

US Economic and Financial Conditions and An Assessment of Policy Responses

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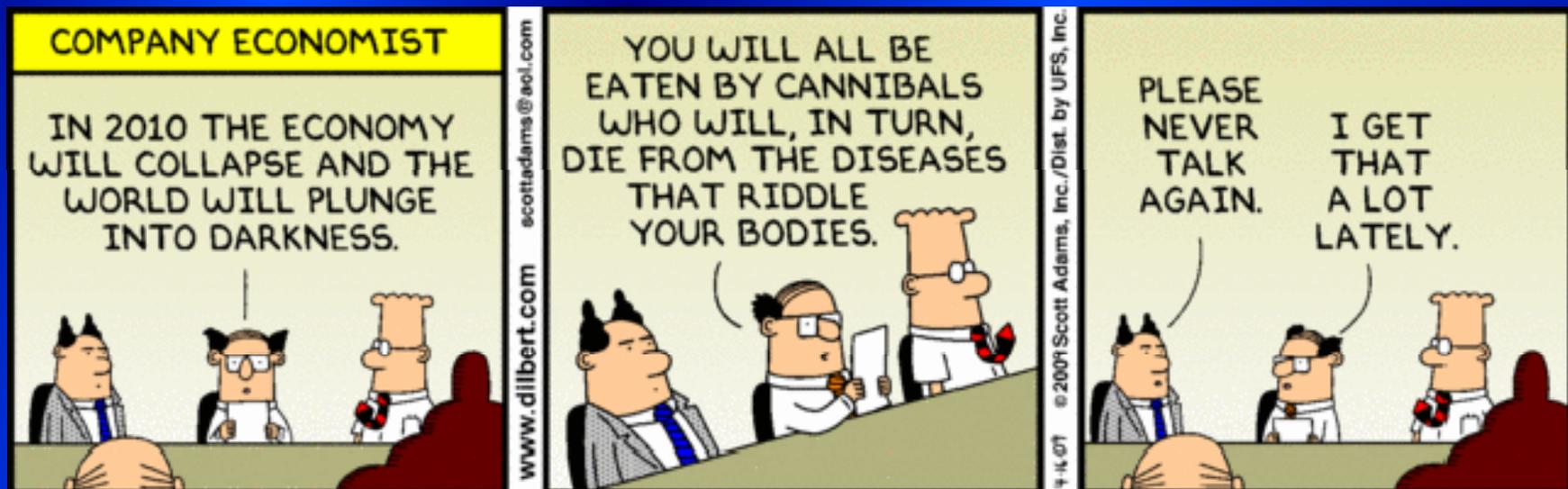


Overview

- We are still in a serious recession
 - There are some signs of hope for the second half of this year
- Plan for the talk:
 - Part I: What's Going on in the Economy Now?
 - Part II: Fiscal and Monetary policy responses to mitigate the financial disruption and the economic downturn

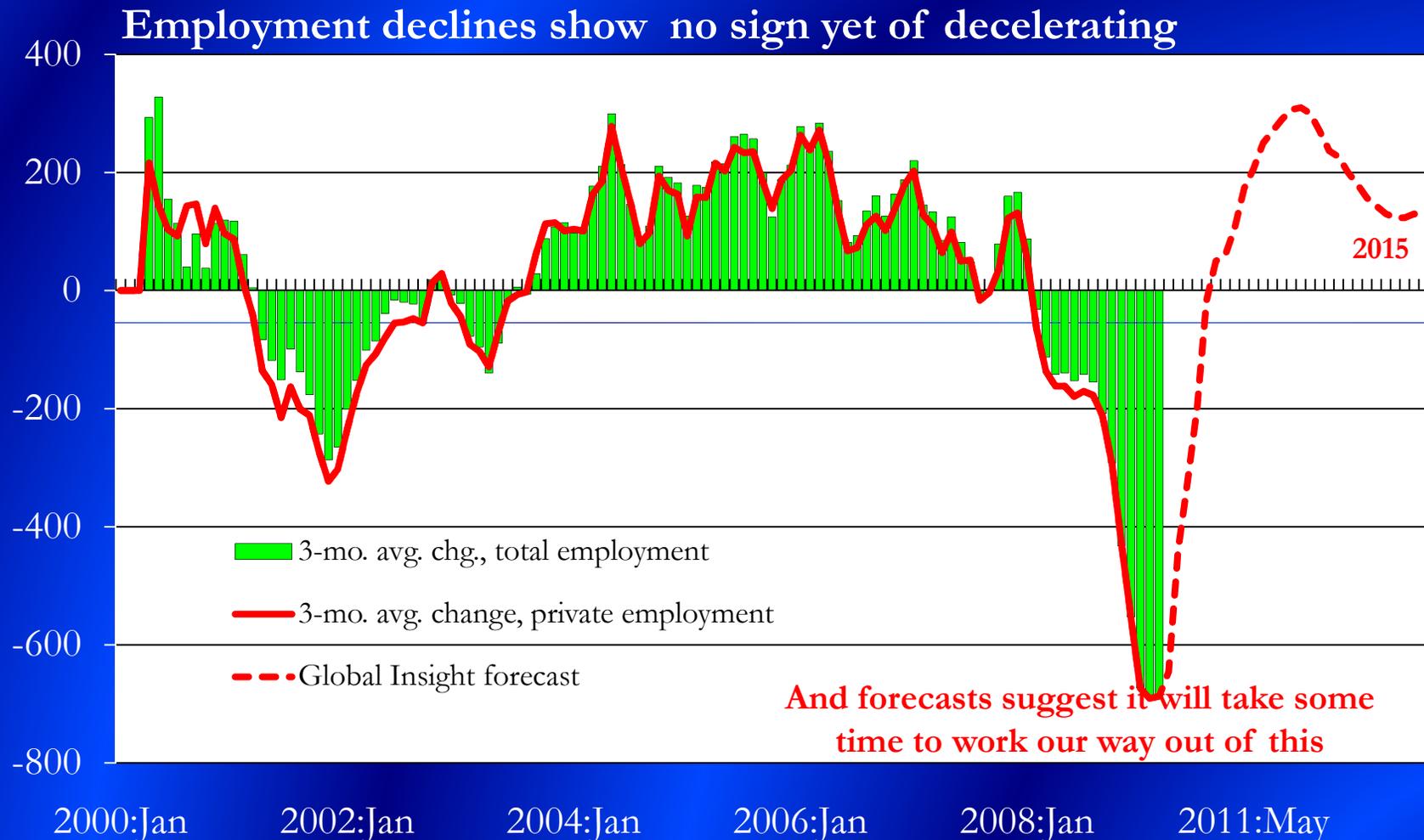
Part I

What's going on in the economy?



