The Current Economic Context[•]

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We meet today and tomorrow to discuss the important problem of how to achieve and maintain financial and economic stability. Before I call on our first speaker, I will take a few minutes to describe what I believe is the current context for the American economy.

This year's conference is a natural follow-on to the discussion here at Jackson Hole last year. The focus of last year's meeting was housing, it role in the business cycle, and its impact on financial institutions.

The decline in house prices continues to be central to our economic problems. What started as a problem for houses with subprime mortgages has now spread to houses more generally as well as to other asset classes.

We are in the midst of a financial crisis caused by the correction of the serious mispricing of all kinds of risks and by the collapse of the house price bubble that developed in the first half of this decade.

The financial crisis is getting worse because of the downward spiral of house prices. That decline is being driven by the increasing number of homes with negative equity, i.e. , with substantial mortgage debt in excess of home values.

Negative equity and defaults are an important problem because mortgages in the United States are generally "no recourse" loans. If a homeowner defaults, creditors can take the house but cannot take other property or attach income to make up any unpaid balance. Even in those states where mortgages are not "no recourse " loans, creditors generally do not pursue the assets or income of individuals who default.

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We cannot be sure about how much further house prices will fall. Experts say another 15 percent fall is required just to get the level of house prices back to the pre-bubble price path. But there is nothing to stop the decline at that point. The growing gap between the mortgage debts and the house prices will continue to increase the rate of defaults. Many homeowners who can afford to make their mortgage payments will choose to default, move to rental housing, and wait to purchase until some later year when house prices have declined further.

As homeowners with large negative equity default, the foreclosed homes contribute to the excess supply that drives prices down further. And the lower prices lead to more negative equity and therefore to more defaults and foreclosures. It is not clear what will stop this self-reinforcing process.

Declining house prices are key to the financial crisis and the outlook for the economy because mortgage backed securities and the derivatives based on those securities are the primary assets that are weakening financial institutions. Until house prices stabilize, the mortgage-backed securities cannot be valued with any confidence.

The uncertain value of the mortgage backed securities and of the associated derivatives means that the financial institutions cannot have confidence in the liquidity or the solvency of potential counterparties or even in the value of their own capital. Without such confidence, credit will not flow and economic activity will be constrained.

The shortage of credit is exacerbated by the need of financial intuitions to deleverage. Since raising capital is difficult and costly, they deleverage by lending less.

The macroeconomic weakness in the United States now goes beyond the decreased supply of credit. The falling house prices reduce household wealth and therefore consumer spending. Falling employment lowers wage and salary incomes. The higher prices of food and energy are depressing real incomes further. And declining economic activity in the rest of the world is lowering the demand for U.S. exports.

The Federal Reserve has, in my judgement, responded appropriately in 2008 by reducing the federal funds interest rate

sharply to 2 percent and creating a variety of new credit facilities. The low interest rate helped by making the dollar more competitive but other than that monetary policy appears to have lost traction because of the condition of the housing sector and the dysfunctional state of the credit markets.

The U.S. Congress and the Administration responded to the situation by enacting a $100 billion tax rebate in an attempt to stimulate consumer spending. Those of us who supported this policy generally knew that past experience and economic theory both implied that such one-time fiscal transfers had little effect but we hoped that this time might be different. Our support was, in the words of Samuel Johnson, a triumph of hope over experience.

In the end, our hopes were frustrated. The official national income accounting data for the second quarter are now available and they show that the rebates did very little to stimulate spending. More than 80 percent of the rebate dollars were saved or used to pay down debt. Very little was added to current spending.

So that is where we are now: in the middle of a financial crisis with the economy sliding into recession, with monetary policy already at maximum easing and fiscal transfers impotent.

Against this background, the agenda of this meeting focuses on what can be done to achieve and maintain stability. There are two basic questions:

First, what should be done to resolve the current crisis, i.e., to stop the financial failures and the excessive downward spiral of house prices?

Second, what should be done to reduce the risk and severity of future financial crises.

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