

Current economic conditions and A retrospective (?) on the economic crisis

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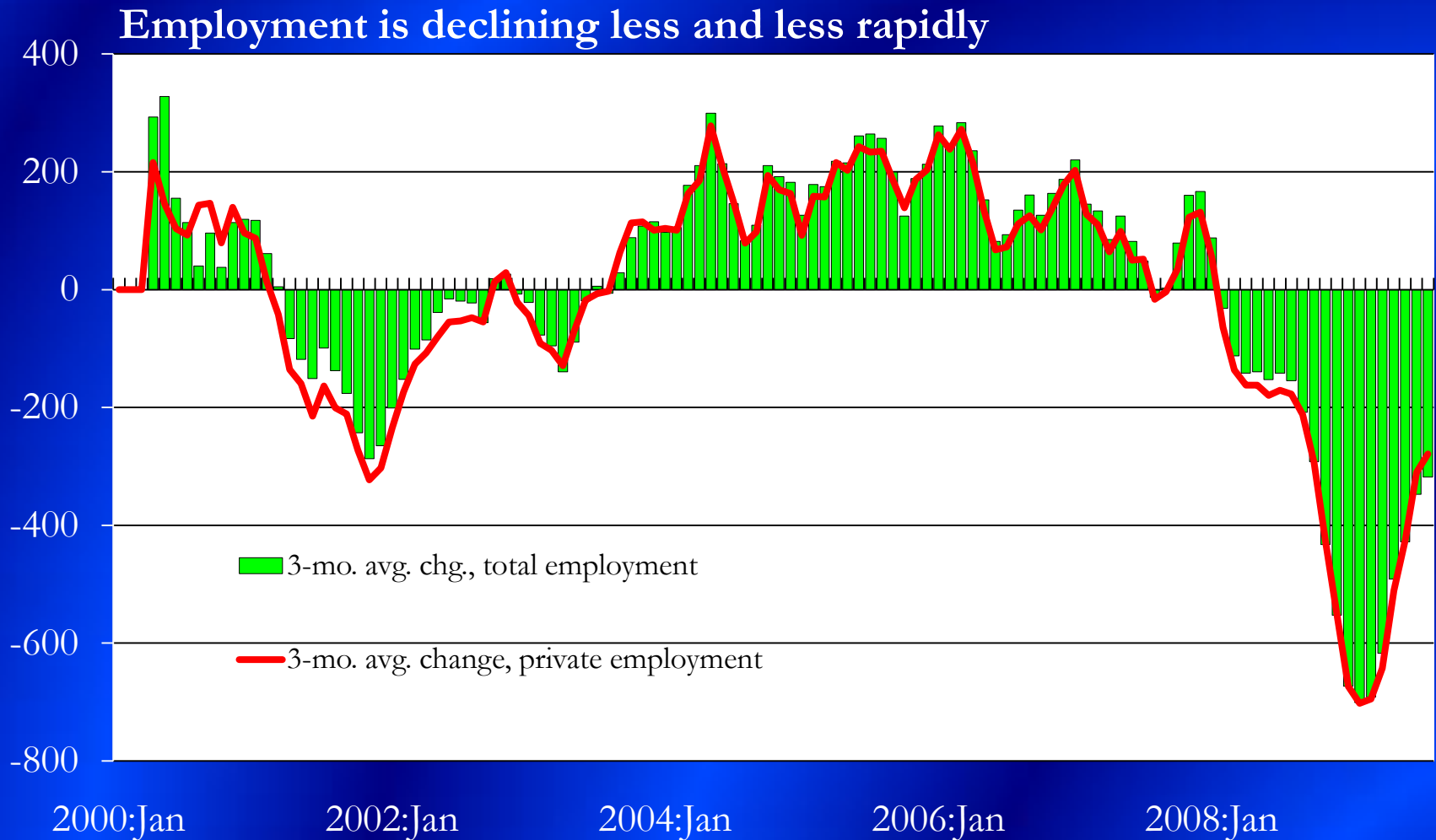
Plan for the talk

- Part I: Review economic conditions and their implications for the outlook
- Part II: Look back on the financial crisis (to date)
 - Innovative Fed actions and market responses
 - Is deflation a concern?
 - Is inflation a concern? (Balance sheet issues)

