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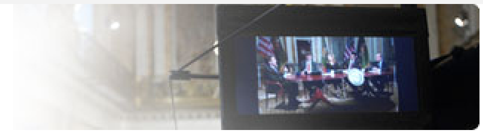
U.S. DEPARTMENT OF THE TREASURY

Press Center



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Washington - Good afternoon. Thank you for the opportunity to share my thoughts on the current state of the U.S. economy, and our housing and capital markets.

U.S. Economy

Data released this morning show that our economy expanded in the second quarter – GDP growth was 1.9 percent. This despite an unusually large inventory reduction which subtracted 1.9 percentage points from growth. Consumption added 1.1 percentage points – with a good boost from the stimulus. Trade continues to drive growth, adding 2.4 percentage points. Earlier this year, before the bipartisan stimulus plan was enacted, many had predicted far slower growth, even approaching zero. Clearly, the stimulus plan has supported the U.S. economy during this difficult period, and couldn't have been timelier. American families spent; companies invested and benefited from strong export growth.

I spent time last fall and winter traveling the country, and heard from many homeowners about their mortgage and other housing difficulties, and of their concerns about the broader economy. I also talked to people in a variety of industries and asked them what their business was telling them about where the economy was headed. My travels, my discussions with industry leaders and a review of the economic data with the rest of the President's economic team convinced me in mid-December that the economy had taken a sharp turn for the worse and the risks were to the downside going forward. President Bush recognized the downturn early, and directed me to work with Congress to craft legislation to bolster both consumer spending and business investment to protect the health of our economy. We all worked together quickly to enact a stimulus package that is temporary, targeted, big enough to have an impact and easy to implement quickly.

On April 28, just 75 days after the President signed the Economic Stimulus Act of 2008, the first electronic deposits were sent into Americans' bank accounts. One week later, the first week of May, paper checks were being printed and mailed. In the second quarter, Treasury employees sent almost 95 million payments totaling over $78 billion to American households. The Financial Management Service managed the high demands of tax season and simultaneously printed stimulus checks; the IRS has handled millions of taxpayer inquiries over the phones and through its website. Given the enormity of the effort, it was accomplished effectively and with minimal disruptions.

The private sector offered promotions that increased stimulus payment buying power. Local and national retailers, from vacation planners to supermarkets, gave incentives, sometimes as much as a 10 percent bonus, to those who spent their checks at those businesses.

We also know that companies are taking advantage of the stimulus package's temporary tax incentives. Businesses ranging from restaurants to computer service providers are using these provisions to invest in their companies and grow. We expect the stimulus to continue to support the economy in the second half of the year.

While the stimulus is making our economy stronger than it would have been otherwise, the housing correction, credit market turmoil, and high energy prices remain a considerable drag on the economy – and the effects of this drag can be seen in the soft job market.

Record high oil prices, which have increased dramatically since year-end, are putting a large burden on the U.S. and the world economy and creating hardships for families, households and industries everywhere. There are no simple or quick remedies for this. High oil prices are the result of supply and demand factors that are likely to persist for some time.

On the positive side, global economic growth from 2002 through the end of 2007 was remarkably strong, averaging over 4 percent. This growth, led by emerging market economies like China and India, has lifted millions of people around the world out of poverty. As living standards improve in emerging economies, demand for oil will continue to rise. Producers, unfortunately, have not made the investments necessary to keep pace with this growing demand. Because production capacity and investment has been curtailed over the last decade, supply now barely offsets declining production in older fields, let alone meets new demand.

Successfully alleviating the pressures in oil markets will require a long-term, comprehensive effort to keep supply on pace with demand. On the demand side, we need to allow market forces to work, to avoid subsidies and other potentially distorting policies. We also need to reduce oil dependency through investments in renewable fuels and alternative technologies, and improved energy efficiency and conservation.

While our economy faces substantial difficulties that will continue to be a drag on growth in the short term, it is important to remember that our long term fundamentals are strong. Recognizing the challenges ahead of us, I expect our economy to continue growing this year although at a moderate pace. We are making progress although not in a straight line; housing continues to be at the heart of our economic challenges and remains our most significant downside risk. We must work through the necessary adjustments in housing and credit markets to return to stronger growth next year and beyond.

