

The Economic Outlook for 2008

Risk Management Association

Richmond, Virginia

January 18, 2008

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Thank you very much, BJ. It's a pleasure to be with you again to discuss the economic outlook.¹ I'll begin this morning by discussing current conditions, and then go on to discuss the outlook for the coming year. Before we begin though, let me note that the usual disclaimer applies – the views I express are my own and are not necessarily shared by any of my colleagues on the Federal Open Market Committee.

Clearly, the severity of the housing market downturn, along with the attendant financial market fallout, has been the dominant macro-economic development of the past year. After a 10-year expansion, residential investment peaked in late 2005. Since then, construction and sales have fallen fairly sharply, first in large metropolitan areas that had seen the strongest booms, and then spreading this year to other markets where housing price increases were less pronounced. Despite the falloff in construction, inventories of unsold homes rose sharply. While inventory levels have actually retreated somewhat in recent months, they have not come down as rapidly as has the pace of sales, and they are currently depressing home prices and new construction.

Home prices increased significantly during the long boom, particularly in local markets with restricted supply. Existing home prices increased about 90 percent between 1995 and 2005 for the nation as a whole. In the Washington, D.C., market, prices increased 148 percent from 1995 to 2005 and rose another 11 percent in 2006. Here in Richmond, prices climbed by 85 percent over the same 10-year period and increased by another 12 percent in 2006. Of course, rapid increases in real quality-adjusted prices are not indefinitely sustainable for any asset, and in the case of housing, potential buyers eventually get priced out of the market. In many markets, prices changed course quickly, but in others, prices have continued to increase. Average prices for the nation as a whole fell in the third quarter of 2007 by 0.4 percent, which is the first national price decline since 1994. And in formerly hot markets, the declines have been larger, with prices falling over 5 percent in San Diego, for example. Prices also have fallen significantly in areas with weak regional economies, like Michigan and northern Ohio. Richmond has avoided an outright decline in prices, although appreciation has slowed significantly, with third-quarter growth of just less than 1 percent.

Developments in housing finance arguably have played a substantial role in the evolving conditions in housing markets. Here the long-term story is the technology-driven wave of innovation in retail credit delivery that dramatically expanded access to mortgage credit over the last decade, just as it expanded access to unsecured consumer credit earlier on.

Technology also has contributed to innovation in securitization and other forms of intermediation of credit flows, which also helped lower borrowing costs. As with any new product or service innovation, however, some experimentation and risk was involved, and in this case some of those risks were realized.

Future research may quantify the extent to which credit market innovations contributed to a boom in housing market activity by expanding the pool of potential homeowners. In any event, when the growth in housing demand came to an end, home prices peaked and began falling in many markets. In hindsight, it seems clear that the success of new methods of lending to riskier borrowers was to some extent dependent on sustained home price appreciation, which provided strained borrowers with the ability to refinance, thus masking the effects of more inclusive underwriting. It takes some time, however, for the likely ultimate loss experience of a mortgage portfolio to become evident. While observers were raising concerns early on – the late Federal Reserve Governor Ned Gramlich, for example² – it wasn't until last year, after home prices had peaked in some major markets, that more quantitative evidence began to emerge regarding the substantial extent to which mortgage loans made in 2006 would underperform previous vintages. The ensuing adjustment in underwriting standards further contributed to the decline in housing activity.

The story behind last year's unfolding drama in credit markets was the continuing re-assessment of the fundamental value of nonprime mortgages in light of incoming data implying significantly higher ultimate losses on recent vintages of subprime mortgages. Securitization was an important part of the expansion of credit in recent years, and securities backed by pools of sub-prime or other nontraditional mortgages served as the backing for other obligations, usually issued off the balance sheets of the sponsoring institutions. As housing slowed over the summer, it became clear that some mortgage-related securities previously judged as relatively safe would suffer substantial losses. Many of these securities were the liabilities of entities with explicit or implicit bank lending guarantees. Many banks that provided such guarantees have had to either meet large funding demands or bring the impaired assets onto their balance sheets. Uncertainty about the scale of such adjustments has at times meant higher funding and capital costs, although risk premia increased far more for some institutions than for others. Since then, such institutions have taken large write-offs, and many have replenished their capital. Many affected banks have dramatically increased their advances from the Federal Home Loan Banks, where lending increased by 29 percent or about \$180 billion in the third quarter.

