

The U.S. Economy and Monetary Policy in 2012

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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

## **Introduction**

I am honored to begin the New Year with a discussion of the economy at the Central Exchange, an organization that has been so important to Kansas City-area businesswomen. It was my distinguished predecessor, Tom Hoenig, who began the tradition of giving his first outlook speech of the year to the Central Exchange eight years ago. I am delighted to continue that tradition today.

My views on the economy are shaped by nearly 30 years of experience with the Federal Reserve, serving in various capacities, but primarily in the area of financial institution oversight and lending operations. I have seen firsthand the realities of our economy from working with financial institutions across the country, and from working through various crises that have not only involved those institutions but also significantly affected you and me.

These are challenging and uncertain times. The U.S. economy continues to recover from the recent recession, but the pace of the recovery has been slow, and threats to the recovery loom large. Against this backdrop, monetary policymakers find themselves in uncharted waters. As policymakers search for solutions to the considerable challenges of the day, it is necessary to weigh the potential costs and benefits of future actions. After all, the crisis has reminded us of the severe consequences that can occur when risk is not priced appropriately. As we look ahead and manage through those consequences, achieving a balanced and sustained recovery will require difficult, but necessary, adjustments.

## **Crisis and Recession**

To understand the current state of our economy, it is useful to look back. In many ways, the performance of the economy today continues to reflect the problems that led to the financial crisis.

The financial crisis did not suddenly materialize. Its roots grew over time, in seemingly benign spurts, as consumers, financial institutions and much of the economy took on unsustainable amounts of debt.

Debt increases related to housing were especially pronounced. Across the economy, mortgage debt rose from 60 percent of disposable personal income in 1997 to 100 percent immediately prior to the recession. As always, the rapid rise in leverage spawned asset price increases and those famous “animal spirits” took hold. As home prices rose, home building surged, credit standards for mortgages eased, leverage increased further and financial markets became highly exposed to housing finance instruments.

Leverage, however, encompassed more than housing. It was rising throughout the financial system. Across all financial businesses, debt as a percentage of gross domestic product (GDP)—the broadest measure of our country’s output of goods and services—almost doubled between 1997 and 2007, from 60 percent to nearly 120 percent. Part of this increase in debt came from the rise of new financial intermediaries, the so-called “shadow” banking system. But banks were also taking on more risk: Across the 10 largest bank holding companies, the ratio of debt to tangible common equity—a measure of bank leverage—rose sharply from 19 in 1997 to 33 by 2007.

With high levels of debt and leverage, the economy was highly susceptible to a reversal in the housing sector. The result was a severe recession and financial crisis. During the recession, real GDP fell by more than 5 percent, and the number of unemployed workers nearly doubled from 7.5 million to just less than 15 million. During the fall of 2008 and the spring of 2009, most measures of economic activity at various points experienced what can only be described as startling declines.

### **A Slow Recovery**

Today, the economy is two-and-a-half years into a recovery that on the whole, has been uneven and underwhelming. With moderate economic growth have come modest job growth and a too-high unemployment rate, in addition to lingering doubts about whether the recovery is sustainable.

Part of the uneven, sluggish pace of the recovery can be attributed to temporary factors. For example, last year began with some promise, but in the spring the economy took a step back in reaction to higher oil prices related to events in the Middle East and North Africa and supply chain disruptions in the auto sector from the earthquake and tsunami in Japan. As these events began to fade, the second half of the year brought us a deteriorating picture in Europe from concerns over sovereign debt and acrimonious debates about our own fiscal problems. Given all of these events, I take some solace in the resilient nature of the economy and its ability to sustain an even modest pace of growth.

However, temporary factors explain only part of the slow recovery. A considerable drag on the recovery remains the consequences of the buildup in leverage leading to the financial crisis.

No place is this drag more acute than in the housing market. The economy continues to deal with the clean-up from the housing collapse: elevated inventories of existing homes, little construction of new single-family homes, too many foreclosures and delinquencies, declining home prices and lost home equity. Recently, the housing market has shown some signs of stabilization, but activity remains very weak.

With the collapse in the housing market, households soon realized they were carrying too much mortgage debt relative to their incomes, leaving no choice but to begin the painful process of deleveraging through paying down debt or through default. The home equity extraction that had supported consumer spending before the recession no longer could play that role in the recovery. Even now, two-and-a-half years into the recovery, consumer confidence remains at low levels. In this vicious cycle, a weak economy and weak housing values reduce household income and wealth, which in turn weighs on consumer spending, which causes businesses to be cautious, which impedes the economy from achieving a rapid recovery.

The health of the financial sector is particularly important now. The financial sector is the heart of the circulatory system of the economy, pumping capital from savers to borrowers who use the funds to direct resources to where they are needed most. A less-than-healthy financial sector limits the strength of the recovery. Although U.S. banks have been reporting increasing net income since 2009, this improvement mostly is related to a reduction in loan loss provisions—banks are putting away less money in anticipation of fewer problem loans. Given current economic conditions worldwide and domestic real estate problems, this is a bold step.