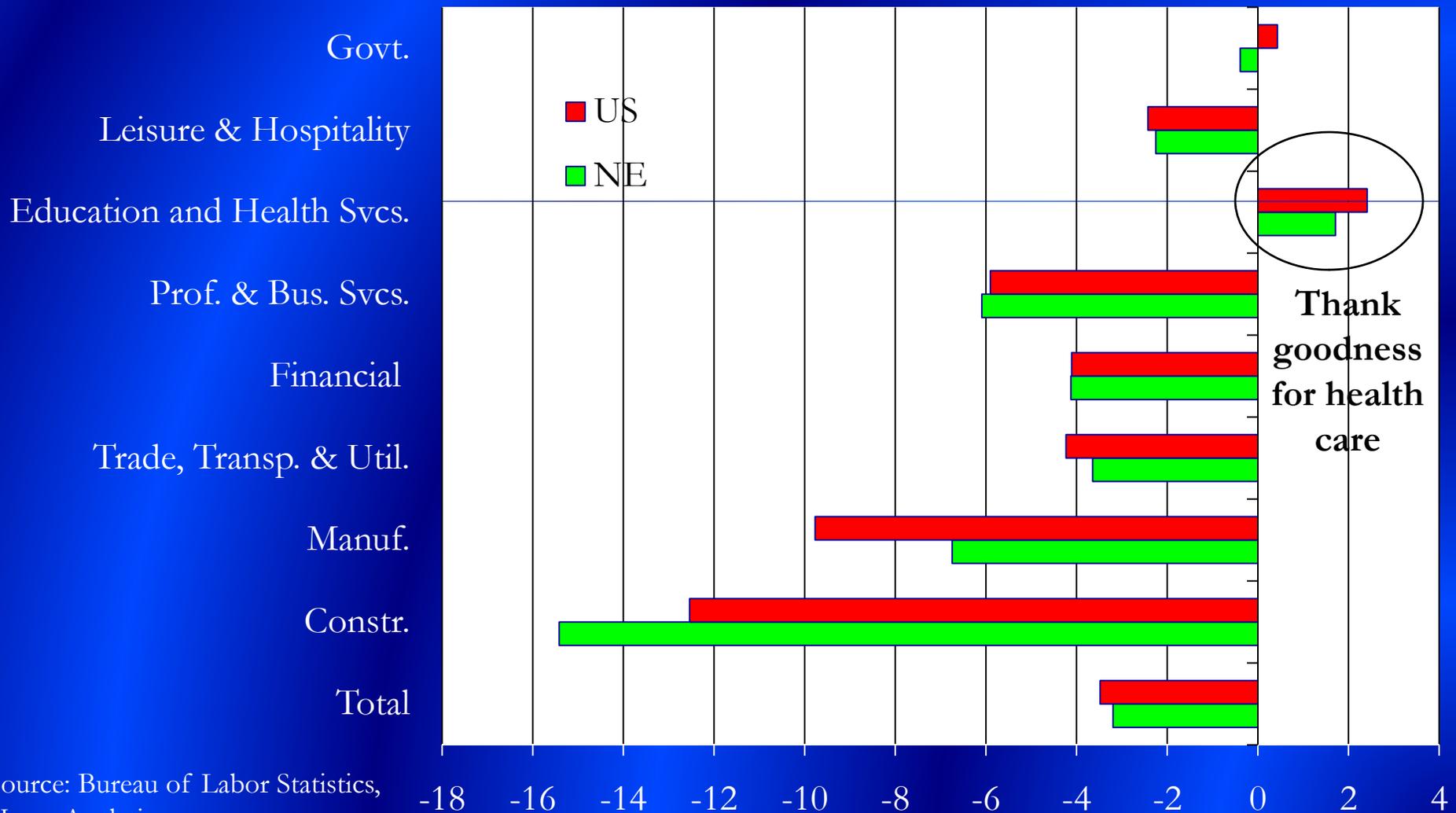
My talk won't be as dire as that

We are still in a serious recession, both nationally...



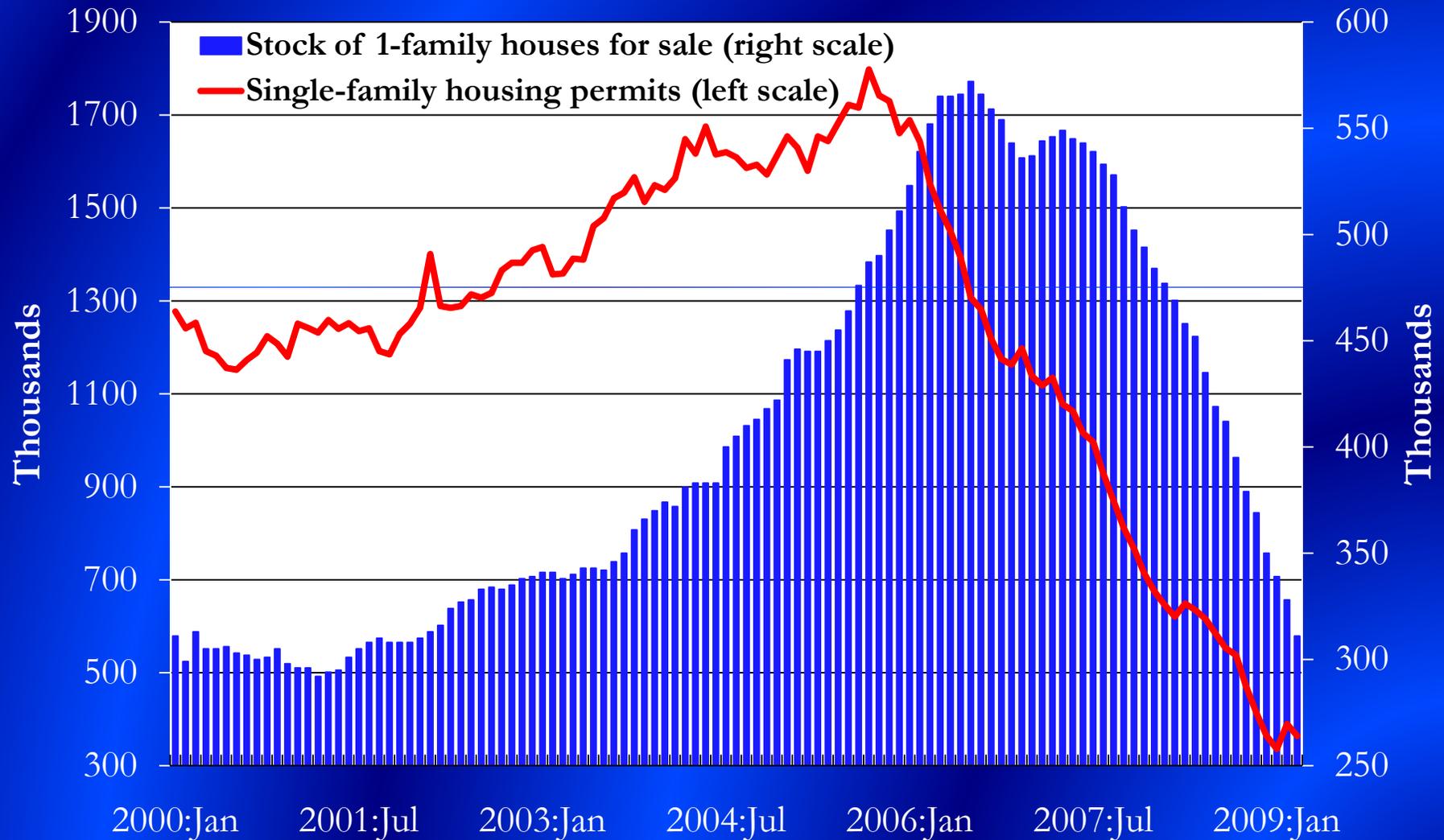
... and in New England

Employment Growth by Sector, March 2008-March 2009



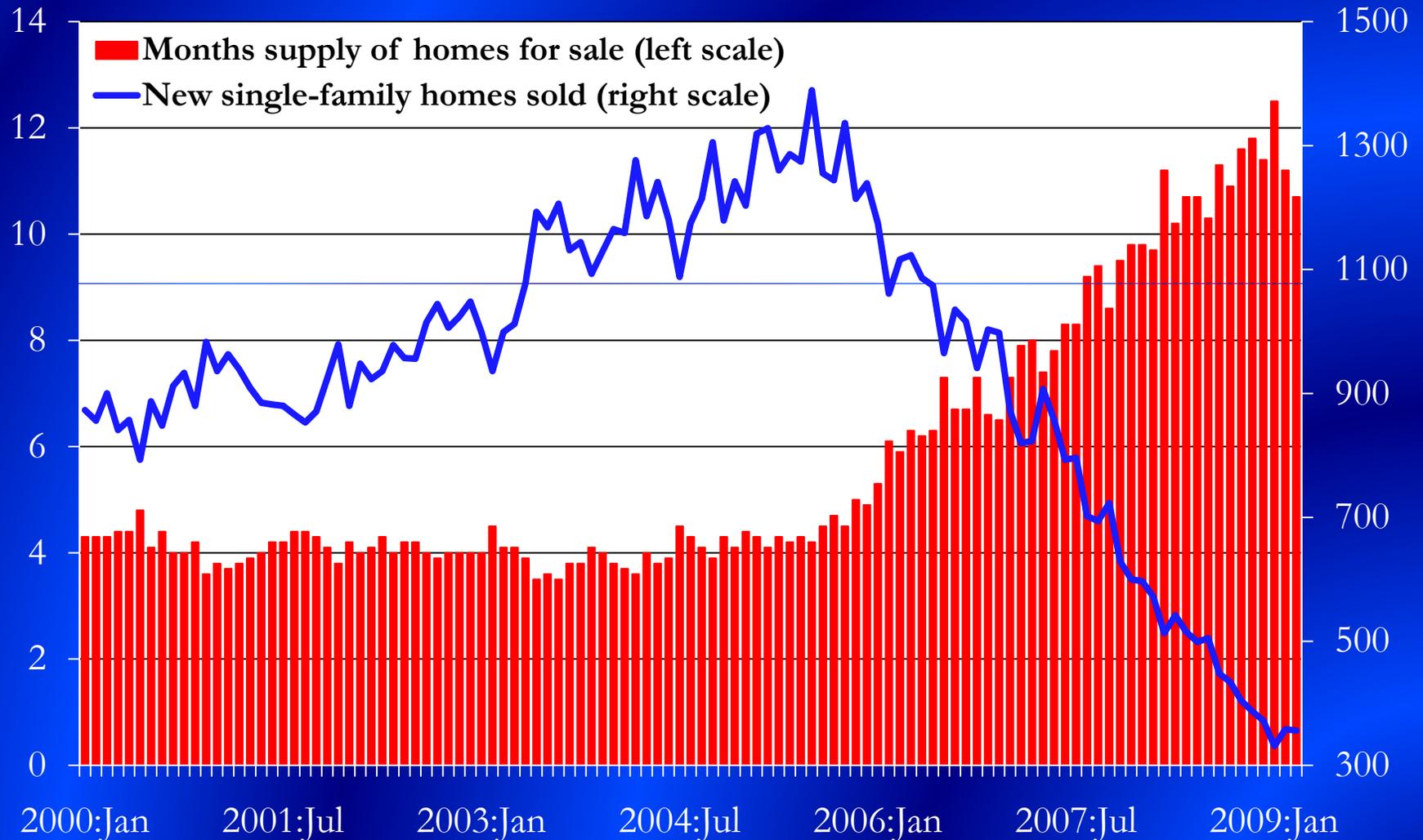
Source: Bureau of Labor Statistics,
Haver Analytics