Housing Markets

It took years of excesses – lax underwriting standards, excessive home price appreciation and overbuilding – to sow the seeds of the housing correction.

That said, we need to recognize that there is not a national housing market, but a collection of regional markets. The severity of the current correction varies widely by state and region. Areas that had some of the most pronounced price appreciation are facing the most pronounced price declines and foreclosure increases. Of course, that does not mean the correction isn't being felt across the nation. Foreclosure starts as a share of total outstanding mortgages have risen from 0.4 percent to 1.0 percent since the beginning of 2006. However, OFHEO's home price data shows that home prices actually rose in about half of the states in the first quarter.

Due to overbuilding in prior years, home inventories are now far above normal levels. At the current sales rate, there is a ten month inventory of new single-family homes on the market, and an 11 month inventory of existing single-family homes. This compares with a historical average of about six to seven months. The key to stabilizing the housing and financial markets is to work through these home inventories as quickly as possible.

Inventories decrease in two ways – fewer homes are built, and more buyers come into the market. We are seeing the necessary sharp decline in homebuilding. Single-family housing starts are down 65 percent from their 2006 peak and look to remain weak through this year.

New home sales appear to have stabilized to a degree – sales of new single-family homes are down 62 percent from their peak; and sales have been flat, rather than declining, for three months now. The drastic slowing in new construction has helped reduce the number of new single-family homes on the market, which is down 26 percent since its 2006 peak. The number of existing homes on the market remains elevated, but there are also tentative signs that sales in this category have been stabilizing since early 2008.

We all recognize that foreclosure sales increase inventories and, as foreclosed homes are put on the market, they drive down prices. Foreclosures and short sales now make up about one-third of existing home sales.

Treasury has worked closely with lenders and key industry participants on an aggressive strategy to do everything possible to help avoid preventable foreclosures. Last summer, we foresaw a wave of struggling homeowners and recognized that without some changes, the industry's protocol would not be able to handle the volume of homeowners seeking assistance. We supported the creation of the HOPE NOW Alliance of industry participants to work to avoid a market failure, in which homeowners who otherwise would have been able to modify or refinance into an affordable mortgage instead lost their homes simply because the system was too overwhelmed to help them. HOPE NOW has been instrumental in this effort and the industry reports that it has helped 1.9 million homeowners avoid foreclosure through loan workouts since last July. At the current pace, nearly 200,000 additional borrowers are helped every month.

From the outset of the HOPE NOW process, I have measured success by whether a borrower who has made all the payments at the initial rate, but couldn't afford the reset and reached out for help avoids going into foreclosure. And so far, the data on this question show an unqualified success. However, given the lax underwriting standards that preceded this correction, some people bought homes that they simply cannot afford. Many of them will become renters again.

Foreclosures and existing home inventories are likely to remain substantially elevated this year and next and home prices are likely to decline further on a national basis. The key question is, "When will the correction be largely behind us?" While home price adjustments will continue for some time, and certainly well beyond the end of the year, I believe we can move through the bulk of the correction in months rather than years.

Supporting the Availability of Mortgage Finance

Of course, to turn the corner mortgage financing must be available. We need more homebuyers to return to the market and buy homes, and to do that they need available and affordable mortgage financing. We have taken several steps to support the mortgage financing market now, and to address some of the structural issues that contributed to the current credit contraction.

In the past year, the FHA has implemented several initiatives to expand access to mortgage credit to troubled borrowers and since last August, nearly 300,000 borrowers have refinanced into affordable FHA fixed rate mortgages. Yesterday, President Bush signed the Housing and Economic Recovery Act into law, which will modernize FHA programs to provide greater access to FHA mortgages, including to some borrowers who are underwater on their mortgage.

More importantly to our system, the new law also includes significant, temporary provisions that will boost market confidence in the two current, largest sources of U.S. mortgage finance, the housing GSEs Fannie Mae and Freddie Mac, and establish the world-class regulator needed to address the systemic risk they pose.