Problem loans remain at historically high levels. For example, among the largest banks, close to 10 percent of residential real estate loans are delinquent. Among smaller regional and community banks, commercial real estate portfolios, especially those with construction and land

development loans, continue to be weak. Complicating this picture has been the absence of an effective process for dealing with the large number of foreclosed properties that continue to depress prices and hold back bank performance.

Unfortunately, there are no quick or simple solutions to these problems. As is historically common in the aftermath of a financial crisis, the recovery takes time, and while there is some progress, it is frustratingly slow. All of this suggests a moderate recovery remains the most likely outlook, depending on developments in Europe and Asia's economies, as well as U.S. fiscal policies that have yet to be defined.

### **Monetary Policy Challenges**

Given the state of the economy and the risks that loom on the horizon, it is clear that the challenges before monetary policymakers remain considerable. This is especially so given the degree to which the Federal Open Market Committee's (FOMC) normal policy tools have been used during and following the crisis.

During the dark days of the financial meltdown in late 2008, the FOMC reduced the federal funds rate to a range of zero to one-quarter percent. Over the past three years, it has maintained this rate and taken other actions affecting the size and composition of the Federal Reserve's balance sheet. These actions were taken first to staunch the crisis, and later to encourage and sustain the economic recovery. Now the question is, "What next?"

Traditional monetary policy tools have been exhausted, and unconventional tools are now in play. As policymakers consider additional options and possible actions, it is necessary to appropriately weigh their costs and benefits. For example, how can policy enable and encourage the financial system to undertake prudent risk-taking that has been temporarily suppressed by the

recession and slow recovery while preventing the recurrence of poorly allocated resources and mispriced risk that contributed so significantly to this most recent crisis?

### **Mispriced Risk**

Over the past three decades with the Federal Reserve, I have had occasion to observe a number of business cycles in which an expanding economy led to mispriced risk and over-investment. Unfortunately, these events are generally recognized only in hindsight, and usually after some gain exceptional advantage while many more suffer irreparable loss. The wake of such cycles leaves a lasting impression.

Having been a bank examiner during the 1980s, I supervised banks in this region as they felt the full brunt of that decade's crisis. Banks by the hundreds failed as a boom in agriculture, energy and real estate came to a devastating end. With the benefit of hindsight, it was clear that investors and bankers had mispriced the riskiness of assets in those sectors, and it took years for the region to recover.

Here we are again. This time, it was the national housing market. The boom created what proved to be an unsustainable rise in housing prices. With the collapse, the economy faces a weak housing market, high unemployment and impaired bank balance sheets leading to a financial sector that is shrinking in size and activity due to a combination of weak loan demand, tighter lending standards and a need to rebuild capital.

Policy choices that attempt to speed improvement in the housing and labor markets can be attractive given these circumstances. But this desire must be traded off against the need to foster long-term stability within our financial sector.

Some bankers with strong balance sheets tell me they must react to the current environment by taking on more risk. While appropriate risk-taking is fundamental to banking and desirable in this environment, creating conditions that encourage the financial system to take on mispriced risk could lead to distortions that will only haunt us later.

Preventing the mispricing of risk as it occurs is a tremendous challenge. Losses are few during good times, which can make adverse events seem unlikely and their risk difficult to estimate. For example, loan-to-value ratios, a traditional measure of safety, lose information content if values are artificial and, thus, ultimately unreliable. As a result, conservative bankers can be caught in the illusion of soundness and bank supervisors caught flat-footed.

Indeed, bank supervisors may see the risks forming but have difficulty conveying a sense of urgency to those risks. My experience with commercial real estate concentrations in the early 2000s highlights this challenge. As supervisors saw growing concentrations in these loans and drafted rules to limit the exposure, industry and congressional backlash delayed action. Federal bank regulatory agencies received more than 4,000 comment letters in response to their proposed guidance on risk management for this exposure. The hard reality of that risk confronts us today as a significant number of the 414 bank failures since 2007 were due to excessive concentrations in commercial real estate.

Today, in our own Midwestern backyard, farmland values are soaring to unprecedented levels. Each week brings a new tale of dizzying prices at the most recent farmland auction. I hear from many well-informed, concerned voices across our region wondering whether this could be a bubble. Only time will tell; however, these types of events have played out in the past, and the results were not kind to the industry involved or its banks. There may be other sectors

experiencing similar conditions that will not be obvious without the benefit of hindsight. This is a common pattern with mispriced risk.

### **Conclusion**

So, it is within this context that I approach my role in monetary policy and contemplate the path ahead. I view monetary policy as attempting to walk a fine line. On the one hand, today's policy settings are designed to encourage risk-taking and to stimulate much-needed growth across our economy. But on the other hand, experience has shown that pushing risk-taking too far can cause the mispricing of risk, the misallocation of capital and the ultimate weakening of financial firms' balance sheets.

Our policy tools must be managed as complements. Macroeconomic and financial stability are too interconnected to separate cleanly. Monetary policy and supervision must work in tandem if we hope to achieve maximum employment and price stability—the goals given to us in the Federal Reserve Act. It is, in fact, a very delicate balance.