As home construction has plummeted, the stock of homes for sale has declined markedly



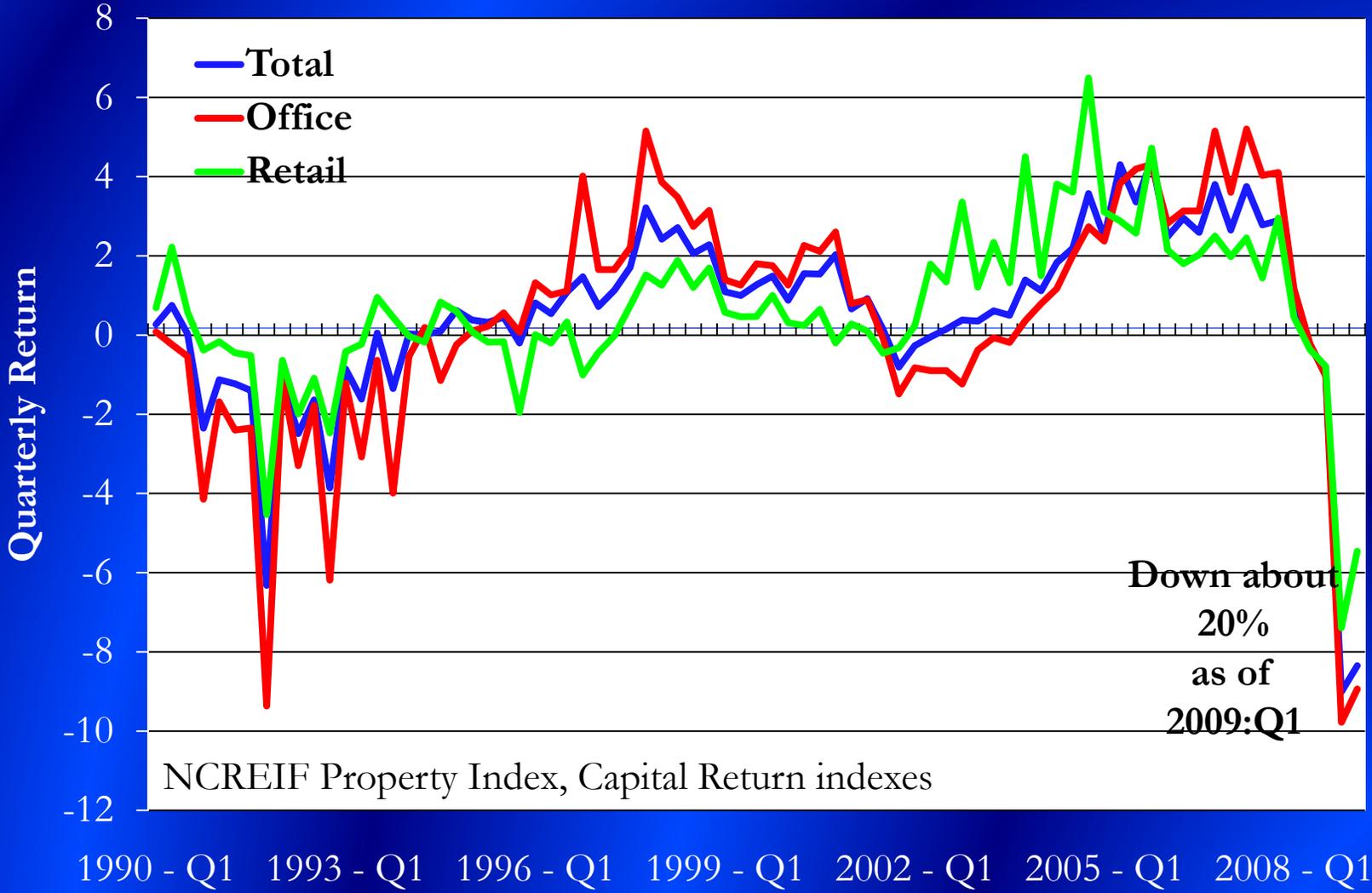
Source: Census Bureau

Despite this breathtaking drop in building, inventories remain very high relative to sales



Source: Census Bureau

Commercial Real Estate: Prices are falling...

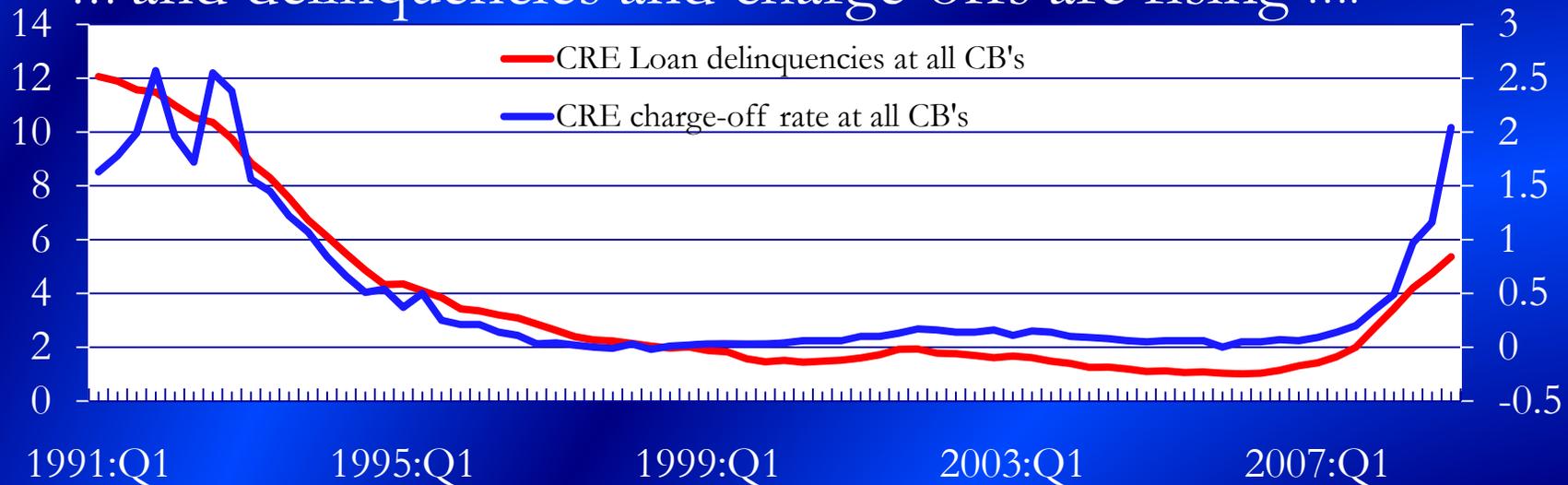


NCREIF Property Index, Capital Return indexes

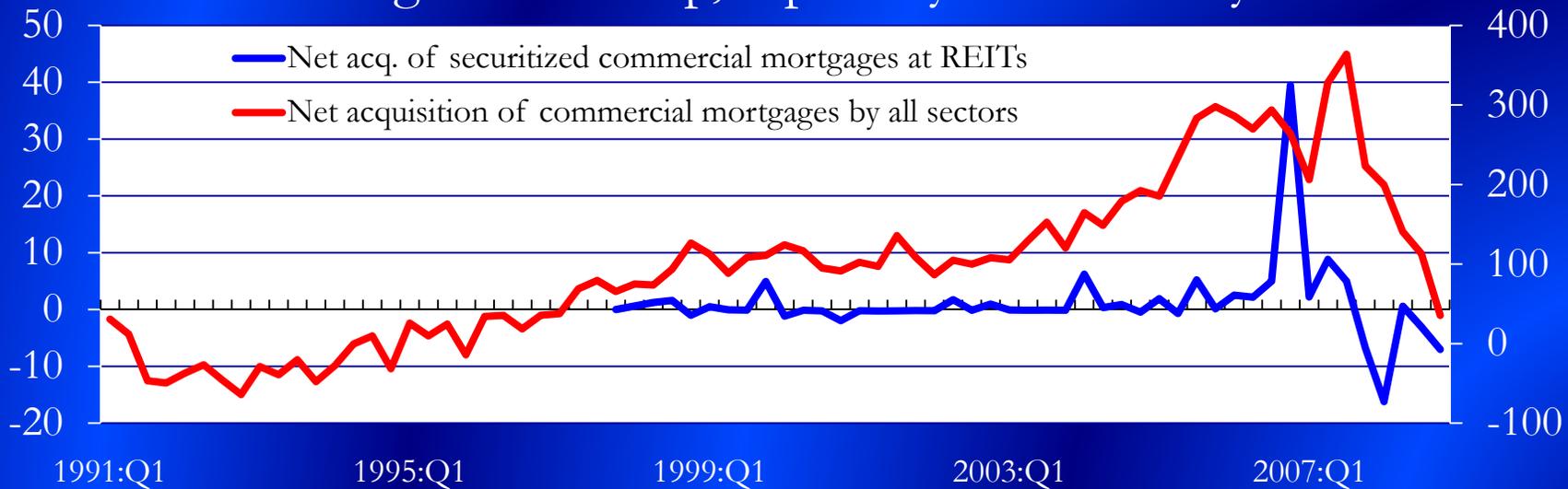
Source: NCREIF

Commercial Real Estate

... and delinquencies and charge-offs are rising ...