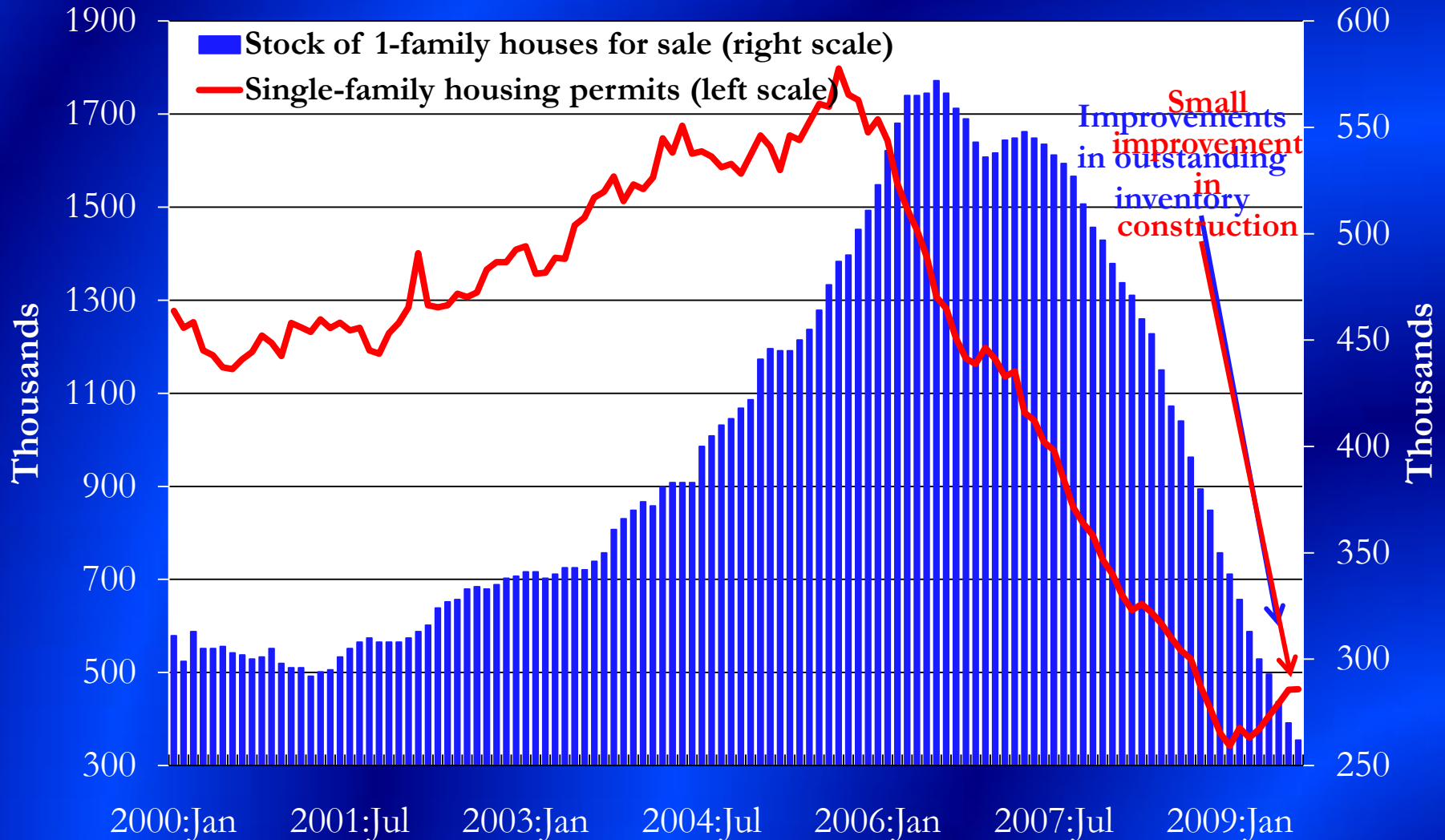
Part I

Economic conditions and outlook

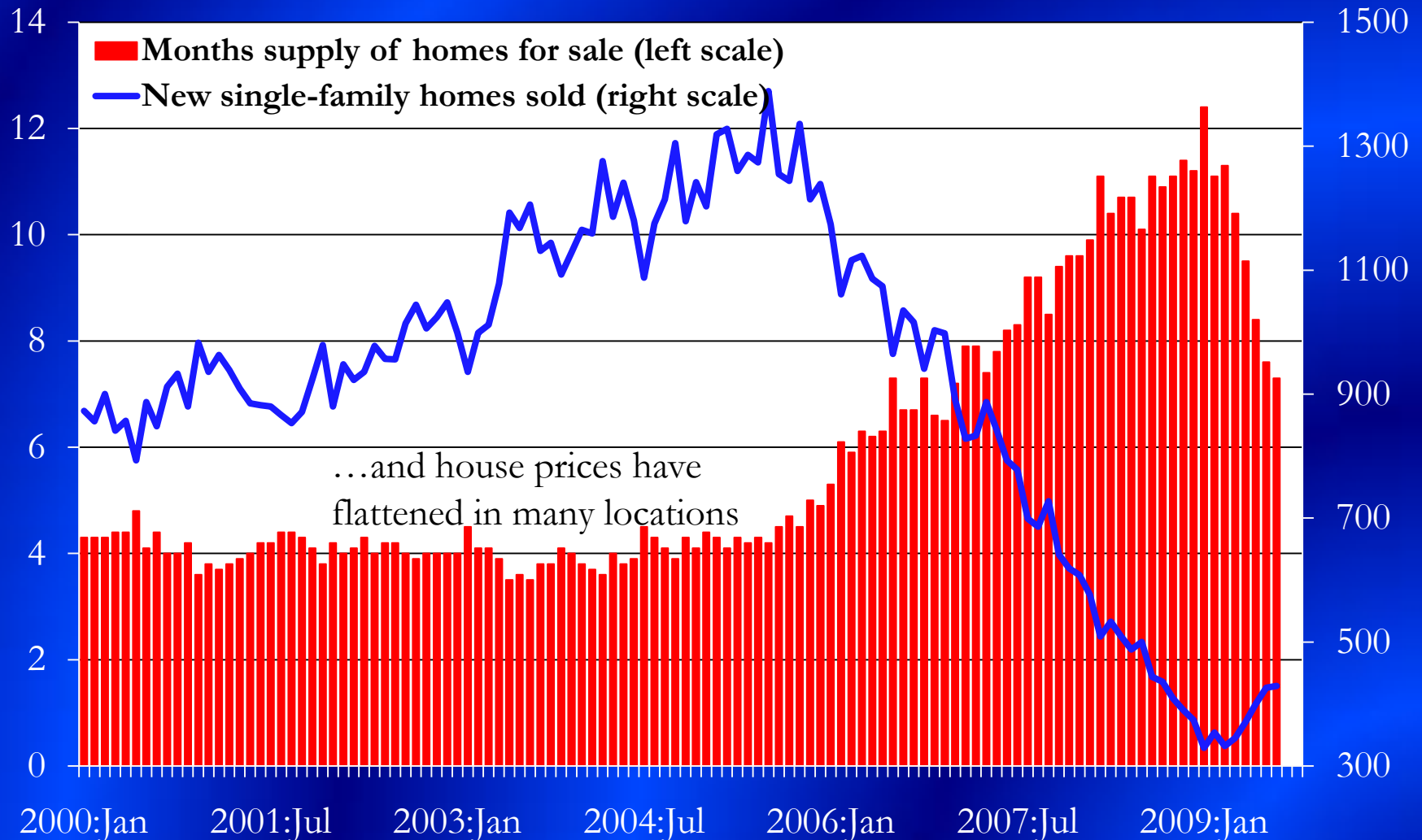
We are emerging from a very severe recession



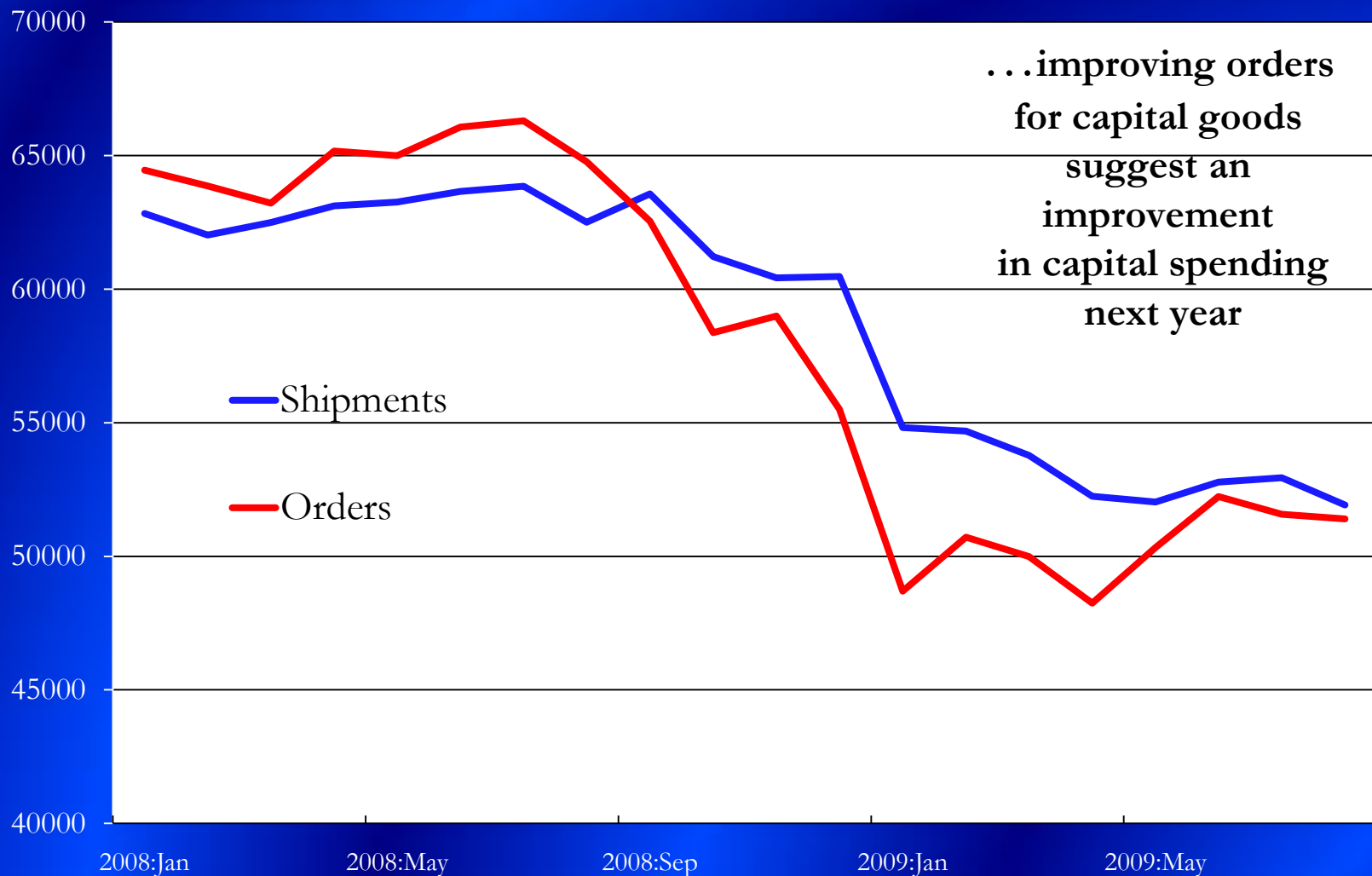
Housing market progress: It's really happening



With reductions in inventories and some improvement in sales, I/S is clearly improving

