Economic Outlook
Annual Economic Conference
Charlotte Chamber of Commerce
Charlotte, North Carolina
December 19, 2007

Jeffrey M. Lacker
President, Federal Reserve Bank of Richmond

Thank you very much, Henry. It's a pleasure to return to Charlotte again at the end of the year to discuss the economic outlook.[1] I'll begin by discussing current conditions in a bit more detail, before going 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 have risen sharply. These swollen inventories are currently depressing home prices and new construction.

Speaking of prices, 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 Charlotte, prices climbed by 49 percent over the same 10-year period and increased by another 17 percent since then. 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 have also fallen significantly in areas with weak regional economies, like Michigan and northern Ohio.

Developments in housing finance arguably have played a substantial role in the behavior of 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.

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 example[2] – it wasn't until this 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 demand.

The story behind this year's unfolding drama in credit markets is the continuing re-assessment of the fundamental value of nonprime mortgages. Demand fell 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.

In the last several weeks wholesale funding markets have increasingly shown the effects of heightened uncertainty surrounding financial institutions' adjustment requirements. Term funding spreads relative to expected overnight rates have become quite elevated for some banks, differentiation in rates across institutions has become more pronounced, and the volume of term funding appears to have contracted. Increases in interbank interest rates associated with year-end, balance-sheet considerations have occurred in the past, but market participants appear to expect low overnight rates over the year-end this time. This suggests that term funding premia reflect assessments of counterparty risk rather than expectations that the funds rate may spike.

Credit terms have tightened for non-financial borrowers as well. Mortgage rate spreads have increased significantly for riskier borrowers and riskier products, and many lenders are requiring larger down payments. Spreads for high-yield debt and commercial mortgage-backed securities have risen sharply. On the other hand, sound businesses with negligible exposure to housing markets have seen little change in the terms on which they can access credit. 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.

How will all this affect the economy going forward? Higher risk spreads and generally tighter lending terms will tend to restrict spending in the near term. But short- and long-term Treasury rates have fallen in the last few months, providing a partial offset to higher spreads. The net effect is lower rates for low-risk borrowers, but higher rates for riskier borrowers.

The housing sector has been and will continue to be affected by the tightening we've seen in lending terms. Home construction and sales are unlikely to bottom out before the middle of the year, and I expect housing to continue to be a drag on growth well into 2008. Business investment is likely to continue to grow, but less robustly than in 2007, as some firms face a higher cost of capital and many firms see more uncertainty in the demand for their products. Exports will be a source of strength next year, as a weaker dollar and strong economies overseas support demand for U.S. goods and services. Accordingly, the trade deficit is likely to continue to narrow, providing a modest boost to real GDP growth.

The main story in the forecast, though, remains household spending, which accounts for 70 percent of GDP. Higher energy prices and falling home prices are cited often as factors that could dampen consumer spending, and these are legitimate concerns. At the same time, though, I have learned not to underestimate the resilience of the American consumer, and here I see some reasonably encouraging signs. Job growth has slowed this year, but even so, payroll employment has expanded by an average of 100,000 jobs per month over the last three months. Moreover, wage gains are outpacing inflation now, and thus real incomes are continuing to expand. I believe the most-likely scenario, therefore, is for reasonably solid income growth next year that will support further gains in consumer spending.

Putting it all together, I expect growth to be very weak for several more months, but to improve as we move through 2008. So if I had to guess – as my host, Henry, insists – I would write down that real GDP growth will be between 2 and 2 ¼ percent from the fourth quarter of 2007 to the fourth quarter of 2008. This represents a growth rate somewhat below long-run trend. I would agree that the most cogent risks to the growth outlook are on the downside – for example, the possibility that household and business spending could come in lower than I expect. Nevertheless, I believe the most likely outcome is for growth to continue and to improve over the course of next year. My baseline outlook is more benign than some others that I am aware of, but I should note that it 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 replenish capital as needed, and investors' desire for transparency will help shape the next generation of financial innovations.

Let me conclude by discussing the inflation picture. 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 August, however, the inflation picture has deteriorated. In September and October, the overall PCE price index rose at a 3.3 percent annual rate, and the core index rose at a 2.6 percent rate. Judging by the closely related consumer price index, the numbers for November will be even worse. 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. If energy prices fail to decline, monetary policy decisions will be that much more difficult in 2008.

---

[1] 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.