...while financing has dried up, especially in secondary markets.

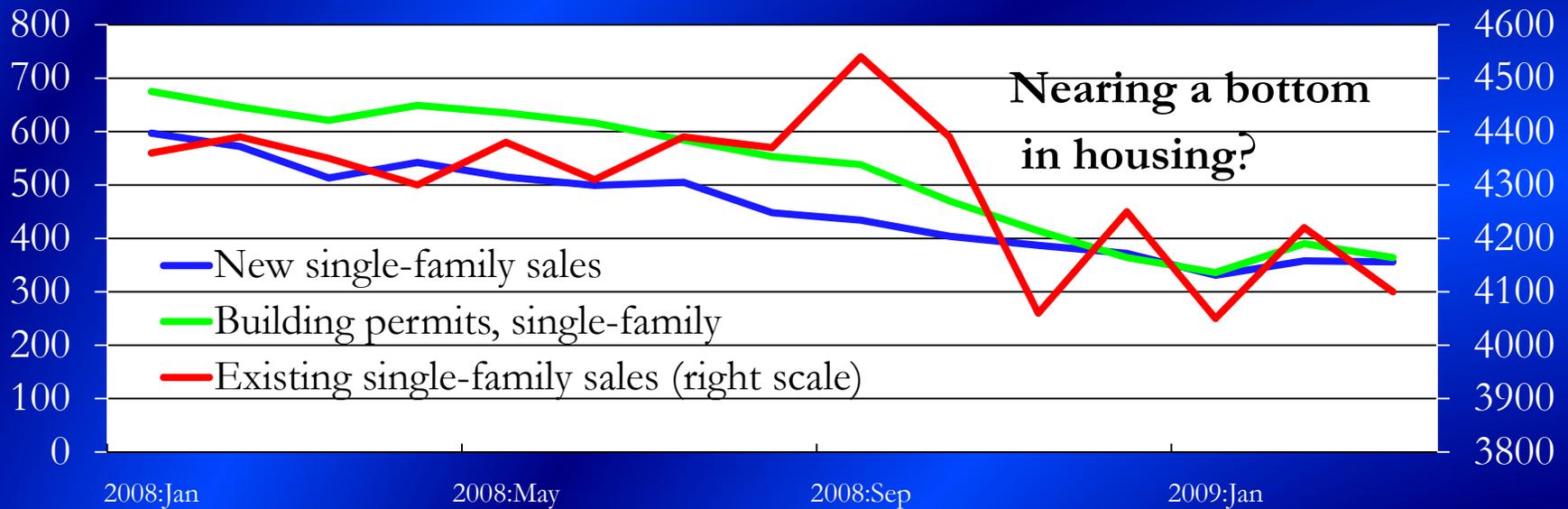


Source: FRB Call Reports, Flow of Funds, Board of Governors of the Federal Reserve System

My sophisticated analysis of CRE can be summarized as follows:



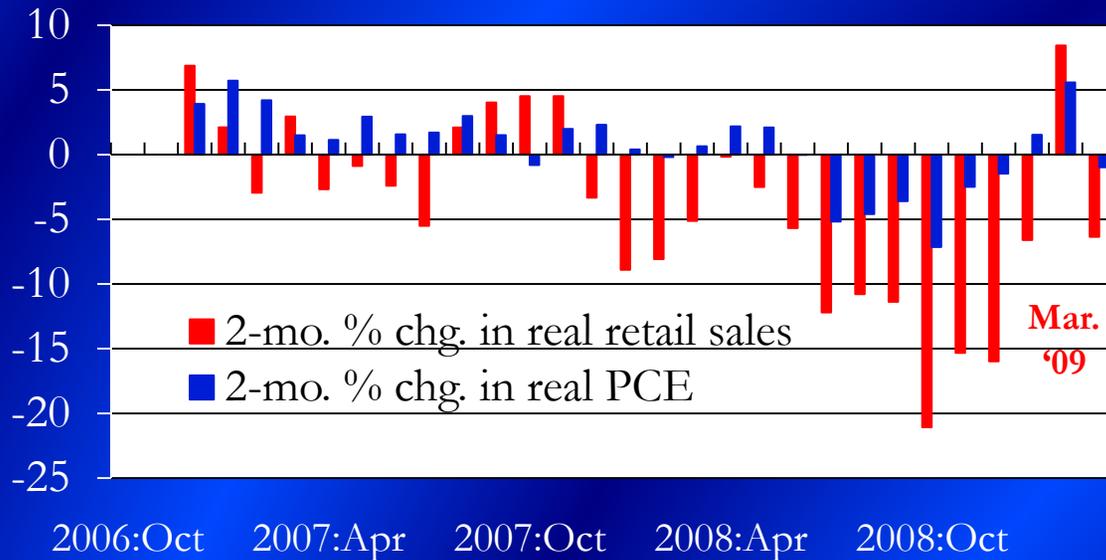
Some hopeful signs in recent data



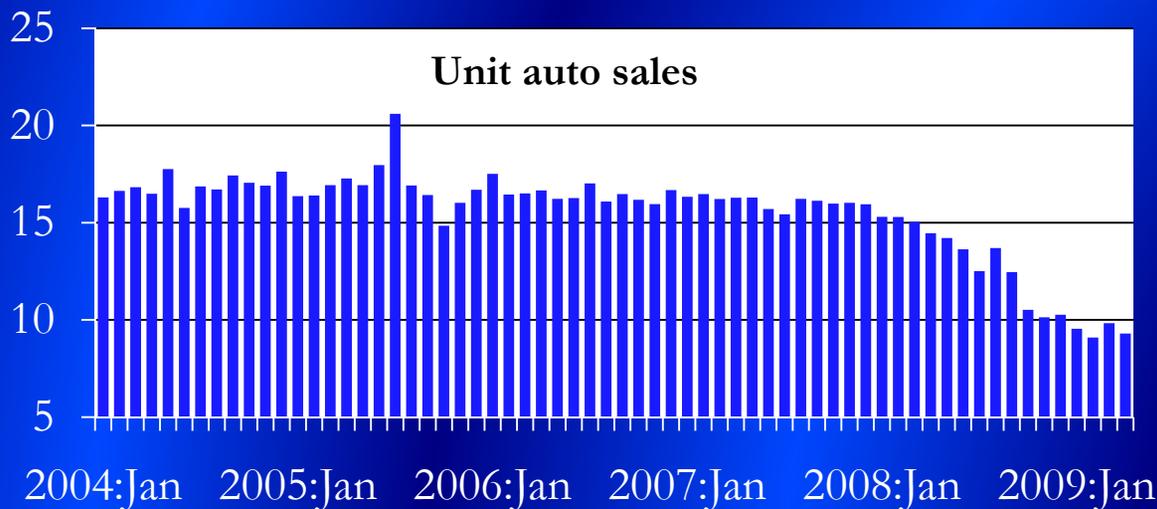
Source: New sales, permits, shipments and orders: Bureau of the Census; Existing sales: Nat'l Assoc. of Realtors