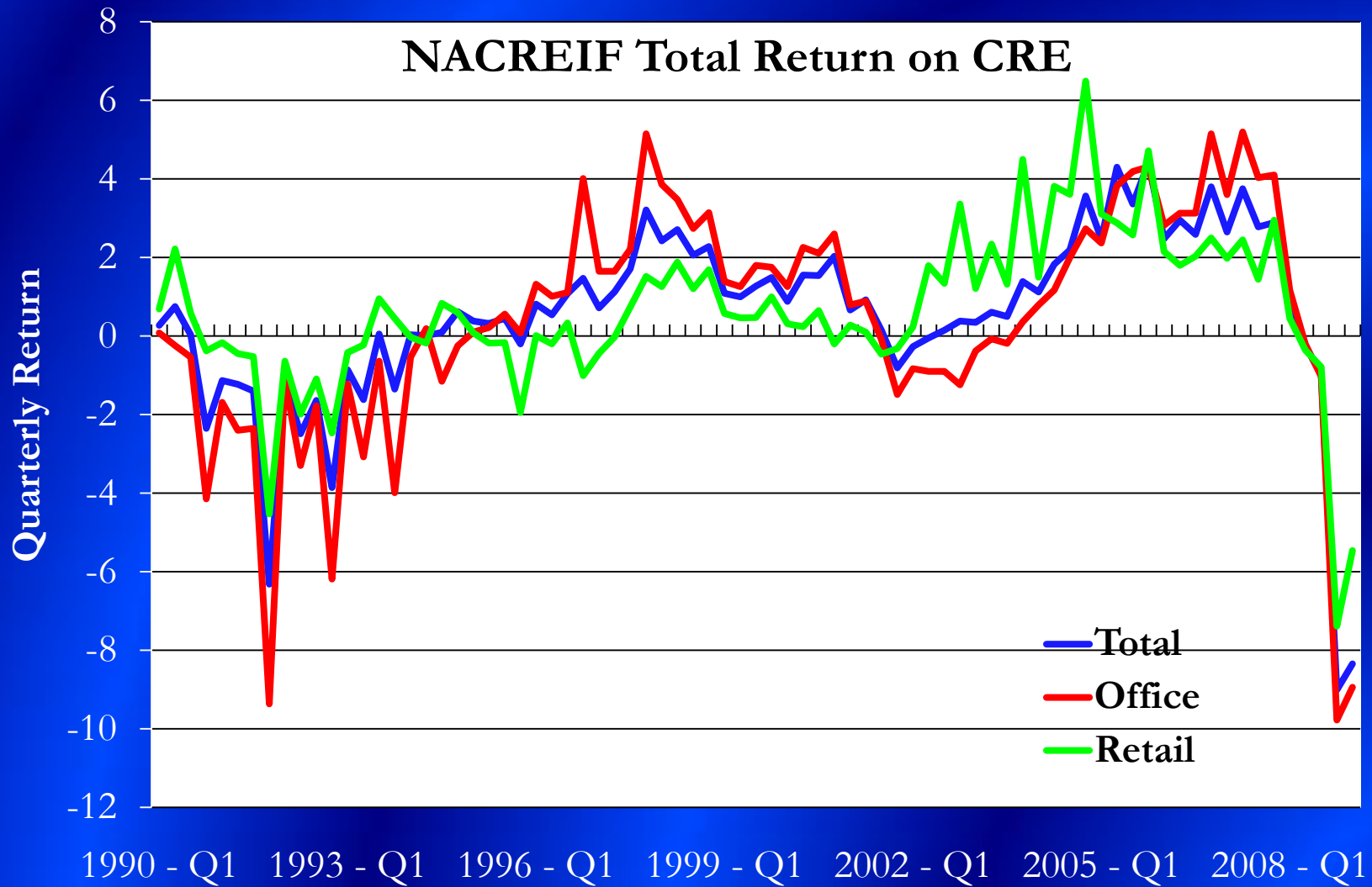


Some hopeful signs in recent investment data



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

Commercial real estate is still a serious concern



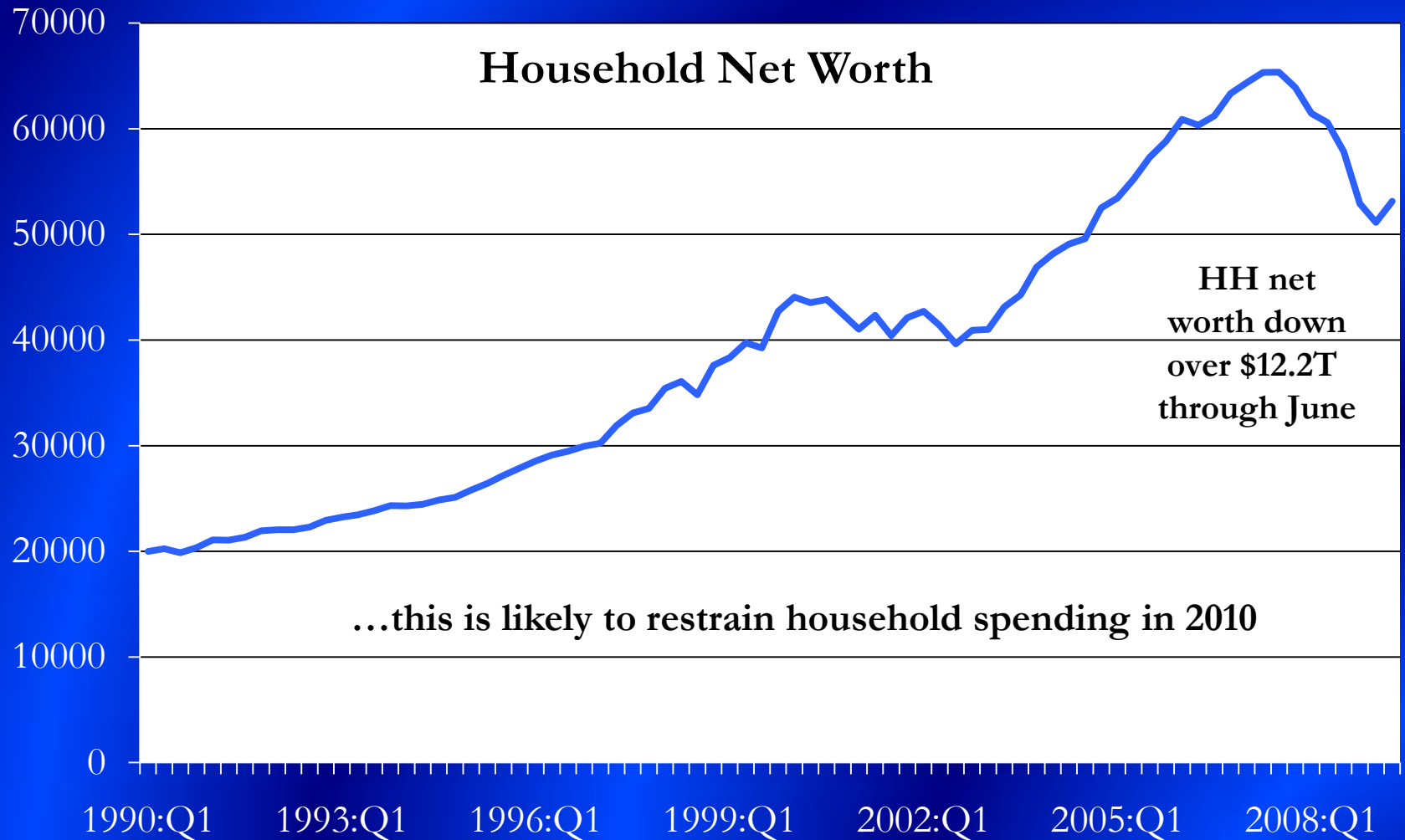
Equity markets have responded favorably of late

This helps to offset the significant loss to household wealth from fallen home prices

