The Regional Economic Outlook
District of Columbia Chamber of Commerce
Washington, D.C.
October 11, 2006

Jeffrey M. Lacker
President, Federal Reserve Bank of Richmond

It is a pleasure to be with you today to discuss the economic outlook for the region. I work, as Barbara's kind introduction noted, at the Federal Reserve Bank of Richmond. The fact that our nation's capital lies within the Richmond Federal Reserve District, rather than the other way around, is an odd byproduct of decisions made over 90 years ago. When establishing the Federal Reserve System as the nation's central bank, Congress created a confederation of regional banks, rather than a single, centrally located bank. The founding organizers then made Richmond the headquarters for the Fifth Federal Reserve District, which covers the area from West Virginia and Maryland in the North down to the Carolinas in the South. The founders' motivating vision was that the nation was better served by an institution that was closely linked to the diverse economies that make up our country. And so, one of our key responsibilities at the Reserve Banks is to understand local economic conditions around our Districts. Of course, the Fed is well represented inside the beltway, since Washington is the home of the Board of Governors of the Federal Reserve System, the entity that oversees Reserve Bank activities. They are kind enough to let me roam Washington at will, and we are kind enough to cut their paychecks for them.

I plan to discuss economic conditions in our Federal Reserve District, with a particular focus on conditions in the Washington metropolitan area. But because our region's economy is so tightly linked with national economic trends, I will spend some time talking about the overall economic picture as well. As always, my remarks reflect my own views, and do not necessarily reflect the views of my colleagues within the Federal Reserve System, but you probably gathered as much from my recent voting record. To set the stage, let us start at the national level. The U.S. economy currently is in a period of transition. Looking back over the last three years, real gross domestic product – our broadest measure of total economic activity – grew at a 3.75 percent annual rate. That's a very healthy growth rate to sustain over a number of years, and it coincided with a significant improvement in the labor market, with 5.3 million new jobs created and the unemployment rate falling by a full 1.5 percentage points. Now that labor market conditions are fairly firm, the economy is transitioning to growth at a trend rate of around 3 percent per year – a pace at which job growth will match the growth in the number of workers over time.

I should note at this time that it would not be unusual for the transition to trend growth to be a little bumpy. That occurred back in 1995, for example. Growth in the first half of that year dipped below 1 percent at an annual rate before returning to a healthy pace that was sustained for the next five years. And this time around, there is an obvious reason to expect growth to drop below average for a time, namely, the end of the boom in residential housing. I'll talk more about this later on, because how the adjustment in the housing market plays out is an important source of uncertainty in the outlook, both regionally and nationally.

The other major source of uncertainty in the outlook is inflation. Price stability is the central responsibility of the Federal Reserve – we contribute best to economic growth when we keep inflation low and stable. That is widely viewed as requiring inflation to average between 1 percent and 2 percent, as measured by the core price index for personal consumption expenditures. Inflation, by that measure, has drifted up to 2.5 percent this year. Inflation is likely to moderate over the near term, but there is some uncertainty as to how long that will take. Should inflation persist around the current elevated level, firmer monetary policy would be required to restore price stability. As a result, I believe policymakers will need to remain quite vigilant in the period ahead, to ensure that inflation moderates at a sufficient pace.

The overall outlook for the Fifth District's economy is positive, though perhaps somewhat less so than if I had been giving this talk earlier in the year. Employment has grown over the twelve months ending in August at a solid 1.7 percent rate, better than the 1.3 percent growth rate for the U.S. Employment growth has slowed since the spring, similar to the national pattern. The combined unemployment rate for the six jurisdictions in our District has been steady near the current 4.5 percent rate, which is comparable to the 4.6 percent unemployment rate for the U.S. as a whole. Household financial conditions are also consistent with the national figures, with second quarter personal income expanding 2.2 percent against a 2.7 percent annual rate of growth nationally. And recent data on household finances indicate that those living in our region are not facing any unusual difficulties servicing mortgages or otherwise meeting financial obligations.