Hopeful signs

Consumer spending data for Q1 have exceeded expectations

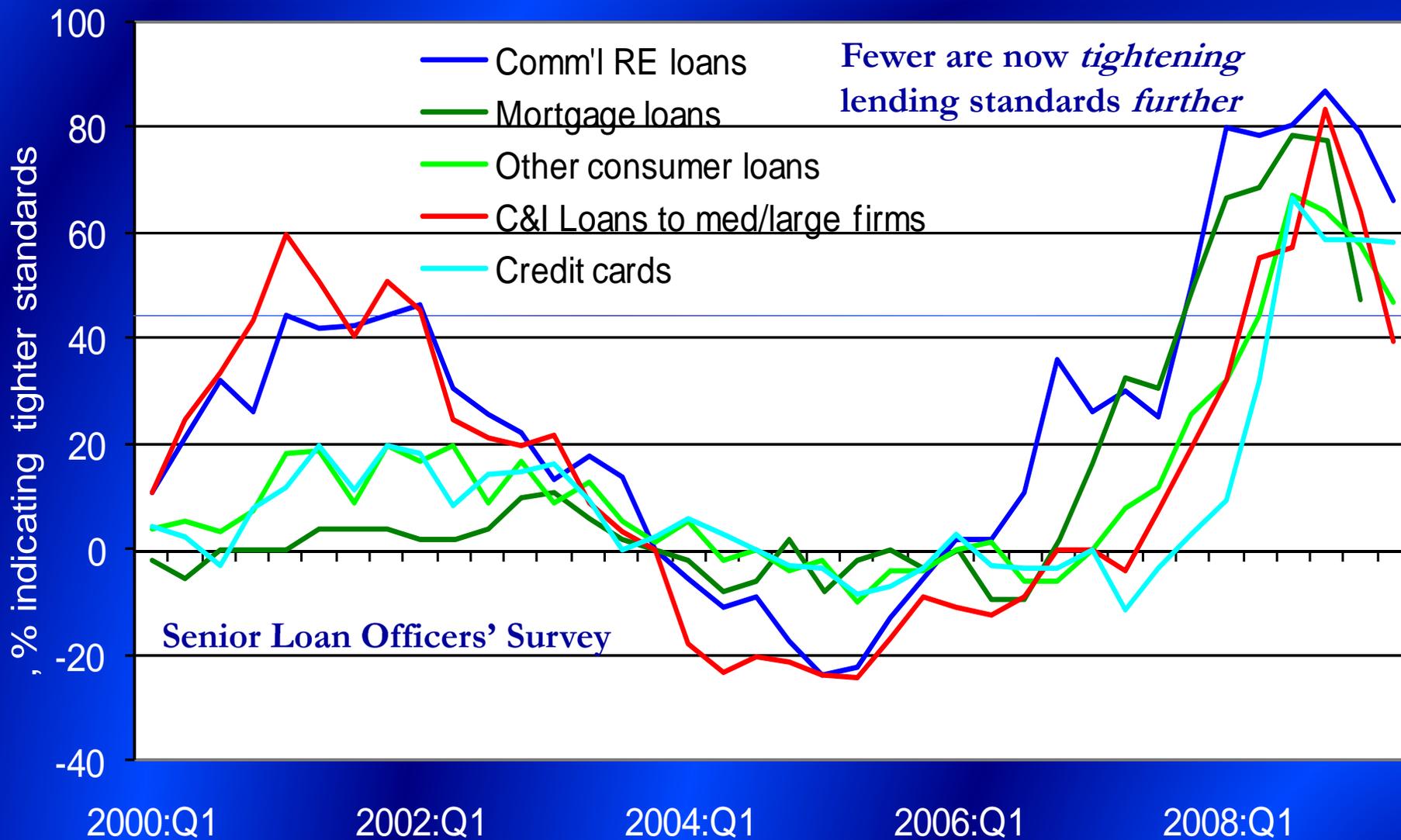


- Altogether, could suggest a bottoming out in some sectors
- But the evidence is a bit skimpy at present, and the fundamentals (wealth, jobs, income, etc.) remain very weak



Source: Bureau of the Census (retail sales), Bureau of Economic Analysis (PCE, unit auto sales)

Financial market conditions: Credit standards still tight, for all markets



Sources: Federal Reserve Board Senior Loan Officers Survey

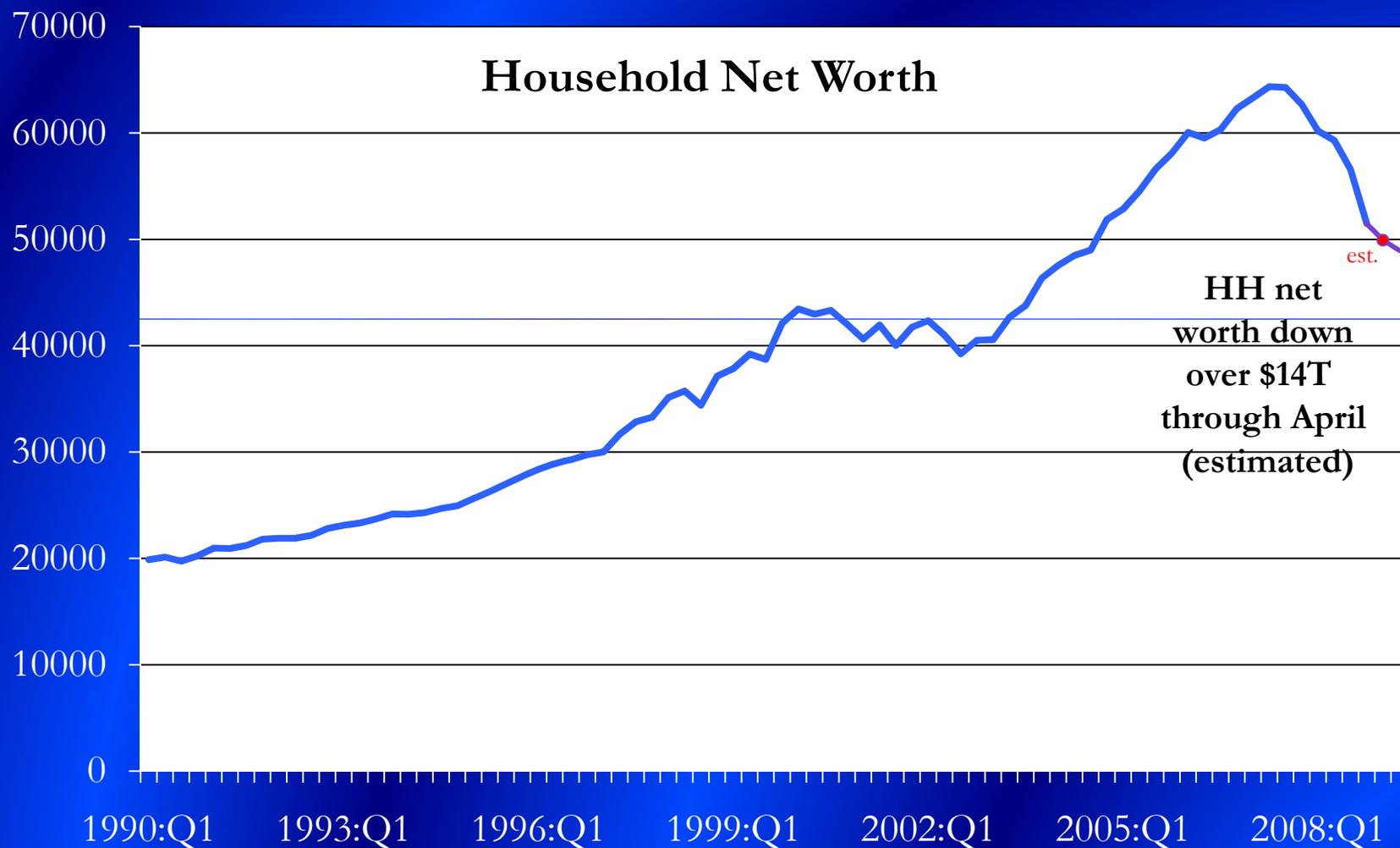
Equity markets have responded favorably of late