Fannie and Freddie's continued activity is central to the speed with which we emerge from this housing correction and remove the underlying financial market and financial institution uncertainty. The temporary liquidity and capital backstops included in this new law are aimed at supporting the short and longer term stability of financial markets, not just these two enterprises. I would rather not have been in the position of asking for extraordinary authorities to support the GSEs. But I am playing the hand that I have been dealt. We saw a clear need to strengthen Fannie and Freddie's ability to continue to play their important role in financing mortgages and in our capital markets more broadly. There are no plans to access either of these temporary backstops. If accessing them becomes necessary, we would do so only under terms and conditions that protect the U.S. taxpayer.

Over the longer term, it is just as vital to our housing markets and our capital markets that structural concerns about the GSEs be addressed. We have long maintained that the GSEs have the potential to pose a systemic risk and recent events remove any debate on that question. Congress now has created a GSE regulator with authorities appropriate to the task and on par with other financial regulators. We have long sought this result, and our work is far from done. All parties must get to work immediately to begin to address the systemic risk issues posed by the GSEs.

In addition to securitization done by Fannie and Freddie, private mortgage-backed securitization provides additional mortgage funding for U.S. homebuyers. This private-label securitization has become severely strained. The sooner we work through the housing correction stabilizing home prices will do much to alleviate uncertainty about the values of mortgage-related assets. The private-label market will evolve in response to current challenges, and I expect it to return with greater risk-awareness and investor discipline.

As we focus on reinvigorating the traditional sources of mortgage financing, we have studied the range of other available choices. Three days ago, Treasury and U.S. regulators were joined by the nation's four largest banks to announce a Best Practices guide to kick-start the residential covered bonds market. Covered bonds are used for mortgage financing throughout the United Kingdom and Europe, and I believe covered bonds are a promising path for a new source of mortgage financing that will complement our existing system.

Capital Markets

The housing correction has fostered capital market strains that are having an impact on the broader economy. Tighter credit standards and increased interest rate spreads affect anyone who wants to buy a house or a car, get a credit card, or take out a loan to pay for school. Credit market strains affect cities, institutions and companies looking to fund long-term projects. Along with the Federal Reserve, we have taken aggressive actions to provide confidence and stability to financial markets, and I continue to urge financial institutions to strengthen their balance sheets by raising capital, de-leveraging and reviewing dividend policies so that they continue to play their vital role in supporting economic growth.

Even in this difficult environment, financial institutions have raised $190 billion in capital. Markets and financial institutions continue to reassess risk and re-price securities across a number of asset classes and sectors. This is a positive return to market fundamentals, and we are making progress. However, until the housing market stabilizes further we should expect some continued stresses in our financial markets.

Our first and most urgent priority is working through the housing downturn and capital market turmoil, and that will be our priority until these situations are resolved. At the same time, we are also examining and addressing the policy issues raised by the events of recent months. Our regulators are shining a light on our challenges, and market practices and discipline on the part of financial institutions and investors are improving. Through the President's Working Group on Financial Markets, the PWG, we have issued a report analyzing the causes of the current turmoil and recommending a comprehensive policy response, implementation of which is well underway. Regulators are enhancing guidance, issuing new rules, and communicating more effectively across agencies – domestically and internationally.

In addition to these immediate actions, the Bear Stearns episode and market turmoil more generally have placed in stark relief the outdated nature of our financial regulatory system, and reinforced my view that it must be updated.

In March, after almost a year of study and analysis, we released our recommendations in the Blueprint for a Modernized Financial Regulatory Structure. It is as compelling now as ever that we need a financial regulatory structure better suited to protect investors, protect the stability of the financial system, support the innovation and risk-taking that fuel our economy and improve both market oversight and market discipline.

