The Economic Outlook

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It's a pleasure to speak to you today. My topic is the current economic situation and the outlook for the period ahead. Before we begin, though, let me remind you 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.[1]

The background for today's economic situation is the remarkable boom in housing that ended a couple of years ago. From 1995 to 2005, new housing starts increased by more than 50 percent, and existing home prices increased by more than 150 percent (as measured by the Case-Shiller repeat sales index), and the homeownership rate increased significantly, from around 64 percent to 69 percent. Favorable fundamentals contributed to the boom; per capita real income grew much more rapidly in the decade after 1995 than in the decade before, and real mortgage interest rates were low relative to prior periods, especially after 2002. The inelasticity of the supply of buildable lots generated significant price increases in many parts of our country. Elsewhere, price appreciation was more modest. Housing demand ultimately became satiated in many major markets, however, and housing activity peaked in early 2006 in several regions. Since then, new housing starts have fallen by 55 percent, and since mid-2006, home prices have fallen by 18 percent.

Developments in housing finance arguably have played a substantial role in the behavior of housing markets in recent years. Here, I believe the central 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 were involved. 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. When housing prices began to fall in many regions, delinquencies and defaults began to rise, particularly among mortgages that were made in 2006 and 2007. It takes some time, however, for the likely ultimate loss experience of a mortgage portfolio to become evident, so it wasn't until the middle of last year, well after home prices peaked in some major markets, that more quantitative evidence emerged 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 demand.

The resulting large number of mortgage foreclosures is an urgent problem and it is one that we at the Fed are responding to with direct actions. The Federal Reserve System's Homeownership and Mortgage Initiatives is a multi-pronged effort to understand and respond to this recent rise in foreclosures. First, we are using our extensive expertise in economic research and analysis to increase our understanding of the events. We are tracking conditions in mortgage and housing markets and conducting ongoing research to fill important gaps in our knowledge. What we learn we are communicating to the public through a variety of audiences. For example, we are providing community groups with analysis that identifies neighborhoods with high rates of foreclosures, so that they can better target their home-counseling efforts. We have organized foreclosure forums across the country with the theme, "Recovery, Renewal, and Rebuilding." We just held the first one in Atlanta and four more are scheduled through the fall. Furthermore, we also have posted interactive maps on the New York Fed's Web site showing the incidence and performance of subprime mortgages across the country.

Second, we are using our extensive footprint across the nation to engage and collaborate with relevant parties, such as community groups, government officials and lenders, to help them take practical steps to address this problem. We are partnering with Neighborworks America by providing analysis and developing tools and training programs for their efforts at stabilizing neighborhoods and dealing with the problem of vacant properties. Furthermore, we have hosted and continue to host many meetings and workshops designed to bring together stakeholders who are interested in reducing the incidence and effects of foreclosures. In sum, the array of efforts under the Fed's Homeownership and Mortgage Initiatives aims to leverage the Fed's comparative advantages in research and geographic reach to assist local responses to the mortgage foreclosure problem.

The story behind the drama in credit markets since last August has been the continuing re-assessment of the fundamental value of nonprime mortgages. I think it's fair to say that a deterioration in the housing market of the magnitude we've seen was not assigned much probability by most borrowers, lenders and investors, even if many observers argue, in retrospect, that it should have been foreseen. As losses have accumulated, demand has fallen for financial securities exposed to those assets, as well as a range of related securities. 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 generally meant higher funding and capital costs, although risk premia have increased far more for some institutions than for others.

After the housing market peaked, the steady fall in home construction became a sizable drag on growth. Last year, the decline in residential investment subtracted about a percentage point from real GDP growth, and in the first quarter of this year, it lowered

growth by more than 1 percentage point. Moreover, swollen inventories of unsold homes continue to depress prices and new construction. For example, the vacancy rate for owner-occupied housing was 2.9 percent in the first quarter, which is the highest value recorded in the 52-year history of that particular data series. Most lenders have eliminated many riskier innovative mortgage products from their line-ups, which makes sense given what has been learned from the recent performance of such products. But that makes homeownership more costly than it was during the boom and will slow down the housing market recovery. Thus, most observers are very hesitant about calling a bottom in housing construction, sales or prices, hesitancy that I share. And even if housing market activity does manage to bottom out later this year, it is likely that any recovery would be exceedingly slow.