This overview of the District's economic picture masks significant differences between several unique economies within the Fifth District. The Carolinas, along with the southern edge of Virginia, for example, is a region that has historically been dependent on manufacturing, particularly textiles and furniture. These industries have shifted much of their production overseas in recent years. Six years ago, employment in textiles and apparel comprised 23 percent of all manufacturing employment in the region. As of August of this year, that share is down to just 16 percent. Despite this tremendous structural change, economies in these areas are currently experiencing job growth at over 2 percent per year, greater than the national average, and employment in the Carolinas has recently reached new peaks. Driving this rapid growth is the continuing expansion of construction jobs — I'll say more about this later — added strength in service sector jobs, and a lessening of manufacturing job losses. In fact, new manufacturing operations requiring more highly skilled workers are offsetting some of the decline of the old-line, low-skill industries. On the service side, we are seeing strong growth in the education and health services category. This mirrors the national picture, likely reflecting greater need for health services as we age.

Another big factor, though, is financial services. In the year ending in August (the latest data available), growth in financial sector employment has been about double the rate of overall job growth in the Carolinas. Some of this is attributable to the recent rapid growth of jobs in Charlotte, which is by some measures the nation's second largest banking center. The Charlotte area accounts for about one-fifth of all the jobs created in North Carolina in the past two-and-a-half years. In contrast, South Carolina still has counties — mostly rural — with double-digit unemployment rates, signaling perhaps that the state still has some catching up to do and that growth in the services sector has not necessarily been as robust in those parts of the state that have been losing manufacturing jobs. In many ways, the southern tier of Virginia is broadly similar to the economy of the Carolinas and it shares some of the economic issues of those states. An exception is the greater Norfolk – Virginia Beach area, which has a large military component in addition to tourism and services. This area has recently posted strong employment growth of 1.7 percent.

Looking westward within the Fifth District, West Virginia has also been shifting to a services economy, with nearly half of the state's residents residing in officially designated metropolitan areas — those in the eastern panhandle being part of the Washington metropolitan area. Outside of the panhandle, however, many areas of West Virginia still rely heavily on manufacturing or mining. Those industries continue to exhibit a pronounced cyclical nature, making the state's economy somewhat more volatile than other areas of our District. Nevertheless, recent expansions by Japanese car manufacturers, combined with the boost to natural resource industries from relatively high energy prices, have paid dividends to the state in recent years.

Closer to home for you, northern Virginia, Washington, D.C., Maryland and portions of eastern West Virginia make up the third broad economic region of our District. This region is composed primarily of service-oriented urban areas that have historically outperformed other regions in our District, as well as the national economy. The federal government has served as a major source of job growth for the region, and has traditionally acted as an economic stabilizer. This region was affected much less than the rest of the country by the recession earlier in this decade, for example. And employment growth has continued to outpace the nation; Washington metro area employment grew 2.5 percent in the year ending August, adding more jobs than any other large metro area outside of New York and Phoenix. Growth in recent years has been powered by defense spending and the ramping up of homeland security. The Washington area receives a substantial share of federal government procurement dollars, and a substantial portion of that spending is technology-related. The job growth has been concentrated in government and professional services and has been in relatively high-skilled, high-pay occupations. But the appropriate question to ask is whether job growth will continue at a breakneck pace. I hesitate to forecast federal policy with a hotly contested election right around the corner, but it seems reasonable to suppose that the real growth in defense and security spending will taper off somewhat in the years ahead. Fortunately, a substantial portion of the recent job increases have come in the private sector, and a substantial portion of these have been in sectors associated with technological innovation. We believe that total metro area employment should continue to expand at a healthy pace, but at a rate that gradually declines over the next couple of years.

On balance, even with the regional differences, the broad outlook across the Fifth District economy remains solid going forward, though there are risks for the regional economy, much as there are for the national economy. Housing is easily the most widely discussed economic risk at the moment. Because home prices in the Washington area have been notoriously high in recent years, I would imagine that the housing market commands even more attention hereabouts. And with good reason. Washington experienced a more rapid price appreciation than most of the nation during the recent housing boom, and has seen a sharper downturn in recent months.