Both to the “glimmers” and to recent policy announcements



Source: S&P 500:New York Times; House prices: S&P Case Shiller

Despite the equity rally, overall household net worth remains well down

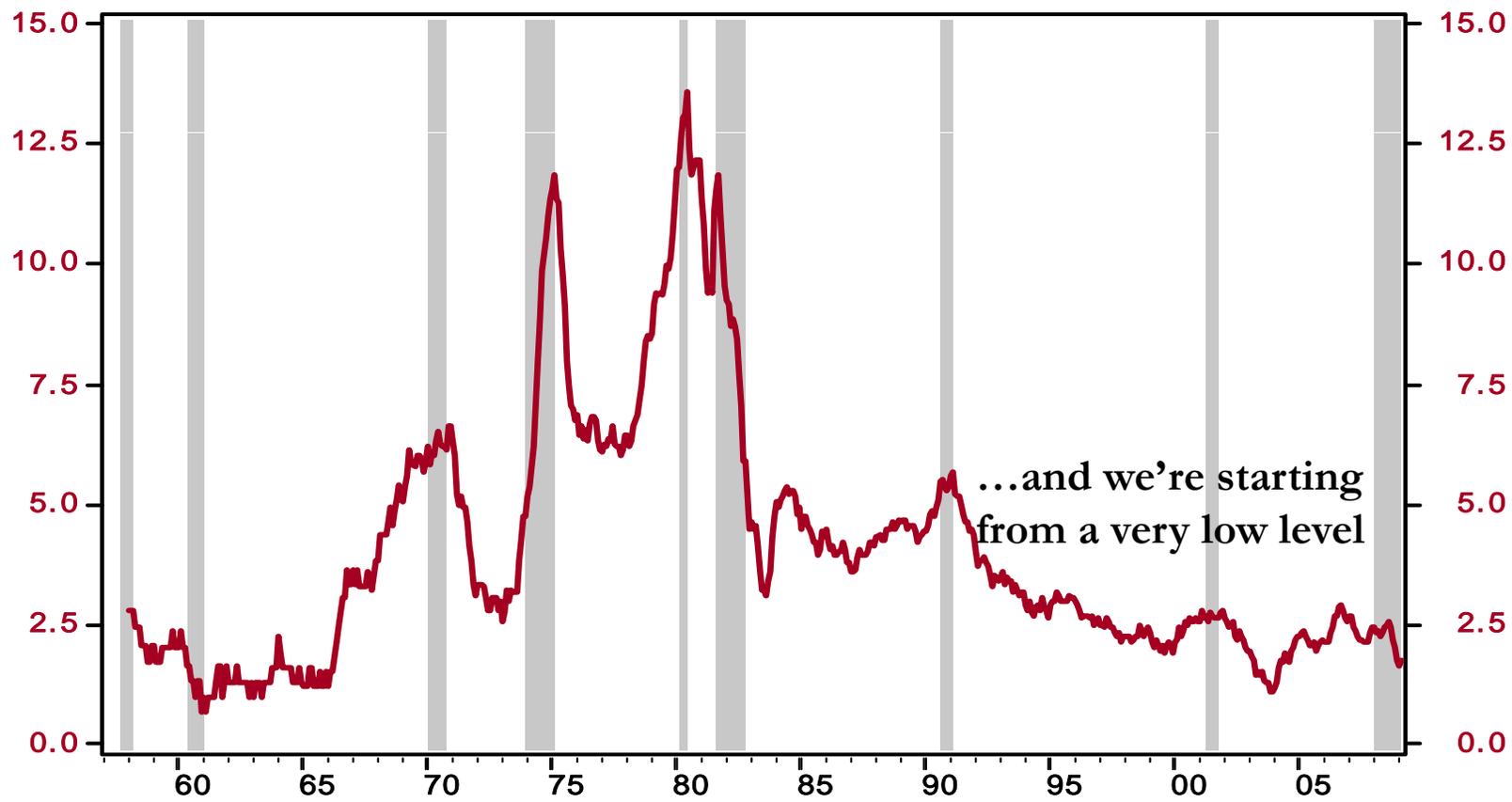


Source: Board of Governors, Flow of Funds Accounts

What about inflation? Are we hosed?

Inflation always declines during recessions

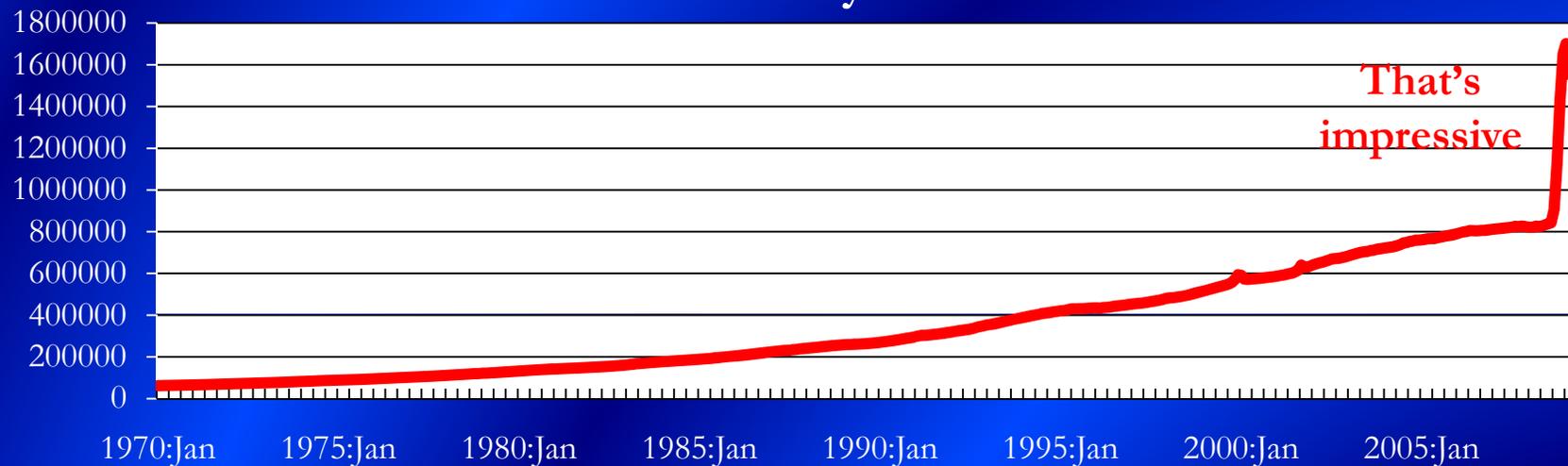
CPI excl. food and energy prices
% change, year to year



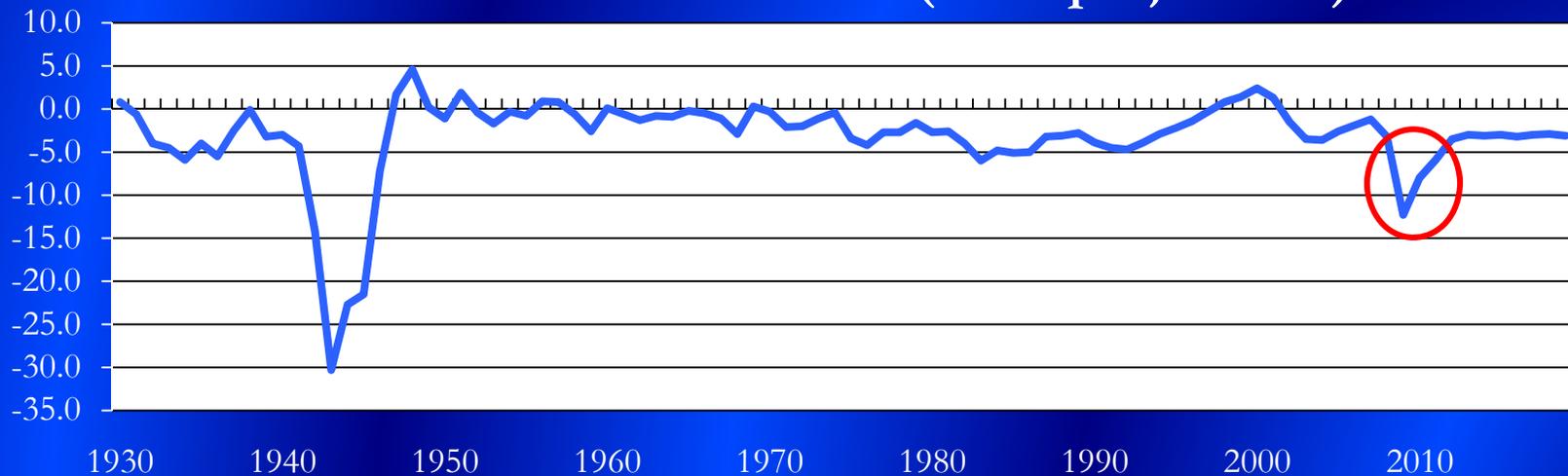
Source: Bureau of Labor Statistics /Haver Analytics

But what about later—will the bloated Fed balance sheet or the deficit cause inflation?

Monetary Base



Federal deficit as % of GDP (CBO projections)



Source: Federal Reserve H.3 Release, Bureau of Economic Analysis, Congressional Budget Office

Will these cause inflation?

Probably not

- Monetary base needs to shrink (*but later*)
 - Terms for most liquidity programs set to be unappealing as economy recovers
 - Those that aren't—we will extinguish
- Deficit
 - Should not “crowd out” private spending, given the significant amount of excess capacity today
 - If deficit declines as economy recovers (tax revenues rise, programs expire), we should be ok
 - Still, the stock of debt matters: cost of financing may rise down the road a piece

Outlook summary

- Weak first half of 2009
 - “Growth” averaging about -4%, with $Q2 > Q1$
- Slower rate of decline/flattening out in second half of 2009?
 - Help from tax rebates, other fiscal stimulus, liquidity, credit and capital programs
- Recovery—whenever it occurs—likely to be slow
 - Wealth overhang, sluggish foreign growth, financial market problems, ...

