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### Economic Outlook and Financial Markets

Federal Reserve System: Board of Governors

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## Testimony

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October 20, 2008

### *Economic outlook and financial markets*

Chairman Ben S. Bernanke

Before the Committee on the Budget, U.S. House of Representatives

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Chairman Spratt, Representative Ryan, and other members of the Committee, I appreciate this opportunity to discuss recent developments in financial markets, the near-term economic outlook, and issues surrounding the possibility of a second package of fiscal measures.

#### **Financial Developments**

As you know, financial markets in the United States and some other industrialized countries have been under severe stress for more than a year. The proximate cause of the financial turmoil was the steep increase and subsequent decline of house prices nationwide, which, together with poor lending practices, have led to large losses on mortgages and mortgage-related instruments by a wide range of institutions. More fundamentally, the turmoil is the aftermath of a credit boom characterized by underpricing of risk, excessive leverage, and an increasing reliance on complex and opaque financial instruments that have proved to be fragile under stress. A consequence of the unwinding of this boom and the resulting financial strains has been a broad-based tightening in credit conditions that has restrained economic growth.

The financial turmoil intensified in recent weeks, as investors' confidence in banks and other financial institutions eroded and risk aversion heightened. Conditions in the interbank lending market have worsened, with term funding essentially unavailable. Withdrawals from prime money market mutual funds, which are important suppliers of credit to the commercial paper market, severely disrupted that market; and short-term credit, when available, has become much more costly for virtually all firms. Households and state and local governments have also experienced a notable reduction in credit availability. Financial conditions deteriorated in other countries as well, putting severe pressure on both industrial and emerging-market economies. As confidence in the financial markets has declined and concerns about the U.S. and global economies have increased, equity prices have been volatile, falling sharply on net.

In collaboration with governments and central banks in other countries, the Treasury and the Federal Reserve have taken a range of actions to ameliorate these financial problems. To address ongoing pressures in interbank funding markets, the Federal Reserve significantly increased the quantity of term funds it auctions to banks and accommodated heightened demands for funding from banks and primary dealers. We have also greatly expanded our currency swap lines with foreign central banks. These swap lines allow the cooperating central banks to supply dollar liquidity in their own jurisdictions, helping to reduce strains in global money markets and, in turn, in our own markets. To address illiquidity and impaired functioning in the market for commercial paper, the Treasury implemented a temporary guarantee program for balances held in money market mutual funds, helping to stem the outflows from these funds. The Federal Reserve put in place a temporary lending facility that provides financing for banks to purchase high-quality asset-backed commercial paper from money market funds, thus providing some relief for money market funds that have needed to sell their holdings to meet redemptions. Moreover, we soon will be implementing a new Commercial Paper Funding Facility that will provide a backstop to commercial paper markets by purchasing highly rated commercial paper from issuers at a term of three months.

The recently enacted Emergency Economic Stabilization Act provided critically important new tools to address the dysfunction in financial markets and thus reduce the accompanying risks to the economy. The Troubled Asset Relief Program (TARP) authorized by the legislation will allow the Treasury to undertake two highly complementary activities. First, the Treasury will use TARP funds to provide capital to financial institutions. Indeed, last week, nine of the nation's largest financial institutions indicated their willingness to accept capital from the program, and many other institutions, large and small, are expected to follow suit in coming weeks. Second, the Treasury will purchase or guarantee troubled mortgage-related and possibly other assets held by banks and other financial institutions. Taken together, these measures should help rebuild confidence in the financial system, increase the

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liquidity of financial markets, and improve the ability of financial institutions to raise capital from private sources.

As another measure to improve confidence, the act also temporarily raised the limit on the deposit insurance coverage provided by the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration from \$100,000 to \$250,000 per account, effective immediately. Unfortunately, the loss of confidence in financial institutions became so severe in recent weeks that additional steps in this direction proved necessary. The FDIC, the Federal Reserve Board, and the Secretary of the Treasury in consultation with the President determined that significant risks to the stability of the financial system were present. With this determination, the FDIC was able to use its authority to provide, for a specified period, unlimited insurance coverage of funds held in non-interest-bearing transactions accounts, such as payroll accounts. In addition, the FDIC announced that it would guarantee the senior unsecured debt of FDIC-insured depository institutions and their associated holding companies. In taking the dramatic steps of providing capital to the banking system and expanding guarantees, the United States consulted with other countries, many of whom have announced similar actions. Given the global nature of the financial system, international consultation and cooperation on actions to address the crisis are important for restoring confidence and stability.

These measures were announced less than a week ago, and, although there have been some encouraging signs, it is too early to assess their full effects. However, I am confident that these initiatives, together with other actions by the Treasury, the Federal Reserve, and other regulators, will help restore trust in our financial system and allow the resumption of more-normal flows of credit to households and firms. I would like to reiterate the critical importance of the recent legislation passed by the Congress; without that action, tools essential for stabilizing the financial system and thereby containing the damage to the broader economy would not have been available. That said, the stabilization of the financial system, though an essential first step, will not quickly eliminate the challenges still faced by the broader economy.