But to understand any given local housing market, it is important to understand several macroeconomic factors affecting housing markets nationwide. So I would like to talk a bit about these macro factors, and then come back to the local housing market. First, remember that the recent housing boom has been very large by historical standards. A couple of numbers help illustrate the magnitudes involved. In 2005, almost 2 million new homes were built in the U.S., which is about a 50 percent increase from the average number built each year in the 1990s. Last year the average price of a home sold in the U.S. rose 13.3 percent; back in the 1990s, the average increase was 2.8 percent per year. The acceleration was even greater in the Washington area, where price appreciation ran as high as 25 percent last year versus around 2 percent in the 1990s.

Some of the concern about the housing outlook is motivated by the observation that large swings in residential housing activity, often in response to movements in interest rates, have played a big part in the post-war business cycles. But if you look carefully at the data, you see a big change beginning in the 1980s. Before that time, the way financial institutions were regulated contributed to extreme volatility in housing markets. Most home purchases then were financed by thrift institutions, who raised the bulk of their funding through retail deposits that were subject to interest rate caps. When interest rates rose in the course of a business cycle, money would tend to flow out of regulated financial institutions in search of higher returns, a process known as disintermediation, which caused severe disruption to the home financing system. This regulatory structure made housing activity much more interest rate sensitive, and much more volatile, than it otherwise would have been. The regulations capping deposit rates were eliminated in 1980, and the housing market's role in the business cycle has been quite different since then. In addition, cyclical interest rate movements were substantially larger prior to the mid-1980s. One should be cautious, therefore, about comparing the current housing cycle to historical episodes, particularly to episodes prior to the mid-1980s.

It's important to remember that the recent housing market boom was driven by fundamental factors that were – and still are – quite favorable. I'll just briefly list a few for you. Population continues to expand; for example, last year the number of households increased by 1 percent nationwide. Income is growing – so far this year, inflation-adjusted disposable income per person has increased at a 2.8 percent annual rate. We are a wealthy nation; household net worth is 53 *trillion* dollars, which represents over five-and-a-half years of disposable personal income. The tax treatment of housing remains highly favorable. Finally, mortgage interest rates were extremely low for many years, and even now are quite reasonable by historical standards.

Given these solid fundamentals, it is not surprising that the demand for housing has risen so strongly in recent years. As one would expect, we saw both higher production and higher prices in response to the sustained rise in demand. The rise in mortgage interest rates since 2004 has helped dampen the demand for housing, but it seems likely that much of the increase in rates was anticipated. In fact, the upward move in rates may have given an extra boost to demand in 2005 as consumers took advantage of the waning days of lower mortgage rates. With the surge in demand apparently satisfied now, we can expect to see a “return to normalcy” in the housing market, if I can borrow a phrase from a former Washington resident. Such a return to normalcy would involve lower production than we saw at the peak, and certainly a lower trajectory for housing prices.

This transition in the housing market is well under way. New home sales are down 17 percent, housing starts have fallen 20 percent, and the rate of price appreciation has fallen substantially, to the point that average prices were slightly lower in August than they were a year ago. These are national figures, of course, and more dramatic swings can be seen in some localities, particularly in areas that saw the strongest increases in housing prices and activity. The Washington area is a good case in point. Prices shot up more rapidly than elsewhere because strong area job growth created demand for housing that area builders had difficulty meeting. Builders say that the availability of building lots limited housing production in many localities within the region. And this makes sense as a simple matter of supply and demand: if supply does not expand elastically to meet a rise in demand, then prices have to rise instead. Indeed, looking across regions both within our District and around the U.S., home price appreciation was greatest where the supply of buildable lots seems to have been least elastic. One would expect most of the price increases in such regions to show up as rising land values, rather than as increases in the value of structures. And when demand subsides, land values reverse course. In contrast, prices did not accelerate as much during the boom in other metro areas in the Fifth District, where the supply of buildable lots was more elastic. And as a result, prices are not decelerating by as much in those areas either. Looking ahead, forecasts by area economists suggest that the Washington metropolitan area will continue to experience relatively rapid job growth. If correct, and if the supply of building lots remains inelastic, these forecasts suggest that the ongoing correction in area housing markets will find a floor sooner rather than later.