Credit markets were hit particularly hard in August, as many participants found it difficult to refinance the asset-backed commercial paper they had issued. Banks began holding larger precautionary reserve balances then, putting upward pressure on interbank lending rates. The New York Fed injected significantly more reserves than usual via open market operations in order to relieve the pressure and keep the funds rate near the target. In addition, the Board of Governors accepted Reserve Bank requests to lower the discount rate by a half a percentage point, reducing the spread above the federal funds rate from the traditional 100 basis points down to 50 basis points. With concern mounting

that housing investment was declining more rapidly than had been expected and that the growth outlook was deteriorating as a consequence, the FOMC reduced the federal funds target rate in September and October, bringing the rate down 75 basis points to 4.5 percent. Financial market conditions showed some improvement in September and October, but turned problematic again in November, a month that also saw a further deterioration in the real outlook, as measures of housing market activity continued to come in below expectations.

In December, wholesale funding markets increasingly showed the effects of heightened uncertainty surrounding financial institutions' adjustment requirements. Term funding spreads relative to expected overnight rates became quite elevated for some banks, differentiation in rates across institutions became more pronounced, and the volume of term funding contracted. Increases in interbank interest rates associated with year-end, balance-sheet considerations have occurred in the past, but market participants appeared to expect low overnight rates over the year-end this time. Rates at the Federal Home Loan Banks are closer to the expected overnight funds rate than to term LIBOR, which may explain the relatively small amount of discount window borrowing even since the August reduction in the discount rate spread over the target. All this suggests that term funding premia reflected assessments of counterparty risk rather than expectations that the funds rate would spike at year end.

Against this back-drop, the Federal Reserve introduced a new mechanism for providing term funding to financial institutions. The Term Auction Facility, or TAF, makes 28-day loans of a predetermined total amount at a rate set by auction. These loans are otherwise similar to discount window loans made by a bank's regional Reserve Bank against collateral posted with that Reserve Bank. Since these auctions began, near the end of December, spreads on interbank term loans have fallen significantly, although they still remain elevated by historical standards. It will be difficult to determine the extent to which the TAF contributed to this easing of rates in the term funding market, since the counterfactual will never be observed. An earlier instance of elevation in term spreads, peaking in early September, abated without such action by the Fed.

As one would expect, revised assessments of mortgage lending risk have resulted in a tightening of credit standards. Many lenders are requiring larger down payments, and mortgage rate spreads have increased significantly for riskier borrowers and riskier products. Mortgage rates have come down since December – the rate on conventional 30-year fixed-rate mortgages has fallen about 50 basis points. And even though the spread between jumbo and conforming mortgages has widened a bit, jumbo rates have also eased in recent weeks, coming down about 30 basis points. Spreads on investment-grade corporate bonds have widened over the last month, but still, the level of yields on such debt has fallen. On the other hand, interest rates on high-yield debt and commercial mortgage-backed securities moved up in the last half of 2007, and have increased further since the beginning of the year. The strong differentiation in the response of lending spreads across borrower classes suggests that increasing spreads have been driven mainly by changing risk assessments rather than bank funding pressures. Higher risk spreads and generally tighter lending terms will tend to restrict spending in the near term. But the fall

in short- and long-term Treasury rates over the last few months has offset the upward movement in higher spreads for a wide range of borrowers. The net effect has been lower rates for all but the highest risk borrowers.

The economic outlook for 2008 has worsened in response to the developments of the last six months, and the recent flow of data has heightened the downside risks. The housing sector has been and will continue to be affected by the tightening we've seen in lending standards. Home construction is unlikely to bottom out this year, and I expect housing investment to continue to be a drag on growth through at least year-end. Business investment has contributed positively to growth over the last year, but I expect it to grow less robustly than in 2007, since some firms may see a higher cost of capital and some firms may face a decline in the demand for their products. Exports are likely to remain a source of strength next year, however, as a weaker dollar and relatively healthy economies overseas support demand for U.S. goods and services. Accordingly, I expect the trade deficit to continue to narrow, providing modest support to real GDP growth.