Part II

Monetary and Fiscal Policy Responses

Fed responses to financial market problems

■ Term Auction Facility (TAF)

- Lend to banks, but remove stigma of discount window borrowing

■ Commercial paper/MMMF lending facilities

- Help commercial-paper and ABCP-based MMMF's to meet redemptions, continue funding (over \$300B)

■ MBS, Treasury purchases (up to \$1.25T, \$300B)

- 30-year conforming rates down 1-1.5 ppts. (anticipatory effect)

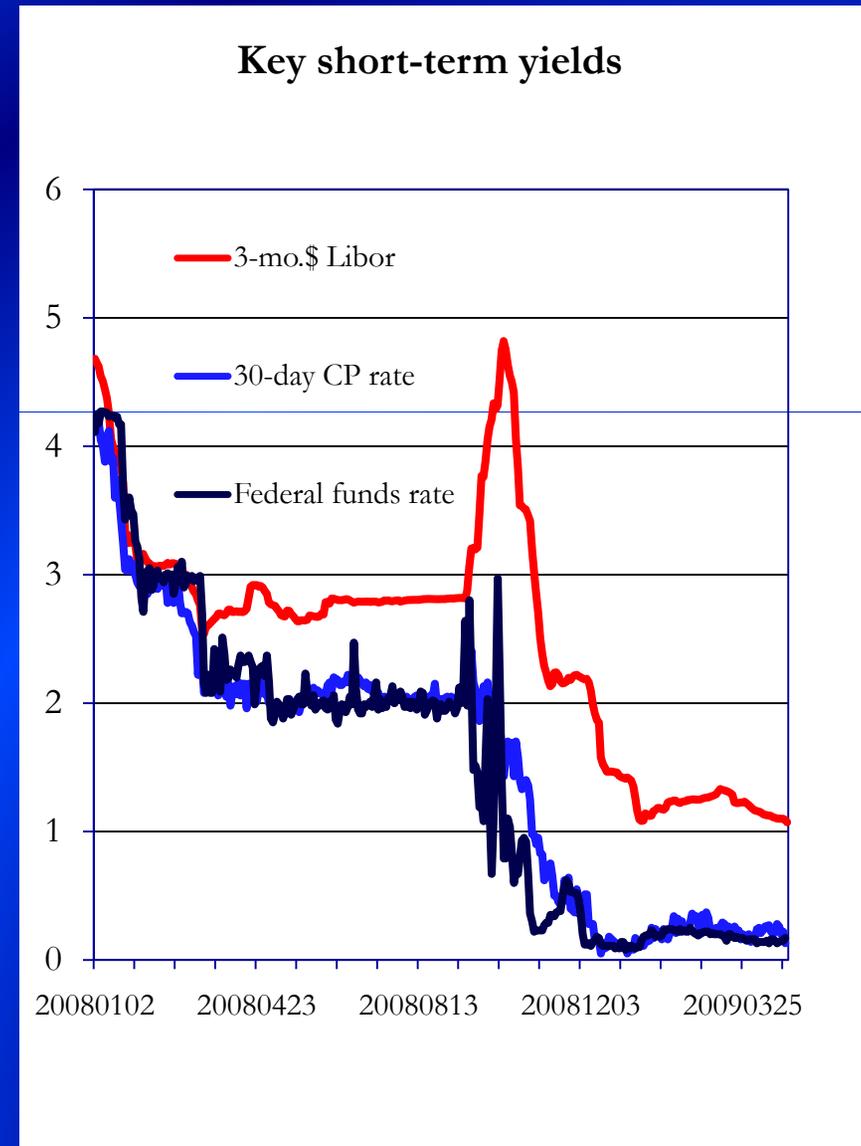
■ ABS facilities (TALF)

- Buy asset-backed securities, up to \$200B (autos, credit cards, ...)
- Buy “legacy securities” (with PPIP program)—CMBS, RMBS

■ FRMLFFA (Facility for Restricting Multi-Letter Fed Facility Acronyms)

Effects of Fed actions

- Short-term markets
 - Commercial paper yields improved
 - Short-term borrowing spreads(Libor, etc.) better
- Improved, but still stressed

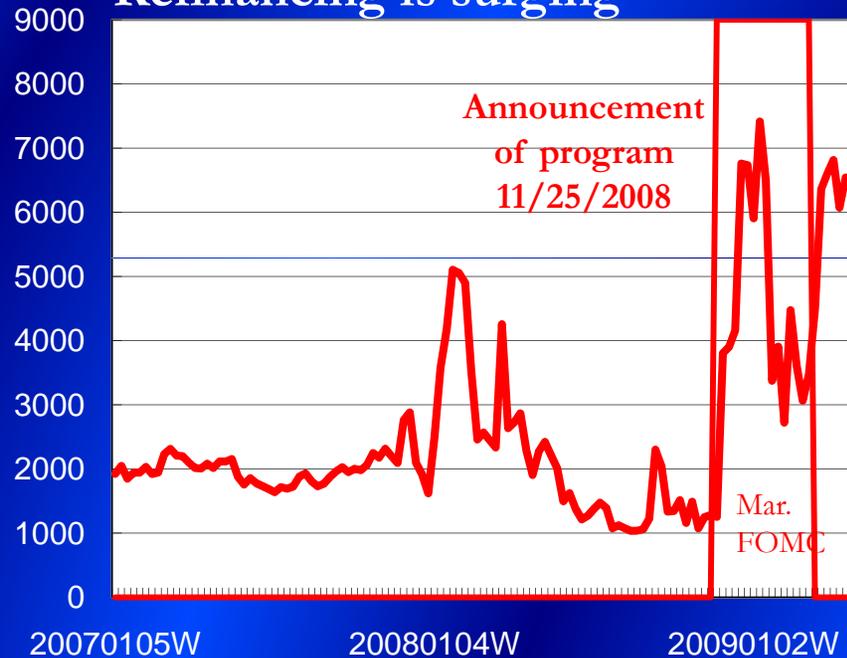


Source: Libor: Financial Times; Commercial paper: Board of Governors; Fed funds rate: FRB New York

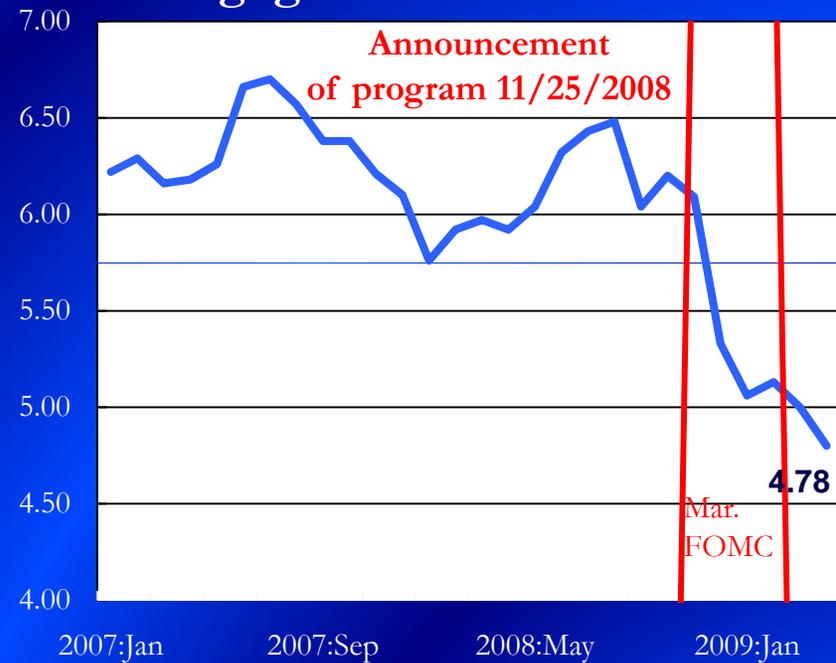
Effects of Fed actions

■ Mortgage market improvements

Refinancing is surging



Mortgage rates are down



■ Treasury yield improvements less obvious

- 10-year about flat since mid-March
- Fighting the effects of pending federal deficits?