#### **Economic Outlook**

Even before the recent intensification of the financial crisis, economic activity had shown considerable signs of weakening. In the labor market, private employers shed 168,000 jobs in September, bringing the total job loss in the private sector since January to nearly 900,000. Meanwhile, the unemployment rate, at 6.1 percent in September, has risen 1.2 percentage points since January. Incoming data on consumer spending, housing, and business investment have all showed significant slowing over the past few months, and some key determinants of spending have worsened: Equity and house prices have fallen, foreign economic growth has slowed, and credit conditions have tightened. One brighter note is that the declines in the prices of oil and other commodities will have favorable implications for the purchasing power of households. Nonetheless, the pace of economic activity is likely to be below that of its longer-run potential for several quarters.

As I noted, the slowing in spending and activity spans most major sectors. Real personal consumption expenditures for goods and services declined over the summer and apparently fell further in September. Although the weakness in household spending has been widespread, the drop-off in purchases of motor vehicles recently has been particularly sharp. Increased difficulty in obtaining auto loans appears to have contributed to the decline in auto sales. Consumer sentiment has been quite low, reflecting concerns about jobs, gasoline prices, the state of the housing market, and stock prices.

In the business sector, orders and shipments for nondefense capital goods have generally slowed, and forward-looking indicators suggest further declines in business investment in coming months. Outlays for construction of nonresidential buildings, which had posted robust gains over the first half of the year, also appear to have decelerated in the third quarter. Although the less favorable outlook for sales has undoubtedly played a role, the softening in business investment also appears to reflect reduced credit availability from banks and other lenders.

As has been the case for some time, the housing market remains depressed, with sales and construction of new homes continuing to decline. Indeed, single-family housing starts fell 12 percent in September, and permit issuance also dropped sharply. With demand for new homes remaining at a low level and the backlog of unsold homes still sizable, residential construction is likely to continue to contract into next year.

International trade provided considerable support for the U.S. economy over the first half of the year. Domestic output was buoyed by strong foreign demand for a wide range of U.S. exports, including agricultural products, capital goods, and industrial supplies. Although trade should continue to be a positive factor for the U.S. economy, its contribution to U.S. growth is likely to be less dramatic as global growth slows.

The prices of the goods and services purchased by consumers rose rapidly earlier this year, as steep

increases in the prices of oil and other commodities led to higher retail prices for fuel and food, and as firms were able to pass through a portion of their higher costs of production. These effects are now reversing in the wake of the substantial declines in commodity prices since the summer. Moreover, the prices of imports now appear to be decelerating, and consumer surveys and yields on inflation-indexed Treasury securities suggest that expected inflation has held steady or eased. If not reversed, these developments, together with the likelihood that economic activity will fall short of potential for a time, should bring inflation down to levels consistent with price stability.

Over time, a number of factors are likely to promote the return of solid gains in economic activity and employment in the context of low and stable inflation. Among those factors are the stimulus provided by monetary policy, the eventual stabilization in housing markets that will occur as the correction runs its course, improvements in our credit markets as the new programs take effect and market participants work through remaining problems, and the underlying strengths and recuperative powers of our economy. The time needed for economic recovery, however, will depend greatly on the pace at which financial and credit markets return to more-normal functioning. Because the time that will be needed for financial normalization and the effects of ongoing credit problems on the broader economy are difficult to judge, the uncertainty currently surrounding the economic outlook is unusually large.

#### **Fiscal Policy**

I understand that the Congress is evaluating the desirability of a second fiscal package. Any fiscal action inevitably involves tradeoffs, not only among current needs and objectives but also--because commitments of resources today can burden future generations and constrain future policy options--between the present and the future. Such tradeoffs inevitably involve value judgments that can properly be made only by our elected officials. Moreover, with the outlook exceptionally uncertain, the optimal timing, scale, and composition of any fiscal package are unclear. All that being said, with the economy likely to be weak for several quarters, and with some risk of a protracted slowdown, consideration of a fiscal package by the Congress at this juncture seems appropriate.

Should the Congress choose to undertake fiscal action, certain design principles may be helpful. To best achieve its goals, any fiscal package should be structured so that its peak effects on aggregate spending and economic activity are felt when they are most needed, namely, during the period in which economic activity would otherwise be expected to be weak. Any fiscal package should be well-targeted, in the sense of attempting to maximize the beneficial effects on spending and activity per dollar of increased federal expenditure or lost revenue; at the same time, it should go without saying that the Congress must be vigilant in ensuring that any allocated funds are used effectively and responsibly. Any program should be designed, to the extent possible, to limit longer-term effects on the federal government's structural budget deficit.

Finally, in the ideal case, a fiscal package would not only boost overall spending and economic activity but would also be aimed at redressing specific factors that have the potential to extend or deepen the economic slowdown. As I discussed earlier, the extraordinary tightening in credit conditions has played a central role in the slowdown thus far and could be an important factor delaying the recovery. If the Congress proceeds with a fiscal package, it should consider including measures to help improve access to credit by consumers, homebuyers, businesses, and other borrowers. Such actions might be particularly effective at promoting economic growth and job creation.

Thank you. I would be pleased to take your questions.

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