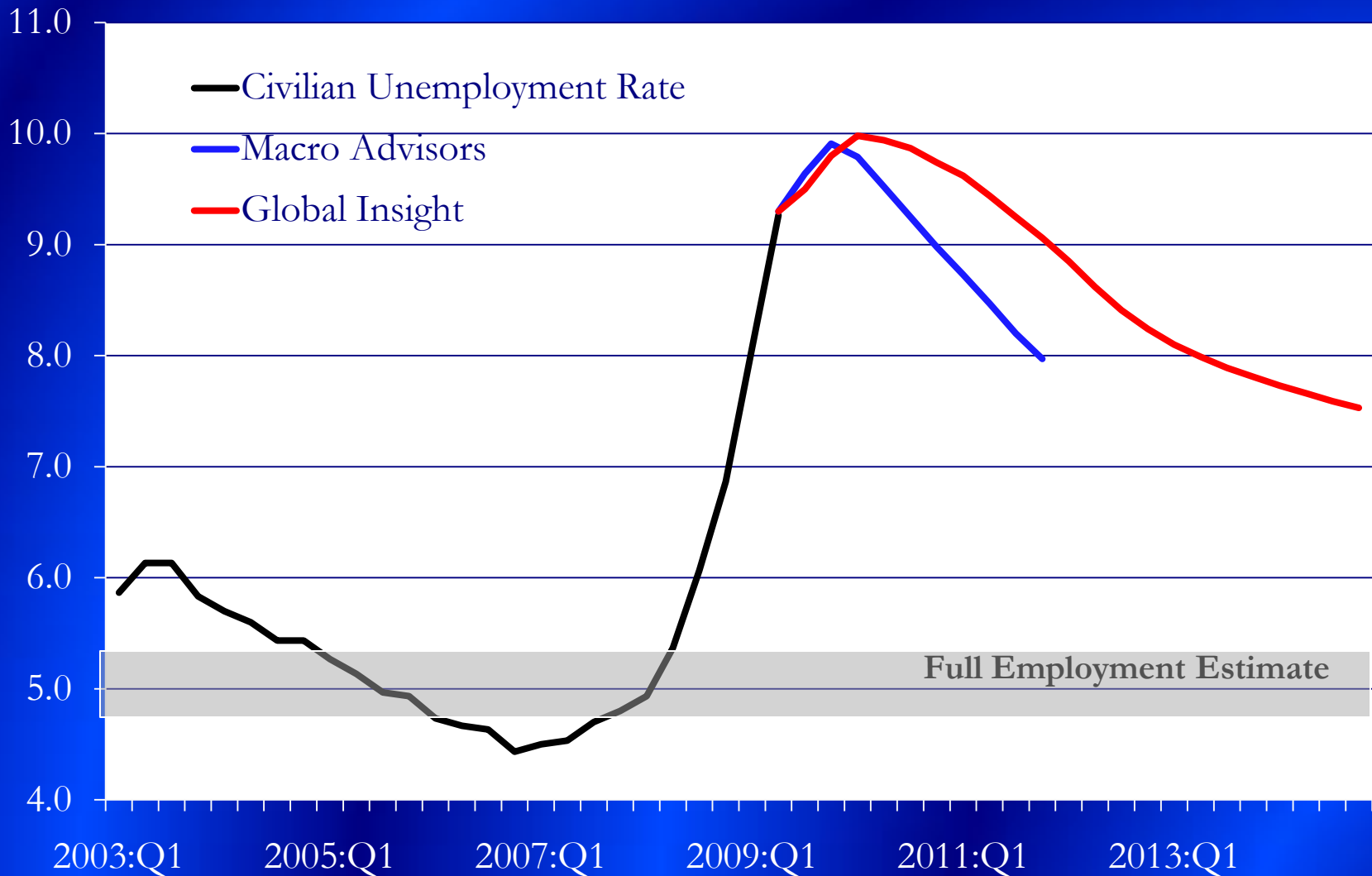


Source: S&P 500: New York Times; House prices: S&P Case Shiller

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

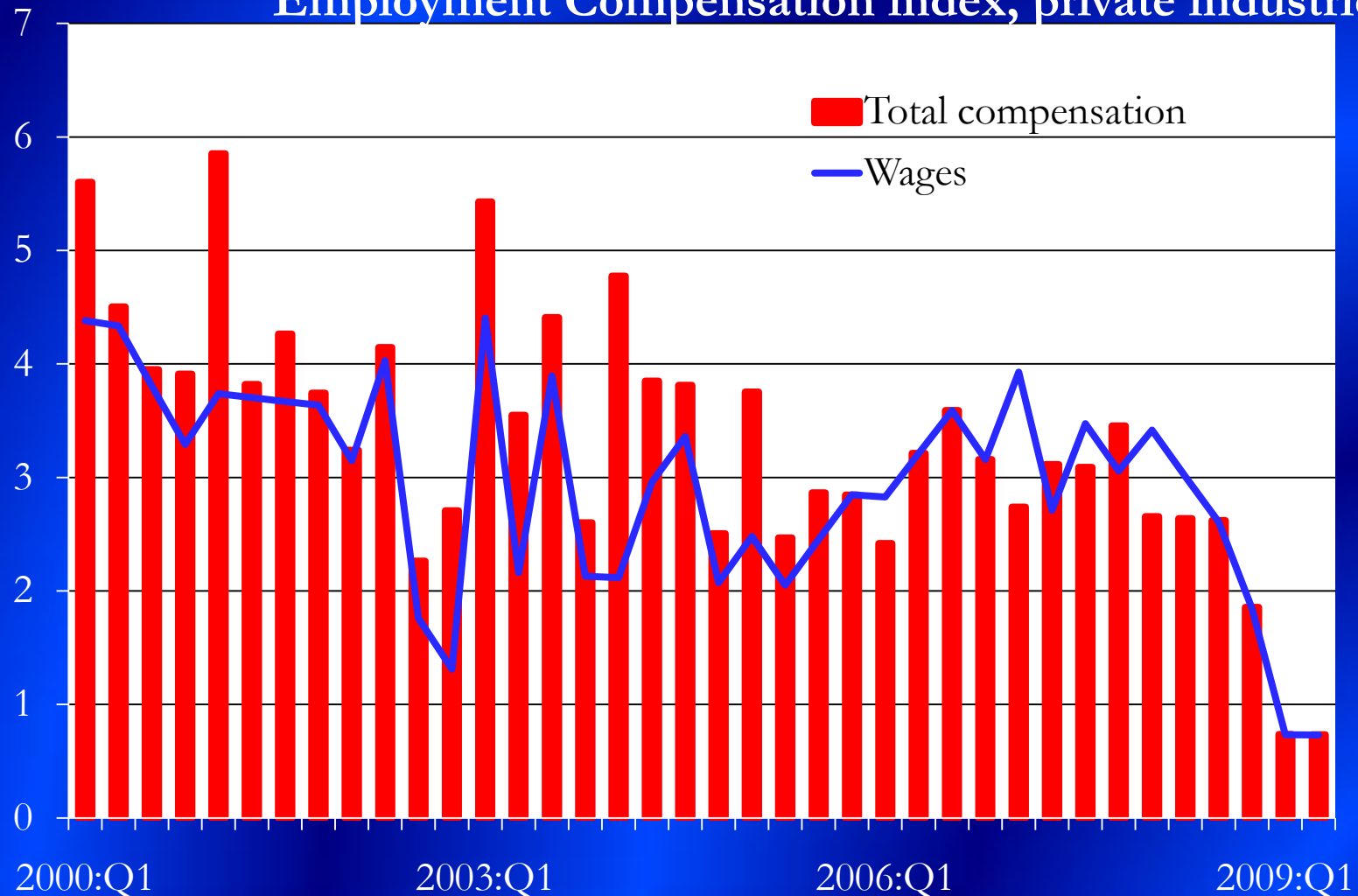


The largest concern going forward: Unemployment is likely to remain elevated



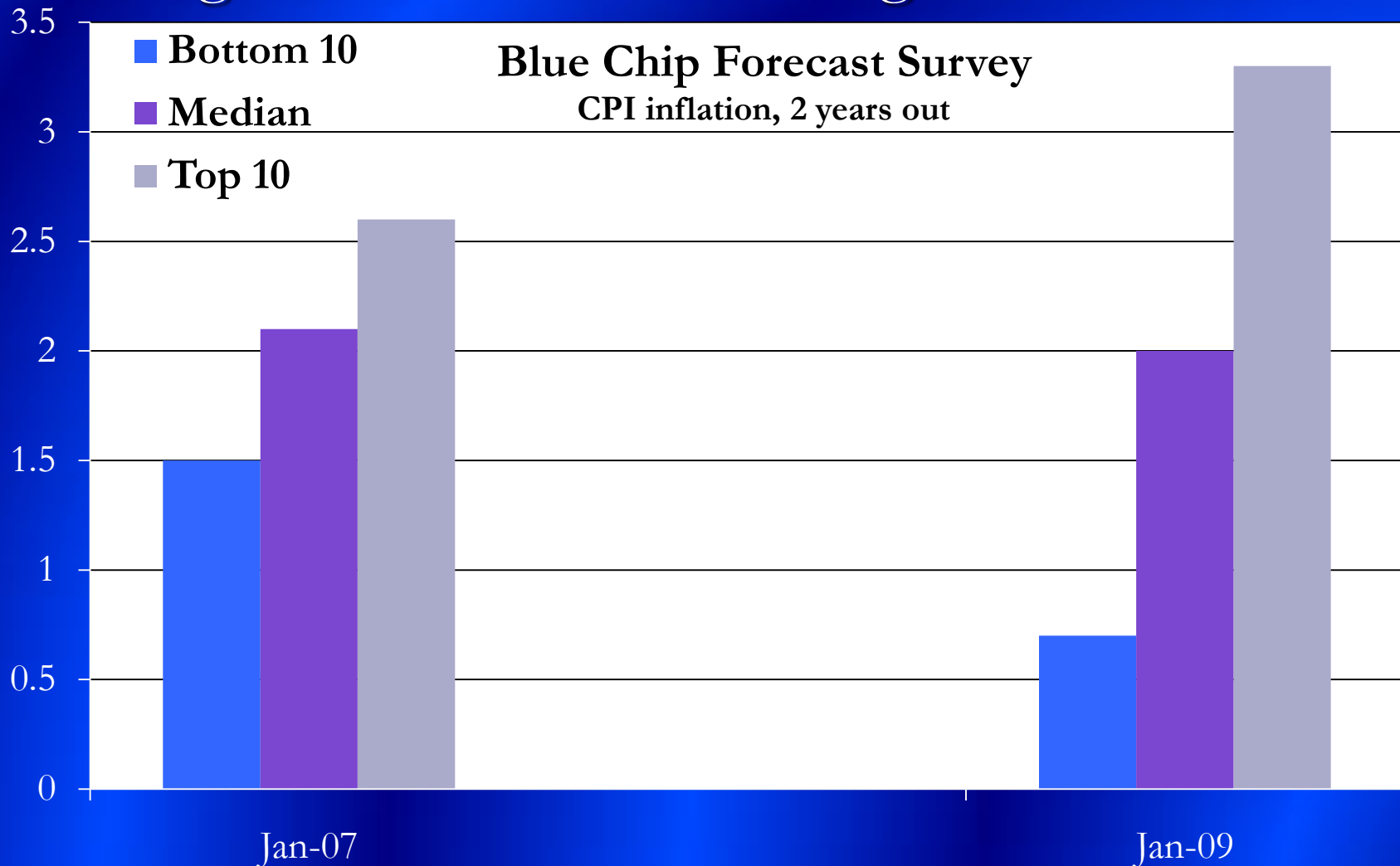
Slow employment growth and slow wage growth will challenge the consumer

Employment Compensation index, private industries



High unemployment may also bear implications for inflation

Disagreement on this: Too high or too low?