At the national level, some further retrenchment in housing markets is likely in the months ahead. But while there is substantial uncertainty about where the bottoming out will occur, I don’t think a catastrophic collapse in housing activity is likely, since the fundamental determinants of housing demand that I listed earlier remain favorable: prospects for population and real income growth look good, net worth remains high, and after-tax mortgage interest rates are still historically low. Instead, I believe we are seeing a return to a more conventional level of housing market activity in which volume, inventories and time-on-market are closer to historical averages. This adjustment naturally involves a fair amount of uncertainty for market participants. Both buyers and sellers are probably more unsure than usual right now about where prices need to settle in order to clear markets. In the meantime, they are collectively engaged in a time-consuming process of discovering the prices at which expectations and plans of buyers and sellers are mutually consistent.

Many macroeconomic analysts are concerned about the potential fallout of a weakening housing market. The direct impact of the housing market on overall economic activity is easy to calculate. The measure of residential investment spending that is included in real GDP has now fallen for three consecutive quarters. In the second quarter it fell at an annual rate of 11.1 percent, and appears likely to decline even more rapidly in the second half of this year. Since residential investment accounts for less than 6 percent of GDP, that lowered the real GDP growth rate by about seven-tenths of 1 percent in the second quarter. It would not be surprising to see housing reduce growth by even more for a few quarters. That would be a significant drag on the economy, but it would not end the expansion either, especially in light of offsetting strength in business investment spending, a topic I will touch on later.

While the *direct* effect of housing on GDP may not be overly large, some analysts worry about *indirect* effects, such as lower housing wealth leading to lower consumer spending. Again, it's important to begin with fundamentals. While fluctuations in household wealth are capable of affecting spending at the margin, the behavior of consumers is predominantly determined by their current and future income prospects. And those prospects are looking pretty good right now. With the unemployment rate below 5 percent**,** the labor market is looking fairly tight right now. Despite large increases in gasoline prices earlier this year, inflation-adjusted incomes are rising, as I noted earlier. And now that we've seen some relief at the gas pump, it would not be surprising to see a modest pickup in real income growth in the next couple of months.

The deceleration and fall in housing prices certainly will cut in to household net worth to some extent, but so far, such wealth effects have done little to slow household spending. Could housing prices end up falling sharply enough to cause consumers to rein in spending? Perhaps, but consumers' balance sheets generally are not as fragile as some commentary might lead one to believe. Housing debt is only 44 percent of the value of household real estate. With that substantial equity position, most homeowners who are not planning to move for other reasons can pretty much ignore transient price fluctuations. And with relatively high levels of *financial* net worth, most households are well buffered against price fluctuations. Moreover, as I emphasized earlier, household spending is driven mainly by current and future income prospects. Taking all these considerations into account, I would look for consumer spending to continue to expand at a reasonably good pace, even if housing prices come in weaker than I expect.

I should note that the end of the housing boom could not have been a complete surprise to most participants. Sure, it's nice to sell your home when bidding wars and escalator clauses are common, as they were in 2005. But these conditions were fairly unusual in most markets, and it's hard to believe many people seriously thought they would persist indefinitely. This is another reason to believe that most people are likely to be reasonably well-positioned for the end of the boom.

Another potential spillover that some analysts like to mention involves mortgage lending, especially with new financing options available to consumers. My sense is that the underwriting and pricing of mortgages has on the whole been sound, despite some individual anecdotes that suggest otherwise. The broad range of households that have taken out nontraditional mortgages are going to find them advantageous, even if, as with many financial products, a small fraction end up regretting their choice after the fact. Moreover, the banking industry looks healthy right now, with strong profitability and high levels of capital. Loan delinquencies are quite low by historical standards, as are chargeoffs of real estate loans. So it looks to me as if the end of the housing boom is unlikely to have any broader spillovers as a result of financial repercussions. Nor is it likely to be exacerbated by financial disintermediation of the type we saw earlier in the postwar era.

The labor market is another potential arena for adverse spillover effects from the housing market. We have seen employment in the residential construction sector fall this year as residential building activity has declined. Fortunately, however, *nonresidential* construction is on an upswing – over the four quarters ending in June, real nonresidential investment rose 7.2 percent. Further increases in nonresidential construction will allow many workers to simply change construction jobs rather than become unemployed. Indeed, over the last year overall construction employment has actually risen by nearly 210,000 jobs even as housing activity has softened.

