"Monetary Policy and the State of the Economy"

Testimony of

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Good morning, Mr. Chairman and Members of the Committee. I am delighted to have the opportunity to share my thoughts about the current economic situation and what policy makers can do to improve it. I will touch on the outlook and what it depends on, the actions of the Federal Reserve, and the possible need for further fiscal stimulus. I would also like to say a few words about what seems to me more challenging question: how to contain the spread of foreclosures and preserve affordable housing.

I know you want to focus today on monetary policy, because you have Chairman Bernanke coming before you tomorrow, but frankly, I think monetary policy should be far down your list of worries. The Federal Reserve has used the tools in its limited arsenal aggressively and imaginatively and clearly indicated its intention do more if necessary. The monetary policy authorities seem to me to be doing a good job. You should also be extremely pleased with the swift bi-partisan action of the Congress and the Administration on the stimulus package. Although you may need to take further action, the initial package was well designed for maximum effect and passed with remarkable alacrity. Rarely does our policy process function so well!

If the consensus forecast is roughly right, we will have slow growth for a couple more quarters, but will avoid recession and see growth resuming by the end of the year. But the situation is precarious. In housing, a spreading wave of foreclosures could undermine

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consumer confidence and increase the probability of recession. Continued risk aversion of investors and unwillingness to lend on the part of financial institutions could raise the probability even more and turn a slowdown into a full-blown economic route that could spread beyond our borders. The hardest challenges now are how to minimize housing foreclosures and how to get the credit markets functioning more normally—both without spending excessive public resources or rewarding people who made dumb or irresponsible decisions.

The Economic Outlook

The slowdown in economic growth and job creation in the last quarter of 2007 was clearly the result of the decline in residential construction and housing prices and the crisis in the sub-prime mortgage market. Nobody should have been surprised. The rapid, sustained increase in the demand for housing--especially in growing metropolitan areas and sun-belt communities--reinforced by low interest rates, the explosion of sub-prime and related lending, and a flourishing secondary market turned a housing boom into a bubble. Bubbles eventually burst.

We should not forget that a lot of good came from the housing boom. Millions of people moved into new or better housing. Most of them (including most sub-prime borrowers) are living in those houses and making their mortgage payments on time. The downside, however, was that many people came to believe that housing prices would go on rising forever. Lending standards became lax, borrowers got over-extended, speculators built housing ahead of the demand, and the prospect of making big bucks attracted the crooks that always gravitate to a bubble.

So we built too many houses. It will take time for demand to catch up with supply. The inevitable downturn in prices led to rapidly rising defaults, especially on sub-prime mortgages, and the prospect of many more defaults as teaser rates on adjustable rate mortgages (ARM’s) are reset to higher levels.

If the story ended there, we might not be having this hearing. Residential construction is not a big part of the economy (even with its linkage to the consumer durables and other real estate services), and neither is the sub-prime market. The big surprise was that the problem ricocheted through the credit markets, here and around the World, because of the widespread ownership of mortgage-backed and related securities.

The explosion of sub-prime lending was a clear regulatory failure. My former Federal Reserve Board colleague, the late Edward M. Gramlich, warned repeatedly that lax standards and predatory practices in the sub-prime market deserved urgent regulatory attention. But most of the questionable practices were not perpetrated by federally regulated banks, and the Washington regulators did not get on the case.

The world-wide fallout from the U.S. sub-prime crisis is yet another lesson in how complex and inter-connected international financial markets have become. It was also a black eye for market capitalism—an embarrassing moment for those who boast about the intelligence and sophistication of financial markets. How come so few people asked the simple question: What happens to the value of these mortgage-backed securities when the music stops—when housing prices level off or decline, adjustable rates reset, and people with not-so-great credit histories can't make their monthly payments anymore? Financial market participants now say they "under-priced the risk," which is code for failing to ask some pretty obvious questions.

A lot of financial institutions and funds found themselves owning securities worth less that they thought or whose values could not be easily determined. The result was some big losses and a panicky flight from risk. Lenders jacked up their lending standards, investors fled to Treasuries, mortgage credit became less available, and banks got skittish even about lending to anyone, even each other. Obscure corners of the financial system—the credit-worthiness of bond insurers and the hazards of relying on auction credit markets—suddenly were front page news. Uncertainty about the future tightness of credit markets makes forecasting the real economy unusually difficult. A scenario in which the crunch gradually resolves and credit flows return to some semblance of normality produces a far rosier economic outlook than a scenario in which financial institutions suffer additional large losses and the crunch gets worse.

Meanwhile, back in the real economy, activity looks slow, but not disastrous. The recently updated CBO forecast, which is close to the consensus of commercial forecasters, expects a slow year (1.9 percent growth in real GDP for the year) with a modest pick-up (to 2.3 percent) in 2009. CBO expects a gradual rise in the unemployment rate (to 5.5 percent in 2009) and some moderation in consumer price inflation. In other words, the consensus is that the underlying resilience of the American economy, aided by surging exports reflecting the weak dollar, and buoyed by monetary and fiscal stimulus, will keep the economy from spiraling into recession. My guess, for what it is worth, is that the consensus will prove about right, but uncertainty remains great, especially about the credit markets and the potential impact of foreclosures on housing values and consumption. The risks are mainly on the down-side and gloomier forecasts are not hard to find.

