in light of declining revenues. The economy is very weak and is likely to remain so for a while despite strong application of both conventional and unconventional monetary policy actions; as such, this point in time would seem to be a textbook moment for substantial fiscal stimulus. With monetary policy likely to be quite accommodative for an extended period and the margin of unused capacity extraordinarily large, crowding out of private-sector spending by the fiscal expansion should be limited.

Potential Policy Risks
The policies that we have pursued have been targeted to the problems we face--strains in funding markets, tight credit conditions, balance sheet weaknesses at some banking institutions, rising foreclosures, and weak overall economic activity. By taking this broad approach to the situation, we allow for positive interactions among the policies we put in place and have the best chance of

countering the adverse feedback loop that has been an important driver of economic and financial developments since the outbreak of the crisis. Nonetheless, the success of these policies is subject to a number of risks.

Protectionism and Financial Nationalism
One risk is that the crisis and the accompanying deterioration in economic conditions will lead to increases in protectionism and financial nationalism. In hard times countries may turn inward, focusing on the difficulties facing their own financial firms and the dislocations in their own economies. And taxpayers may conclude that commitments of government money should be devoted primarily to policies that will directly benefit their nations' citizens. Although these reactions are natural, we need to recognize that if all countries react in this way, the result will be great inefficiency and a worse outcome for all. For example, as is well known, international trade benefits all nations by allowing for the more efficient production of goods and services. The current system of relatively open international trade has been gradually built up over many years and has contributed substantially to global prosperity. To backtrack now would be a tremendous setback that likely could not be reversed for a very long time. And if governments responded to problems at financial institutions in their countries by attempting to protect only domestic investors, the result would be a rapid, and likely very disruptive, unwinding of the international capital flows that run through the global banking system, resulting in greater strains on financial institutions and so on the economy.

Re-creating the Problems That Got Us Here?
A second risk that we should consider is whether in our efforts to deal with the financial crisis, we are inadvertently re-creating many of the structures and behaviors that contributed to the crisis. For example, the government is providing increased leverage even as markets are calling for deleveraging; some of the government programs make use of credit ratings from the same agencies that so evidently fell short in their assessments of structured financial instruments; some of these programs employ financial structures similar to the off-balance-sheet entities that proved unstable in the crisis; we are trying to keep interest rates very low to support asset prices and spending after an episode in which low long-term rates probably contributed to unsustainable housing prices; and, finally, we are supporting economic activity by further increasing government deficits at a time when the longer-term fiscal outlook is already troubling. So are we just perpetuating the errors and misjudgments that led to the crisis, and thus sowing the seeds of a new crisis in the years to come?

I don't think so. The steps we have taken need to be seen as part of an effort by the government to smooth the transition of our financial sector and economy to a more sustainable situation. Both markets and regulators are going to press financial firms to employ less leverage. Similarly, households will need to save more of their income over time, and in that process domestic spending will be brought more into line with our nation's potential to produce, thus reducing our dependence on foreign savings. However, the speed and force of the private-sector adjustments risk overshooting. Investors, badly surprised by the performance of some structured instruments and also by the extent of the economic downturn, have--at least for the time being--pulled back sharply from risk-taking. But they will regain confidence over time and return to markets that are now at a standstill. Government programs, like the TALF, can help rebuild that confidence. Similarly, the prices of some assets may be in the process of overshooting their long-run levels, reflecting heightened risk aversion and the very weak economic outlook. And low asset prices could lead to a prolonged period of depressed consumer and business confidence and what will ultimately prove to be an excessive shortfall in consumer spending and business capital outlays. While these adjustments are playing out, we are, in effect, temporarily substituting the government's balance sheet and spending for their private-sector counterparts.

However, while near-term stability seems to require slowing these adjustment processes, we must put in place frameworks for exiting these programs if we are to end up with a market-based economy that is more balanced and more resilient. Over time, the Federal Reserve must reduce its lending; the government must put its deficits on a distinct downward track; financial institutions must retire government assistance and operate on their own.

Dealing with the Government

The success of these policies requires that they be utilized. Because the government must protect the taxpayer, it needs to be sure that institutions taking taxpayer money are using the resources efficiently to address the intended problem. To ensure that government money is used appropriately, the government must monitor how it is used and impose conditions on those receiving it. However, the conditions for government assistance need to be carefully calibrated to protect the taxpayer while still allowing the policy objectives to be accomplished. Firms might hold back on accepting government help if they saw the cost of meeting the conditions as greater than the benefit of the assistance or if they were concerned that the conditions might change in an undesirable way after the assistance had been accepted. Such hesitance could impede the effectiveness of government programs and slow the recovery of jobs and income.

Will We Need to Do More?

My final issue is the hardest: Are the policies we have put in place sufficient to restart the flow of credit, or will the government need to do more? The answer, of course, is that we don't know--we have no reliable precedents for the current situation. Policymakers are operating in a highly uncertain environment--one marked by a huge amount of unquantifiable risks.

Most people, including policymakers, did not anticipate the depth, breadth, and severity of the financial meltdown and economic downturn. We have had to remain very flexible and open to policy actions that had no precedent. And all of us--the Federal Reserve, the Administration, and the Congress--must continue in this posture. We must keep our ultimate objectives for the economy firmly in mind--sustained recovery to high levels of output and employment with price stability. We will continue to adapt our policies as necessary to accomplish these objectives.