Source: Refi index: Mortgage Bankers' Association; 30-yr. mortgage rate: FHLMC

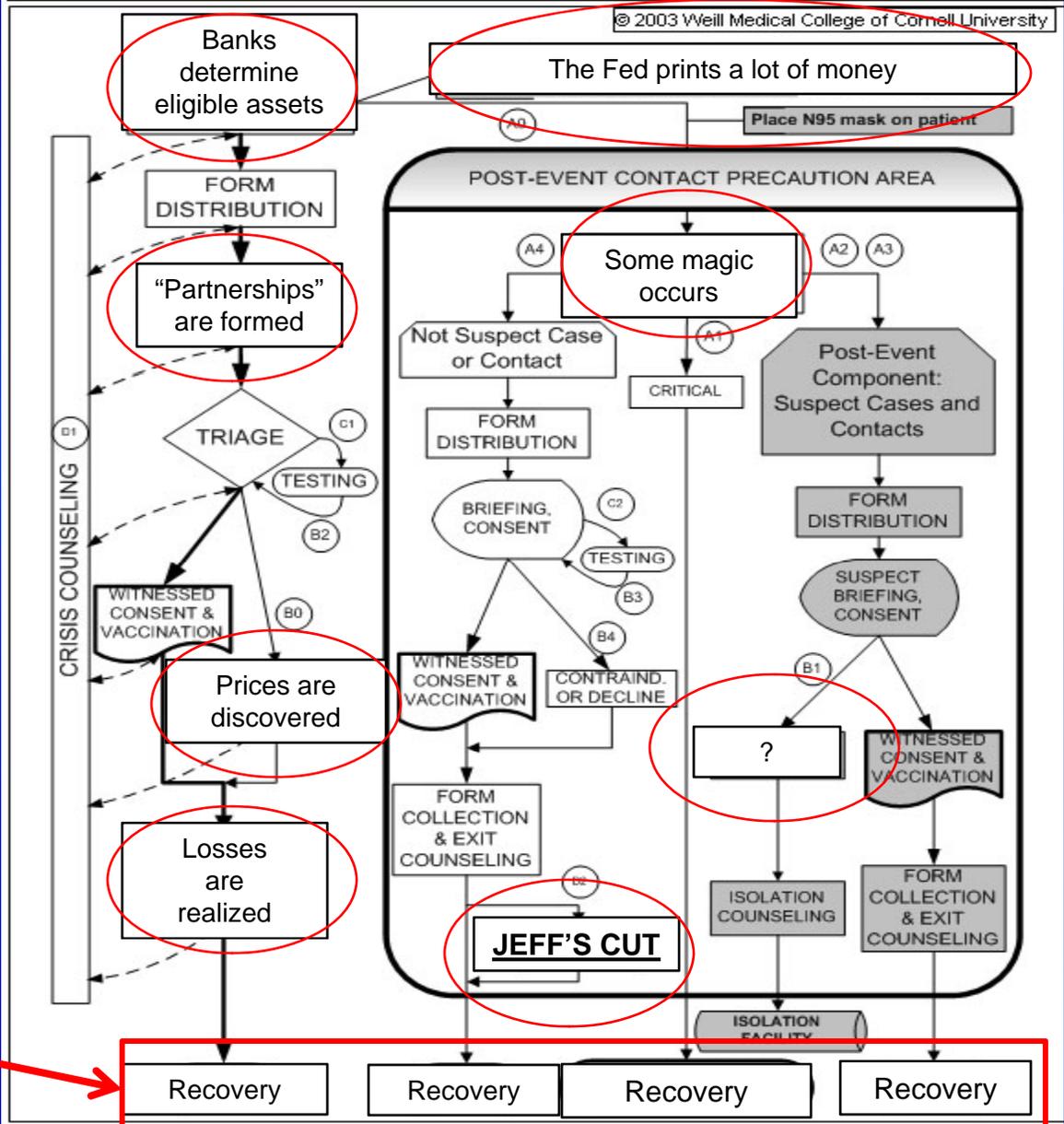
Fiscal responses: the stimulus package

- The package is sizable, but the effect will be smaller than its dollar value
- We estimate about
 - 2-3 percentage points added to GDP by year-end 2010
 - Less than nominal size (\$787B) because:
 - Expect only 70% of tax cuts spent;
 - AMT was not new stimulus;
 - Much of S&L spending delayed until later in 2010/2011 or beyond

Fixing the Banks: The capital adequacy program

- “Stress test” results to be announced Thursday
- Not an easy thing to do
 - Large, extremely complex organizations
 - Somewhat different accounting standards for thrifts, comm’l banks, merged institutions
 - Quite a few lines of business to evaluate
 - Mortgage, non-mortgage consumer, portfolio, reserves, commercial RE, C&I loans, credit card

Fixing the Banks: The PPIP made simple



All roads lead to recovery

Fixing the Banks: “Legacy Loans” Plan

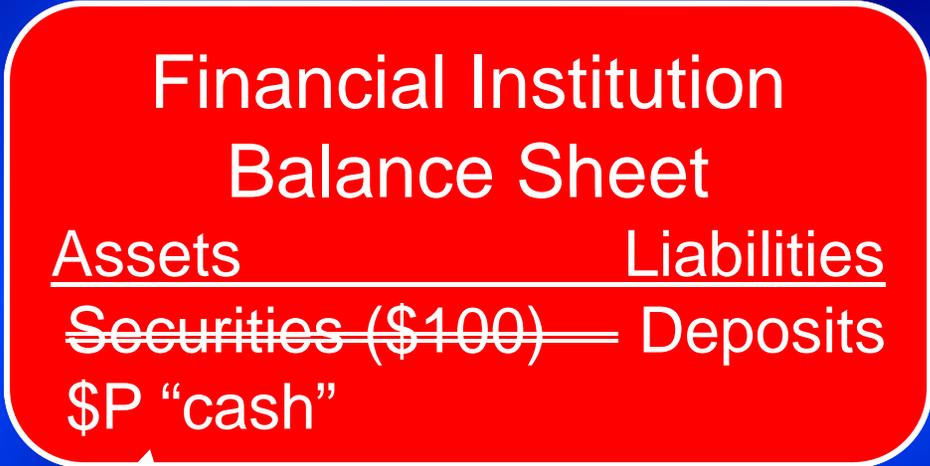
<u>Assets</u>	<u>Liabilities</u>
Loans (\$100)	Deposits
\$P “cash”	

Private bidders determine price (\$P) at auction

- 50/50 equity shares
- No more than 6:1 D/E

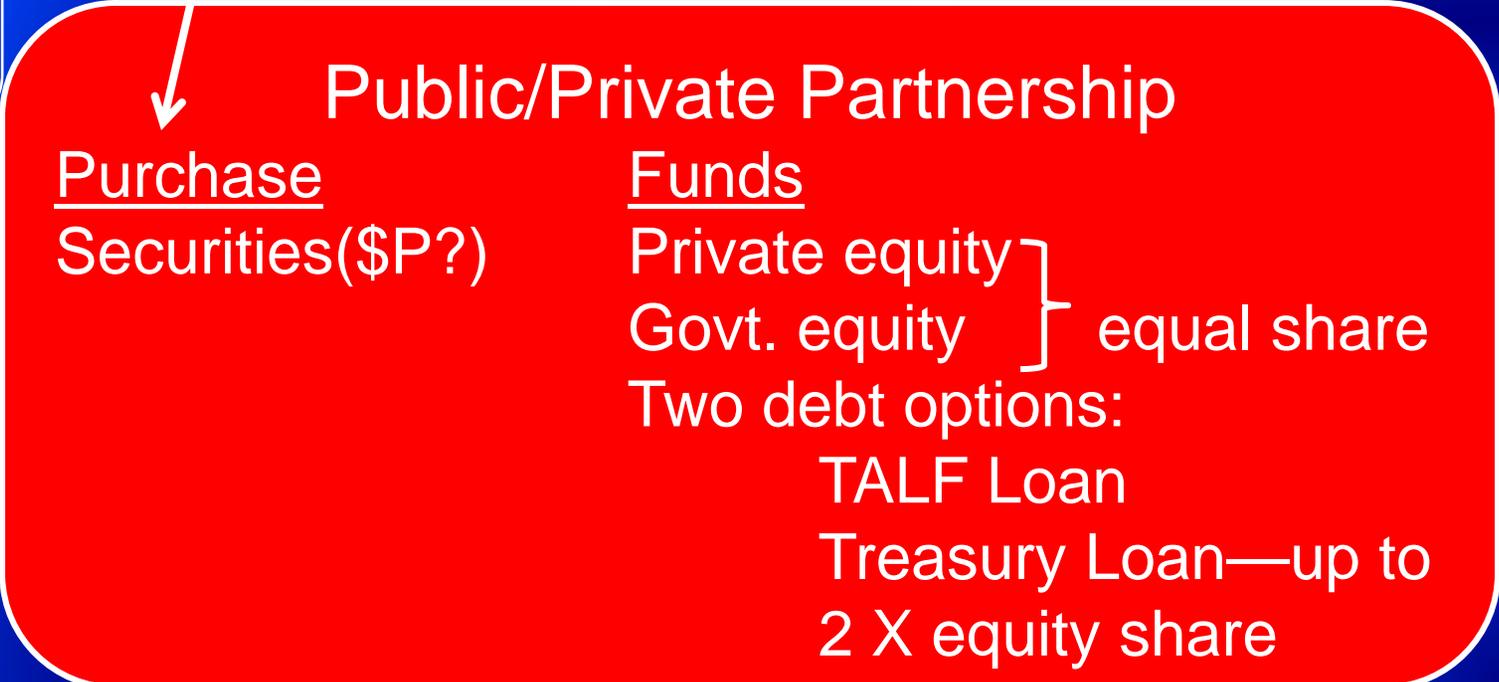
<u>Purchase</u>	<u>Funds</u>
Loans (\$P?)	Private equity (.07 x \$P)
	Govt. equity (.07 x \$P)
	FDIC-insured debt (.86 X \$P)

Fixing the Banks: “Legacy Securities Plan”



- Securities
will include:
- CMBS
 - RMBS (Jumbos)

Private bidders determine price (\$P) at auction



Lessons learned from these crises

■ What have we learned?

- We are infinitely capable of getting ourselves in trouble.
- That's probably here to stay.
- Regulation is to self-regulation as important is to self-important^a.
- A “AAA” rating for a fancy new asset really means “Hey, I paid good money for this rating”
- When it comes right down to it there's only one institution you can trust:

^aWillem Buiter, 2008

In summary

- The economy is still struggling
 - Some signs of a slowing pace of decline
 - A modest recovery could take shape later this year—
but it depends on policies working well
- Fed policies
 - Purchase of mortgage securities—spur housing
- Fiscal policies
 - PPIP plan, bank re-capitalization, stimulus package
- We may get out of this alive