Monetary Policy

The Federal Reserve has been using its tools aggressively and inventing new ones on the run, in an intense effort to keep financial institutions liquid and preserve credit flows to businesses. Since August the Fed has lowered the federal funds rate 225 basis points in a series of fairly big steps. The most dramatic was the surprise 75 basis point drop on January 22, prompted by the melt down in overseas equity markets and the anticipated response of our own. Most of the Fed’s recent action has been aimed at pumping liquidity into the credit system in hopes of getting the banks lending again. The Fed lowered the discount rate and encouraged borrowing at the discount window. When that approach proved insufficient (and made calibrating the federal funds rate more difficult) it invented a new tool, the Term Auction Facility (TAF)—a mechanism to enable banks to borrow large fixed amounts directly from the Fed. This effort was coordinated with similar ones at other major central banks.

I find the Fed's actions both appropriate and creative. I know there are those who think that the Fed is "behind the curve." I suspect these critics have in their heads, for whatever reason, a forecast of deep recession to come, and do not think the Fed is acting on their forecast. However, the consensus forecast—and the Fed's—does not anticipate recession. Moreover, there are ample reasons for concern about bringing the short-term interest rate as down as low is it was in 2002-3. Fear of aggravating inflation is one. Another is apprehension about making monetary policy so accommodating that it fuels the next bubble—in whatever asset class might catch investor's fancy.

Fiscal Stimulus

One way to take part of the onus off the Fed and avoid excessive easing of monetary policy, is swift action on fiscal stimulus. Congress and the Administration worked together surprisingly quickly to pass the stimulus package that the president signed last week. The package negotiated by the Speaker and the Administration adhered to the prescription of most macro-economists that an effective short-term stimulus should be timely, targeted and temporary. It was designed to send checks to low and middle income people, who are most likely to spend them quickly, and increase incentives for near-term business investment. The Senate improved the House-passed package by adding low income seniors and retired veterans to the recipients. The proposal also increases the loan limits for Fannie Mae, Freddie Mac, and the Federal Housing Administration (FHA) and ties future loan limits to median house prices in the metropolitan area. That this legislative initiative became law with the President's signature in mid-February is gratifying. The accomplishment proves that the two branches, the two houses of Congress, and the two political parties can work together constructively when the need is urgent, which is very heartening to all of us enjoy seeing our government functioning well.

I was among those who urged several additions to the package, including an extension of unemployment compensation for an additional 13 or 26 weeks, a temporary increase in food stamp payments, and some relief to the states in the form of an increase in the Medicaid match. The states are always hard hit in an economic slow-down, and tend—

since they have to balance their budgets—to cut spending, often on Medicaid and other benefits to low-income people, and to raise taxes. These actions tend to make the economic situation worse, and federal relief can help forestall them. I would, however, urge the Congress not to load a second stimulus package with slow-spending projects, such as infrastructure, that do little to stimulate the economy in the short-term and add to the growing federal debt.

Even though temporary stimulus will not add substantially to the long run deficit, I believe that the stimulus should be paid for over a five-year period, like any other spending. Adherence to the PAYGO principle is an important discipline, and making exceptions to it for any reason can become a dangerous habit.

Avoiding a Wave of Foreclosure

The difficult challenge now, it seems to me, is designing a workable way of minimizing foreclosures and keeping families that are able to pay on their mortgages in their homes. Foreclosures are in nobody's interest. They are expensive for lenders and servicers, painful for families, and destructive of property values in the surrounding neighborhood and beyond. Secretary Paulson has worked energetically to pull the major servicers of mortgages together into an effort to contact borrowers in danger of default and give them the opportunity for counseling and adjustment of terms. Many states are also encouraging lenders and servicers to work with borrowers to avoid foreclosures. These efforts will reduce the potential volume of foreclosures, perhaps significantly. By itself, however, this approach is unlikely to be sufficient to prevent a wave of foreclosures in the next couple of years.

Legislating in this area is tricky, both legally and morally. Rescuing individuals and institutions from the consequences of imprudent decisions smacks of condoning their poor decisions. However, it may be worth some moral hazard to avoid the spreading contagion of foreclosures that is likely to damage the prudent along with the imprudent. One approach would be to channel federal money through established local community groups with experience in affordable housing. They could be charged with buying properties in the foreclosure process and reselling or leasing them to low-income families on affordable terms. Another option is creating a new government corporation charged either with buying and reselling properties in foreclosure or refinancing defaulted loans. Rather than creating a new institution, however, it would probably be faster and more effective to use the expertise and experience of Fannie Mae and Freddie Mac carry out this mission. A different approach, more oriented to stabilizing the credit markets, would be to give investors government bonds in exchange for whole mortgage pools. The investors would take losses but acquire assets of known value, and the entity acquiring the pool could work with the borrowers to refinance the loans and avoid foreclosures where possible.

Several groups of expert far more knowledgeable than I am on housing finance are working on such proposals. The trick will be to craft a structure that can be made to work quickly and effectively, while avoiding adding excessively to the looming federal debt.

Conclusion

So far, I think the policy response to the current economic situation is on the right track. The Fed has acted aggressively and with some imagination to keep the financial services sector liquid and ease monetary policy. The stimulus package will certainly help avoid recession or mitigate a downturn if it occurs. One of the difficult tasks still ahead, however, is crafting a set of policies that will be successful in containing the spreading contagion of foreclosures. Thank you, Mr. Chairman and members of the Committee.