The main story in the forecast, though, remains household spending, which accounts for 70 percent of GDP. Consumer spending held up quite well up until the end of last year, having grown at over 3 percent in real terms during the three months ending in November. Higher energy prices and falling home prices are cited often as factors that could dampen consumer spending, and these are legitimate concerns. In addition, we could see more moderate growth in household income in the year ahead. Job growth slowed somewhat over the course of 2007, and in December employment was reported to have expanded by a meager 18,000 jobs, with the unemployment rate rising by three-tenths of a percentage point to 5 percent. Payroll employment is a fairly choppy series from month to month, however, and over the last three months payrolls grew by 97,000 jobs per month, on average. So while employment has certainly decelerated over the last 12 months, I continue to expect moderate job growth in 2008. With wage gains outpacing inflation now, and thus real incomes continuing to expand, I believe the most likely scenario is for reasonably solid income growth next year that will support some gains in consumer spending.

Putting it all together, I expect growth to be very weak for several more months, but to improve toward the end of this year. Clearly, the most cogent risks to the growth outlook are on the downside. With the strains in housing persisting, a substantial slowdown in business spending could raise the odds of a recession. This risk would be heightened if December's job market weakness proved persistent, pulling down prospects for personal income and household spending. Nevertheless, I believe the most likely outcome is for growth to continue and to improve. I should note that my baseline outlook does not depend on an overly sanguine view of financial market conditions, which are, after all, a significant source of uncertainty right now. Much remains to be learned about the magnitude of ultimate losses in various mortgage market segments and on various related securities. Episodes of turmoil could recur in response to new information. But I believe that financial market participants will find ways to work through problems as the year progresses. Financial intermediaries will re-adjust balance sheets and continue to

replenish capital as needed, and investors' desire for transparency will help shape the next generation of financial innovations.

Risks are not limited to the outlook for real economic growth. Inflation has stepped up recently. As measured by the 12-month change in the PCE price index, inflation was 3.5 percent ending in June 2006. That measure of inflation fell to 1.8 percent in August 2007. Similarly, core inflation, which omits volatile food and energy prices, was 2.5 percent in August 2006, and then declined to 1.8 percent in August 2007. Those declines were heartening, and when the financial market turmoil intensified in August the improving inflation picture allowed even an inflation hawk to endorse an easier monetary policy stance. Since then, however, the inflation picture has deteriorated. From August through November, the overall PCE price index rose at a 4.8 percent annual rate, and the core index rose at a 2.9 percent rate. Judging by the closely related consumer price index, the numbers for December will not be any better. Now these numbers do display transitory swings, so I wouldn't extrapolate them forward indefinitely. Still, I have to say that I am uncomfortable with the inflation picture, and disappointed that the improvement we saw earlier this year was not more lasting.

I am also troubled by the lengthy divergence we've seen between overall and core inflation. Some of you may recall that core inflation was devised in the 1970s to filter out some of the more volatile consumer prices to get a better read on inflation trends. For several decades, core inflation seemed to work well due to the fact that food and energy prices had no clear trend relative to the overall price level. In the last few years, though, overall inflation has been persistently above core inflation, and few observers expect oil prices to go back below \$20 per barrel. Because the job of a central banker is to protect the purchasing power of currency, it is overall inflation that we need to keep down, not just core inflation. Going forward, markets expect oil prices to back off slightly from their current level, and I hope they are right this time.

The Fed has responded to the slowing economy with a cumulative reduction in the federal funds rate of 100 basis points. A slowing economy requires a lower real interest rate because it means softer relative demand for resources now compared to the future. And the current downside risks mean that further slowing, and thus further easing, is quite possible. But inflation also presents risks. Throughout the period since 2005, when inflation rose, eased off, then rose again, longer-term inflation expectations have remained fairly stable. If energy and food prices continue to push overall inflation above core inflation, then this higher overall trend could work its way into expectations, further complicating monetary policy in 2008.

¹ This is a revised and expanded version of a speech I gave to the Charlotte Chamber of Commerce on December 19, 2007. I am grateful to Roy Webb for help in preparing this speech.

² Edward M. Gramlich, *Subprime Mortgages: America's latest Boom and Bust*, Urban Institute Press, Washington D.C., 2007.