Summary of conditions

- The economy is recovering, *likely* slowly
- Underlying fundamentals are still challenging
 - Household net worth remains low
 - Employment and wage growth remain weak
 - Foreign growth remains weak
- Expect a gradual recovery over the next several years, with elevated unemployment
- Inflation
 - Balance sheet, deficit suggest higher inflation
 - Lingering excess capacity suggests lower inflation

Part II

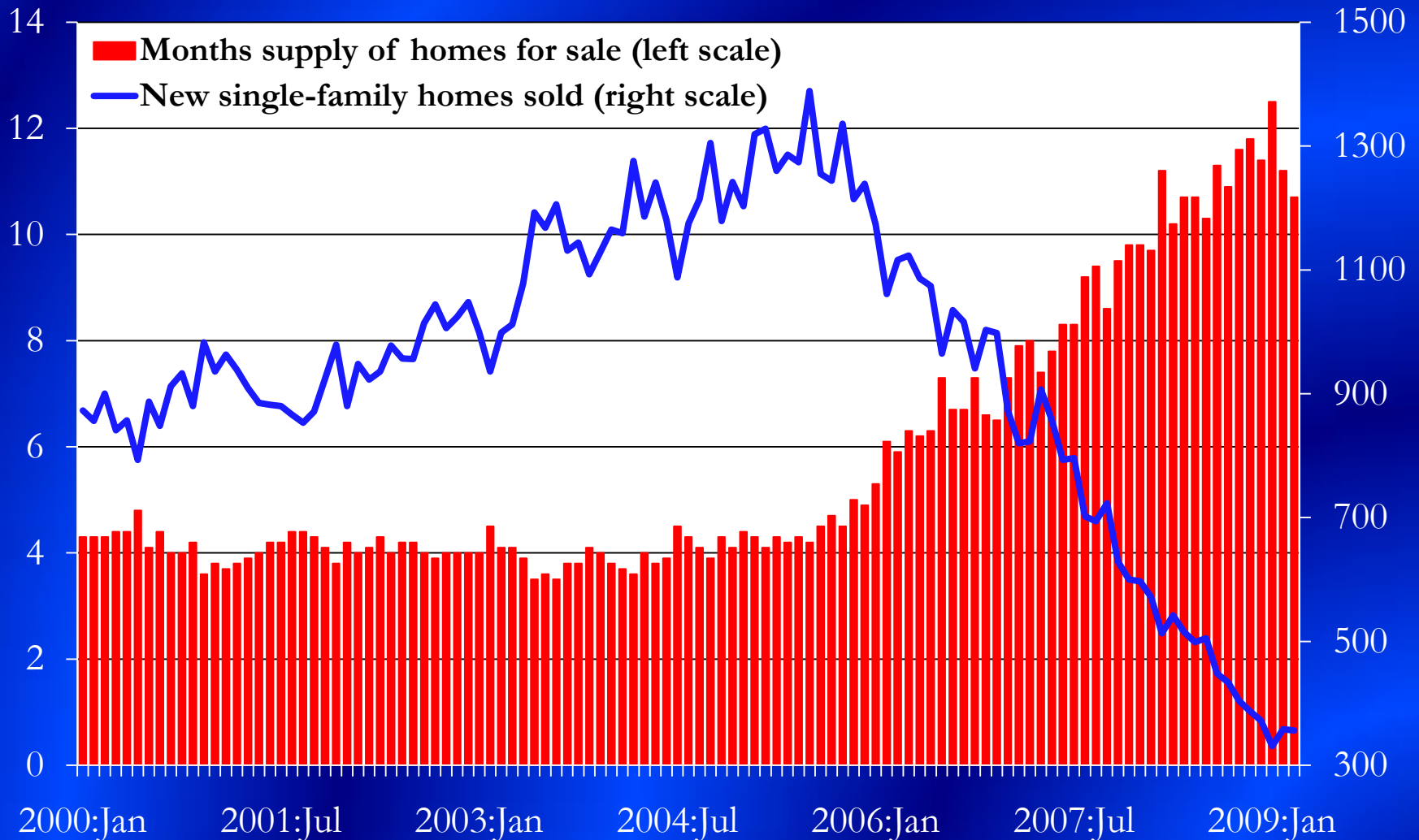
A look back (and forward) at the
crisis

What caused all this?