Until early this year, the bad news has been limited to housing, but that's no longer the case. Last year, more than 16 million cars and trucks were sold in this country; in the first quarter of 2008, the sales rate fell to 15.3 million units; and in the second quarter, the sales rate fell to 14.1 million units. Not surprisingly, motor vehicle assemblies have fallen 21 percent this year.

That's a stringent dose of bad news. But a couple of other demand components have provided somewhat brighter news of late. First, the demand for exports has been strong due to robust economic activity abroad and the weakness of the dollar in foreign exchange markets. Exports added a full percentage point to real GDP growth in 2006 and 2007 and are likely to make a healthy contribution to growth this year as well.

We also have seen surprising indicators of firmness in business investment. At the turn of the year, we began hearing anecdotal reports, both in our District and elsewhere in the country, of commercial development projects being deferred or cancelled outright. Many of us had expected to see a contraction in commercial construction by now, but since the beginning of the year private nonresidential construction has increased by more than 5 ½ percent. Still, I think it is reasonable to expect at least some slowing later this year. Commercial construction projects tend to have a fairly long lead time, and architectural billings have fallen off notably in recent months. Thus, it would not surprise me to see the pace of commercial construction soften in coming months.

Business spending on equipment and software this year has also been firmer than I had anticipated. For example, shipments of non-defense capital goods, excluding aircraft, have increased for three straight months, and are now higher than at any point since December 2000. This category covers a large part of business equipment investment and recent reports indicate that business capital spending is holding up relatively well.

Real consumer spending slowed at the very end of last year and was sluggish for the first few months of 2008, rising by an annual rate of only 1.1 percent from November through April. The slow growth in consumer spending is understandable, given the restrained growth we've seen in household income. For example, real disposable personal income increased by only 0.5 percent during the first four months of this year. Personal consumption expenditures picked up noticeably in May, but this could well be

attributable to the disbursement of federal stimulus payments, so it's difficult to tell whether it represents a fundamental improvement on household spending trends.

A major reason for the slow growth in household income is the weak state of labor markets. Job growth was robust in 2006, with payrolls expanding by about 175,000 jobs per month. Job growth tailed off in 2007, as the residential construction industry began shedding workers. And payrolls have fallen every month so far this year, with an average loss of 73,000 jobs per month. Consistent with this picture of a worsening labor market, the unemployment rate has risen from a cyclical low of 4.4 percent in March 2007, to 5.5 percent this June.

Another factor that has dampened real income growth is the large increases we've seen in food and energy prices. While forecasting such prices is a challenging endeavor, if they follow the relatively flat trajectory implied by futures prices, then they would no longer restrain the *growth in* (as opposed to the level of) real income.

Putting the bad news together with the good, the story that emerges is of an economy that is growing at only a tepid pace overall. Over the last two quarters for which we have data (that is, the fourth quarter 2007 and the first quarter 2008), real GDP has grown at an annual rate of only three-quarters of a percent, which is about one-fourth of our long-run potential. Earlier this year, many observers extrapolated this slowdown into an outright decline in economic activity and concluded that the economy was in or about to enter a recession. But the data we've seen since then have not yet shown the sharp, widespread reversals that define a recession. While the risk of an acute near-term downturn has not entirely disappeared, it has diminished substantially.