In our Blueprint, we recommend a U.S. regulatory model based on objectives that more closely link the regulatory structure to the reasons why we regulate. Our model proposes three primary regulators that are organized by objective rather than functional financial institution category: one regulator focused on market stability across the entire financial sector, another focused on safety and soundness of institutions supported by a federal guarantee, and a third focused on protecting consumers and investors. This structure takes into account the new financial landscape and the role played by non-bank institutions and can more easily adapt to the ever-changing marketplace. Our Blueprint also recognizes the critical role market discipline plays in maintaining stability.

When we released the Blueprint, I was clear that it was a long-term vision that would take time to consider and implement. That is still the case, but today we have both a clear need and a unique opportunity to accelerate this process.

Whether it was Long Term Capital Management in 1998 or Bear Stearns this year, Americans have come to expect the Federal Reserve to step in to avert events that pose unacceptable systemic risk. But, as we noted in our Blueprint, the Fed has neither the clear statutory authority nor the mandate to attempt to anticipate and prevent risks across our entire financial system. Therefore we should consider how most appropriately to give the Federal Reserve the information and authority necessary to play its expected role of market stability regulator. The Fed would need the authority to access necessary information from complex financial institutions -- whether it is a commercial bank, an investment bank, a hedge fund, or another type of financial institution -- and the tools to intervene to mitigate systemic risk in advance of a crisis.

This is a tall order. History teaches us that in a dynamic market economy regulation alone cannot eliminate instability. To be clear, I do not believe that we can eliminate, by regulation or otherwise, all future bouts of market instability -- they are difficult to predict and past history may be a poor predictor of the future. However, just because the overall task is difficult, we should not stop trying to understand and mitigate instability.

To that end, we should create a system that gives us the best chance of foreseeing a crisis, including a market stability regulator with the authorities to avert systemic issues it foresees and providing the information, tools and authorities to deal better with unexpected events when they inevitably occur.

To complement this regulator's efforts, we must have strong market discipline to reinforce the stability of our markets. Market discipline constrains risk most effectively when a financial institution can fail without threatening the overall system.

However, two concerns underpin expectations of regulatory intervention to prevent a failure. They are that an institution may be too interconnected to fail or too big to fail. We must take steps to reduce the perception that this is so -- and that requires that we reduce the likelihood that it is so.

Strengthening market infrastructure will reduce the expectation that an institution is too interconnected to fail. We need to strengthen our practices and financial infrastructure in the OTC derivatives market and in the tri-party repo system. Important work is underway in each of these areas, and needs to be completed quickly.

To address the perception that some institutions are too big to fail, we must improve the tools at our disposal for facilitating the orderly failure of a large complex financial institution. Today, our tools are limited. We have specialized resolution provisions that apply solely to insured depository institutions. For these institutions, this special insolvency regime was deemed necessary because of the role these institutions play in the overall financing of economic activity and the presence of a government guarantee.

In contrast, bankruptcy law serves as the resolution regime for non-depository financial institutions and most corporations. These two very different approaches for resolution have advantages and disadvantages. Bankruptcy imposes market discipline on creditors, but in a time of crisis could involve undue market disruption.

We need to consider broadly the resolution regime in light of a changed financial landscape where non-bank financial institutions play a significantly greater role. It is clear that some institutions, if they fail, can have a systemic impact, so we must give regulators the authorities to limit that impact and facilitate an orderly failure. In my view, looking beyond the immediate market challenges of today, we need to create a resolution process that ensures the financial system can withstand the failure of a large complex financial firm. To do this, we will need to give our regulators additional emergency authority to limit temporary disruptions. These authorities should be flexible and -- to reinforce market discipline -- the trigger for invoking such authority should be very high, such as a bankruptcy filing. As part of this process we should consider ways to ensure that costs are imposed on creditors and equity holders. Any commitment of government support should be an extraordinary event that requires the engagement of the Executive Branch. It should be focused on areas with the greatest potential for market instability and should contain sufficient criteria to ensure that the cost to the taxpayers is minimized.

Conclusion

This period of market stress has revealed broader financial regulatory issues, and we are working to address these on a number of fronts as I have described. We remain focused and vigilant. I am confident that we will work through current challenges and Americans will benefit from an economy that emerges stronger and better poised for robust growth.

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