■ Many causes

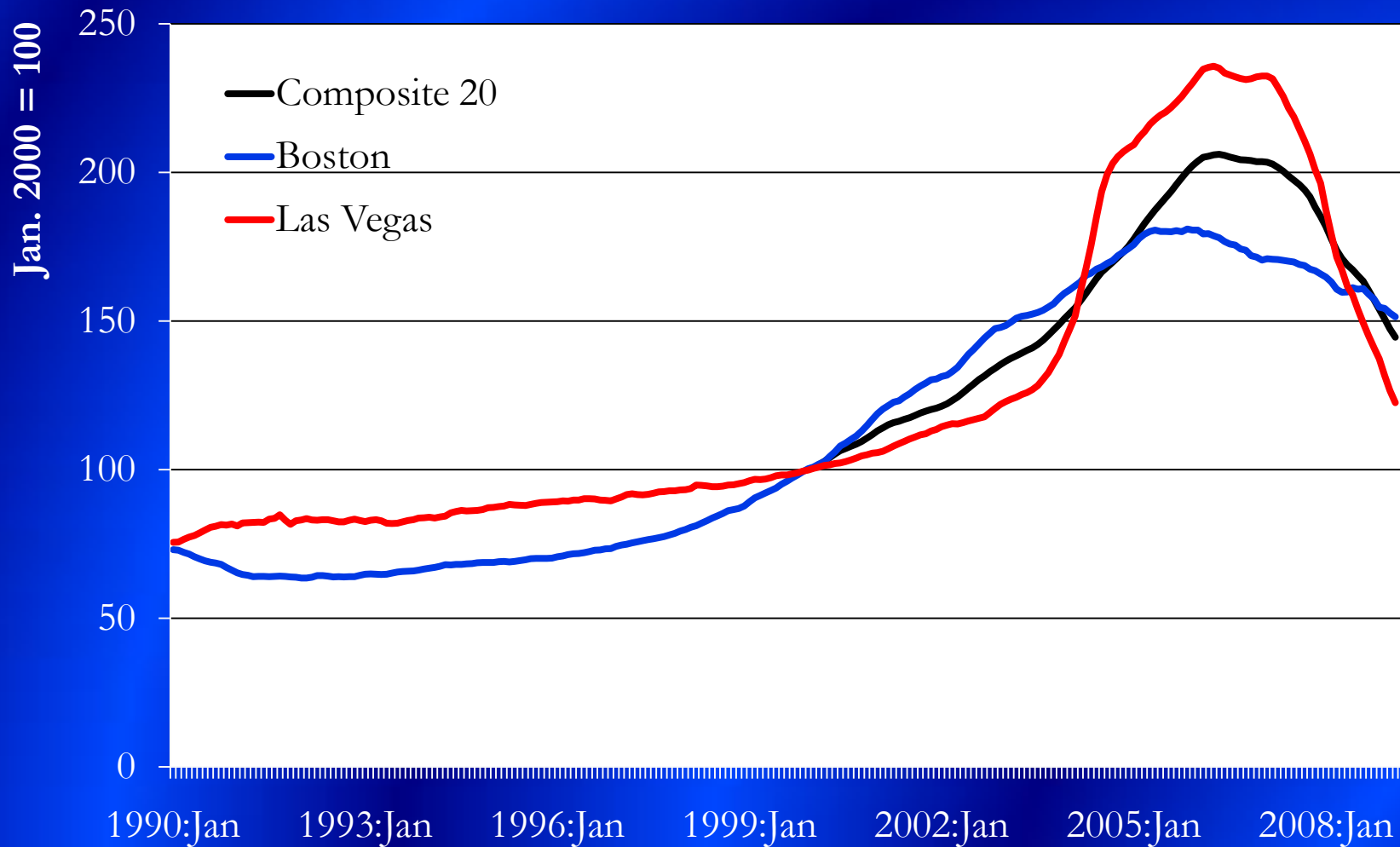
- Over-priced residential real estate
- Over-priced commercial real estate
- Over-building in residential real estate
- Heavy leverage in all of the above—borrowers in precarious positions
- A significant decline in house prices (a result of the over-building above)
- Households in trouble due to job loss, falling prices, default
- Financial firms in trouble due to losses on mortgage-related securities
- Similar problems at many foreign financial institutions
- Some missed supervisory opportunities
- Reliance on ratings agencies for new, untested products
- Contagion from mortgage-related to all other securities
- Loss of confidence among consumers and businesses—PANIC
- Loss of short-term credit at major financial institutions
- Pull back in hiring, spending, etc.

What caused this? Housing and Debt: Over-building, Inventory overhang

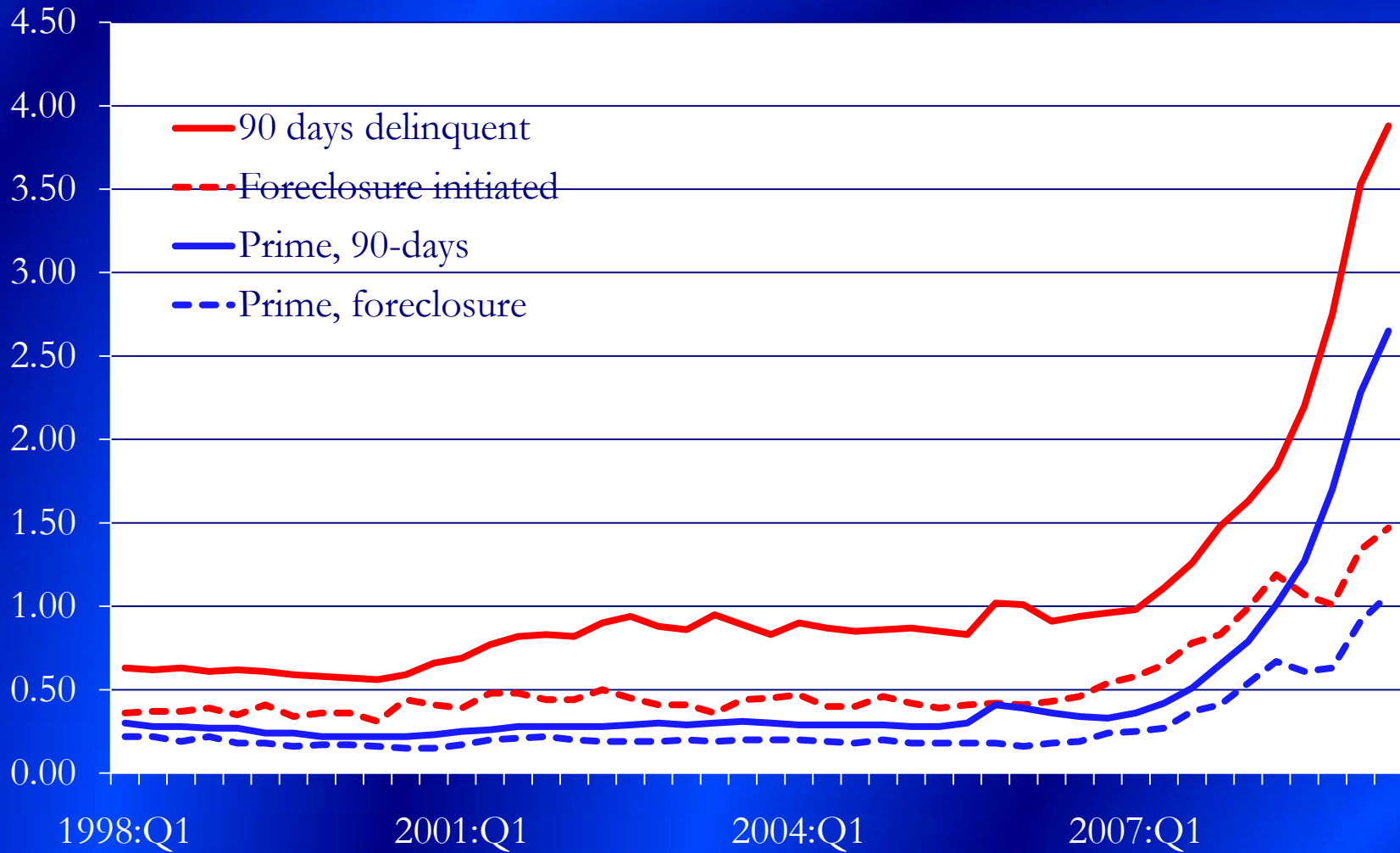


What caused this?