Looking ahead, consumer spending is likely to continue to be bolstered by the government's stimulus checks over the next few months, although the extent of the spending effect will be hard to gauge. Beyond that, there are legitimate concerns about the outlook for real growth. The timing and size of any decline in commercial construction activity is uncertain, and could hamper growth in the second half. In addition, if we see a pick-up in the pace of the labor market contraction, which so far has been relatively mild, then consumer incomes and spending are likely to slow and restrain overall economic activity going forward. Moreover, the bulk of the stimulus checks will have been distributed soon, and the effects on consumer spending could start wearing off in the fourth quarter.

At the same time, it pays to not underestimate consumer resilience. People tend to look forward and will often take transitory income shocks in stride, even severe ones. This well-grounded principle suggests the possibility that consumers will save most of their stimulus checks, as appears to have happened in May, and spread out their spending increase smoothly over time. It also suggests the possibility of renewed consumer spending growth if energy prices flatten out, as futures markets predict.

It also pays not to underestimate the power of monetary policy. The Federal Open Market Committee has lowered the federal funds rate from 5 ¼ to 2 percent in less than eight

months. Adjusting for expected inflation brings the current funds rate to well below zero in real terms. Thus, we have quite generous monetary stimulus in the pipeline to support economic activity in the months ahead.

On the whole, then, I expect growth to be positive, but quite modest for the rest of this year, and to gradually pick up over the course of next year. Although the downside risks to growth are by no means negligible, they have diminished significantly to my mind since the beginning of the year.

While the growth outlook has improved since the beginning of the year, the inflation outlook has deteriorated. The latest figures confirm that inflation is unacceptably high. The price index for personal consumption expenditure increased 3.1 percent over the 12 months that ended in May, and is up at a 3.9 percent annual rate for the last 3 months. To put that in perspective, for several years, I have suggested an inflation target of 1.5 percent.

Of course, price increases have been concentrated in the food and energy categories, and taking those out, the conventional PCE core inflation rate has run slightly above 2 percent over the last year. Because core inflation has traditionally exhibited a fair amount of persistence, last year's core inflation is often a good forecast of the coming year's core inflation. The conventional approach to forecasting overall inflation is to combine that rule-of-thumb for core prices with projections for food and energy price derived from futures prices. Since futures markets have generally implied flat price paths, the result is an expectation that overall inflation will decline until it converges with core inflation.

One shouldn't ignore the information embodied in market prices, and I don't; competitive trading markets are impressively effective mechanisms for weighing and amalgamating widely divergent views. However, the deviations of actual prices from the forecasts implied by energy futures prices have been predominantly on the high side in recent years. While it is entirely possible, as a statistical matter, for this to happen due to chance alone, the risk is that elevated rates of increase in overall prices become embedded in expectations.

We seem to have dodged this risk so far. Despite several years of elevated inflation, the public's expectations for future inflation have not become completely untethered as they were in the 1970s. We have several ways of gauging expectations, none of them perfect, but they agree that inflation expectations are higher than I would like but are relatively stable. That sense of relatively stable expectations is consistent with the behavior of wages. There are no signs yet of a wage-price spiral, in which wages accelerate in a futile attempt to stay ahead of accelerating prices. In fact, gains in overall compensation have been remarkably stable over the last couple of years.

The apparent stability of inflation expectations does not justify complacency, however. Those expectations depend critically on confidence in how the Fed will tend to react to incoming data. Maintaining credibility depends on continuing to conduct policy in a way

that is consistent with the stability of inflation expectations, and acting forcefully should those expectations erode.

Part of the rationale for the speed with which the FOMC brought down the funds rate was the risk that the slowdown we are experiencing would prove to be more severe. While that uncertainty has not entirely disappeared, my sense is that such downside risks have diminished appreciably. And just as easing policy aggressively in response to emerging downside risks made sense, withdrawing some of that stimulus as those risks diminish makes eminent sense as well. Moreover, our attention to risks needs to be two-sided, I believe. As we move through this period of low growth, we need to be attuned to the risk that we emerge from the slowdown with inflation following a higher trend than when we went in. This danger associated with the persistence of elevated inflation warrants an additional measure of vigilance.

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