As I mentioned earlier, the expected further weakening in housing activity is likely to be largely offset by business capital spending. Over the last three years, business fixed investment has grown at a quite solid 6.6 percent annual rate. Since business fixed investment is over 10 percent of GDP, this means that is has *added* about two-thirds of a percentage point to GDP growth, which has counteracted the drag from housing that I cited earlier. Indeed, when business investment demand fell sharply following the technology boom of the late 1990s, and the FOMC lowered interest rates in response, the anticipation was that interest rate-sensitive sectors such as housing and consumer durables would take up some of the slack until business investment spending rebounded. Now that business investment has substantially recovered, it makes sense for housing activity to subside in turn.

The fundamental underpinnings of near term investment demand are encouraging. Profitability is high, capacity utilization has been steadily rising, and many firms see strong demand for their products. Thus, it is not surprising that new orders for capital equipment increased 7.5 percent over the last year, and I see a solid outlook for capital spending over the next several quarters.

So, the outlook for overall spending looks reasonably good – consumer spending is on track, business investment is robust, and the softening in the housing market is not likely to be large enough to cancel out those sources of strength. To round out the picture on the national economy, let me say a few words about the labor market and the inflation outlook. Last year we added almost 2 million jobs, or about 165,000 jobs per month. We maintained that rapid expansion in the first quarter of 2006, but over the last six months job creation has averaged 118,000 jobs per month. While that sounds low, it's actually pretty close to what we would need to keep employment growth in line with population growth. And with the unemployment rate fairly low, it's appropriate that employment growth is close to its trend value. So what we're seeing in the labor market looks quite consistent with trend growth in overall economic activity.

The inflation outlook, on the other hand, is less appealing, and that is quite important to us at the Federal Reserve because as I mentioned earlier price stability is our central responsibility. I've said on several occasions that I would like to see inflation average about 1.5 percent over time, as measured by our preferred statistic, the price index for core personal consumption expenditures (often referred to as just "the core PCE index.") Moreover, I have also said that I would be comfortable if inflation was a little higher or lower, coming in between 1 percent and 2 percent**.** Several other policymakers and economists have also endorsed that range as a functional definition of price stability. But inflation has been outside that comfort zone for over two years now. It was 2.2 percent in 2004, 2.1 percent in 2005, and has come in at a 2.5 percent annual rate so far this year. And inflation looks worse if, instead of using the core PCE index, we were to use the overall index, which includes energy prices. That measure of inflation was 3.2 percent over the last 12 months.

My concern regarding these inflation readings is straightforward. On a month-to-month basis, practically anything that affects the supply or demand for particular commodities can unexpectedly move a price index around, and the financial press dutifully highlights a different special factor each month. But over a period of several years, a central bank can achieve whatever average inflation rate it chooses. And while there really is no benefit to high inflation, keeping inflation low and stable has a wide range of benefits to society. Low inflation helps people make better plans and commitments, since they will have a better idea about the future purchasing power of their money. And when inflation is low, people don't have to devote time and effort to protecting their wealth from being eroded by inflation. Thus, it is quite important to keep inflation from drifting away from target over time.

Moreover, the longer inflation remains elevated, the more difficult it will be to bring it back down. As people observe actual core inflation of 2.5 percent**,** along with the FOMC's reactions, they adjust expectations regarding future inflation, and those expectations become the basis for price setting in product and labor markets. (By the way, it was for his contributions to economic research on exactly this phenomenon that Professor Edmund Phelps was awarded the Nobel Prize in economics a few days ago.) If the Fed were to allow inflation to remain above target for too long, inflation expectations could become centered around the higher rate. Once that occurs, history tells us that strong and more costly policy actions would be needed to bring inflation and inflation expectations back down. We don't have any perfect measures of inflation expectations, but what we do have suggests that market participants do not foresee a rapid fall in core inflation. This is why I have argued for further policy actions to convincingly restore price stability.