Housing and Debt: Price rise and fall

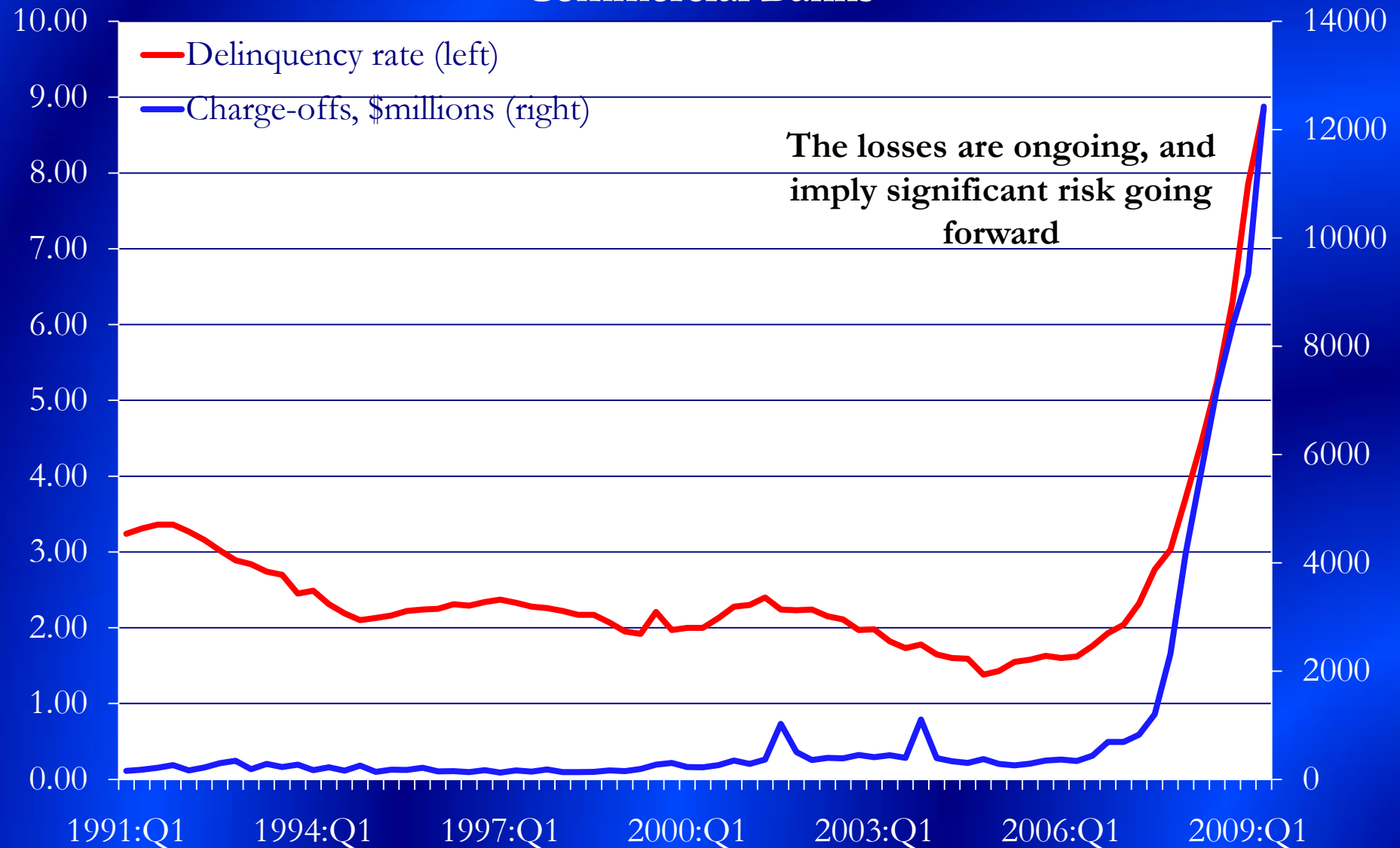


As prices fell and unemployment rose, delinquencies and foreclosures surged



Losses at financial institutions soared, especially for mortgage-related securities

Commercial Banks

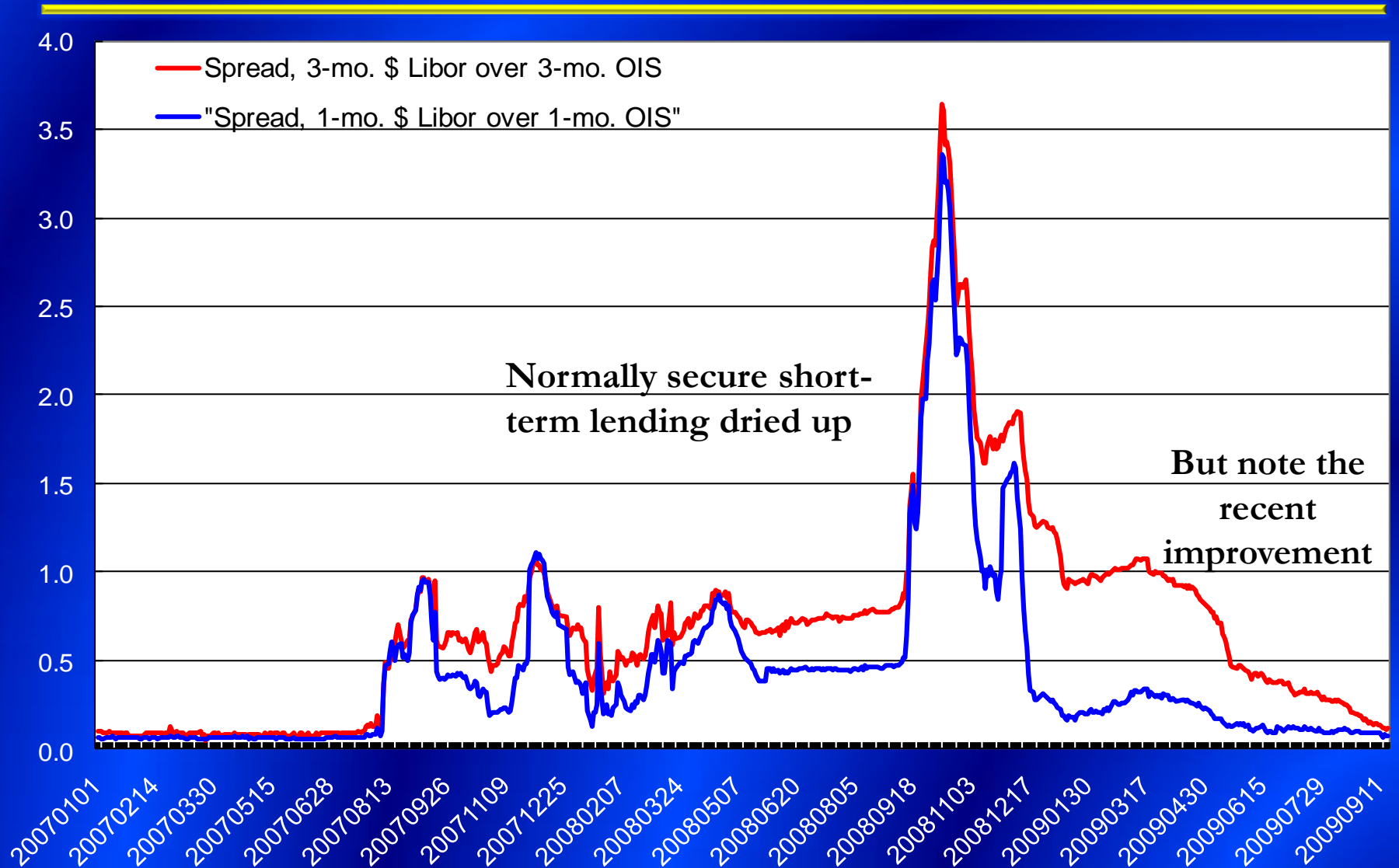


Some mortgage lenders disappeared

Table 2: Top 10 Subprime Lenders in Massachusetts, 1993–2007

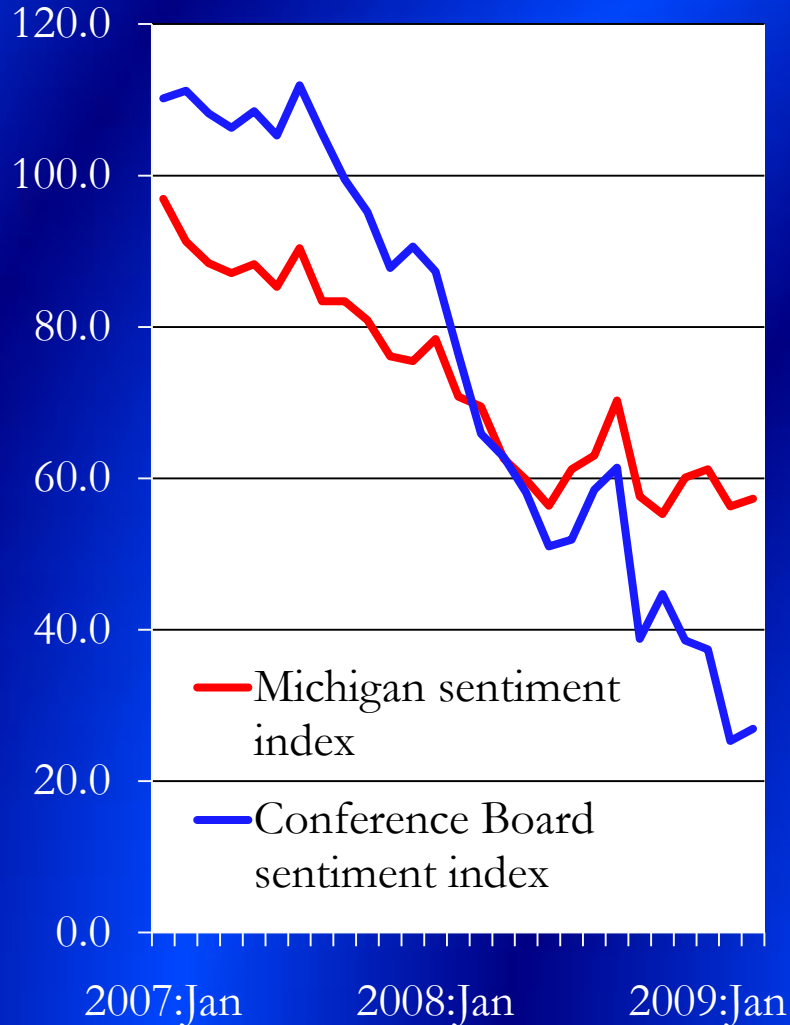
	# loans	% of subprime purchase mortgages	status
Option One Mtg. Corp.	11,243	18.6	shutdown
New Century Financial Corp.	5,951	9.9	shutdown
Fremont Investment & Loan	5,550	9.2	shutdown
Argent Mtg. Co.	3,599	6.0	shutdown
Summit Mtg. Co.	3,067	5.1	shutdown
Mortgage Lender Net	2,798	4.6	shutdown
Long Beach Mtg. Co.	2,520	4.2	shutdown
WMC Mtg. Corp.	2,316	3.8	shutdown
Accredited Home Lenders	2,174	3.6	shutdown
First Franklin Financial	1,896	3.1	shutdown
Total	41,114	68.1	-

Financial markets freaked out

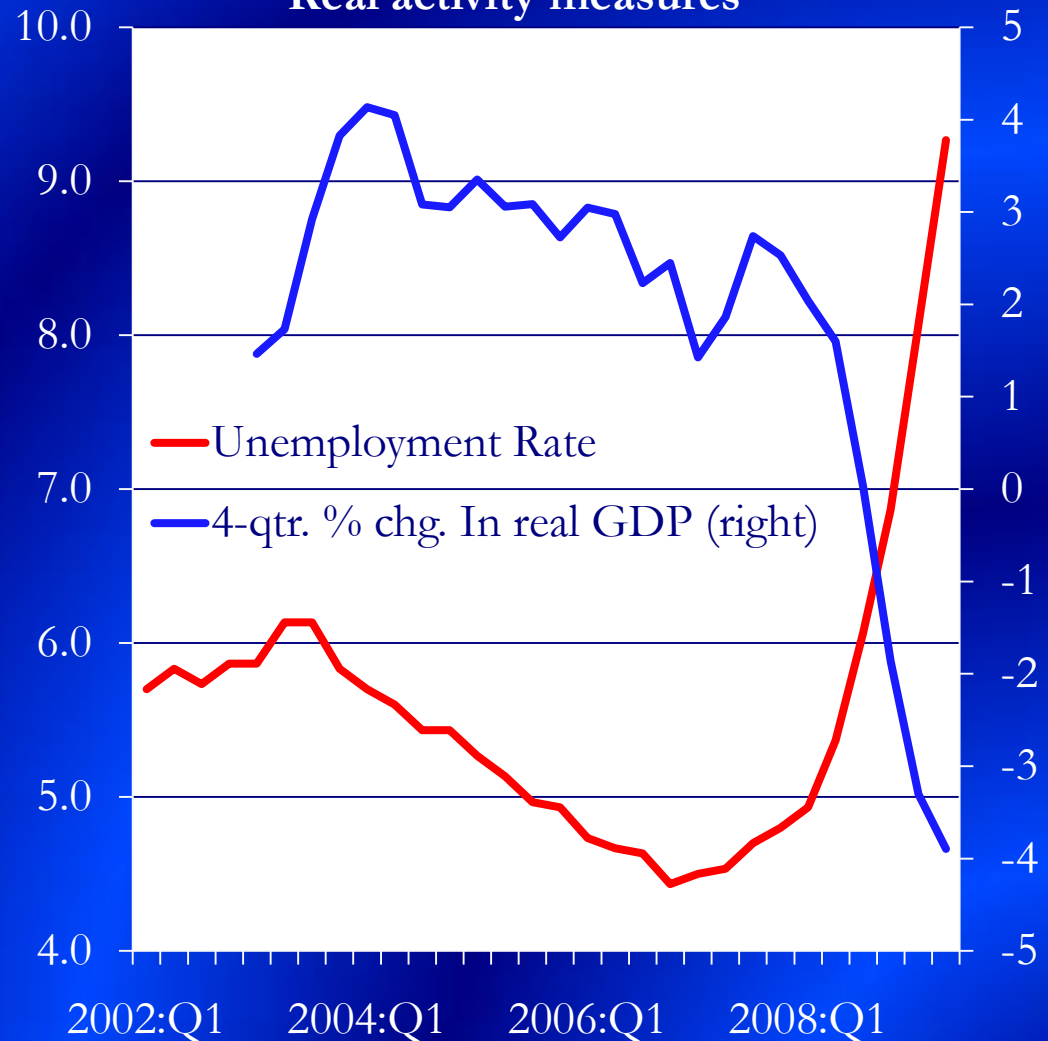


Widespread loss of confidence; Real activity plummeted

Confidence measures



Real activity measures



Policy Responses

■ The Fed

- Lowered the funds rate to zero—can't get any lower!
- Pursued liquidity policies (short-term lending)
- Rescued individual firms (good or bad?)
- Tried some substitutes for conventional policy (purchased MBS)

■ The Treasury

- Pumped capital into the banking system
- Insured deposits, secured lending
- Provided fiscal stimulus package
- Bailed out auto companies

Fed Responses, itemized

- Provide short-term liquidity

 - Term Auction Facility (TAF)
 - Lend to banks, but remove stigma of discount window borrowing
 - Commercial paper (CPFF)/MMMF (AMLF) facilities
 - Help commercial-paper and ABCP-based MMMF's to meet redemptions, continue funding (over \$300B)
- Provide longer-term credit, macro stimulus

 - ABS facilities (TALF)
 - Facilitate new-issue AAA ABS purchases, up to \$200B
 - “Legacy securities” (with PPIP program)—CMBS, RMBS
 - MBS, Treasury purchases (LSAP: up to \$1.25T, \$300B)
 - 30-year conforming rates down 1-1.25 ppts., refis up
- Maintain sanity

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

Summary

- The economy is in better shape than it was
- The recovery is likely to be characterized by
 - High unemployment for an extended period
 - Risk of falling inflation—but some disagree
- The crisis: A post-mortem
 - *Many* causes
 - Hard to predict many of the consequences
 - Some appropriate policy responses
 - Some are debatable