

FRBSF ECONOMIC LETTER

Number 2008-28-29, September 19, 2008

The U.S. Economic Situation and the Challenges for Monetary Policy

This Economic Letter is adapted from speeches delivered by Janet L. Yellen, president and CEO of the Federal Reserve Bank of San Francisco, on September 4 and 5, 2008, to a group of community leaders in Salt Lake City, Utah, and to the Rotary Club of Los Angeles, respectively.

Regrettably, the nation's economy has been in rough waters for over a year now. Last summer, a precipitous slide in house prices triggered a crisis in financial markets and a credit crunch that is making it hard for consumers and some firms to borrow. These developments are ongoing and perhaps deepening, as banks and other financial intermediaries are continuing to delever by scaling back their balance sheets and shrinking their lending activity. In the face of these developments, firms and consumers have also been pulling back, causing unemployment to rise. As if this cycle of events feeding back on each other weren't bad enough, oil and other commodity prices have surged in recent years, generating worrisome numbers for headline consumer inflation. So, the problems facing the Fed have been myriad, complex, and difficult. We have had to balance concerns about economic weakness with equally compelling, but conflicting, concerns about inflation.

Quite recently, there has been a bit of a shift in the inflation picture, however. Commodity prices—most notably oil prices—have fallen well below their earlier peaks. I will argue that this development probably largely reflects a weakening in economic conditions in many industrialized countries, including European nations and Japan. By reducing the worldwide demand for commodities, weaker global growth should relieve upward pressure on U.S. inflation. Lower commodity prices should also be good for U.S. economic growth, although this benefit is likely to be counterbalanced to some degree by the detrimental effects of slower foreign economic growth on our exports, which have been surging. If commodity prices keep falling—or even if they remain at current levels—the Fed's objective of promoting *both*

price stability and full employment will become more readily achievable. In the remainder of my remarks, I want to elaborate on these points.

Housing

I'll begin with housing, because the “boom and bust” cycle in the housing market was the trigger for many of the developments I'll be discussing. The effect of the collapse in the national housing market on our economy has been profound. First, outlays for residential construction have been falling at double-digit rates in inflation-adjusted terms since 2005 and this decline has been a huge drag on growth. Slower economic growth has pushed up the national unemployment rate to 6.1%—over a full percentage point above the level that, in my view, is consistent with “full employment.” Going forward, it seems unlikely that construction activity will pick up any time soon. Inventories of unsold homes remain at elevated levels, and, although home sales have shown signs of leveling off recently—certainly a ray of hope—the volume of sales remains quite weak.

Second, the drop in house prices—around 15–20% off its peak, depending on which measure you use—has weakened the financial condition of many consumers. The value of their homes is an important part of their wealth, and equity in those homes serves as collateral for home equity loans and other types of borrowing. The result is that consumers are likely to spend less, reducing the pace of economic activity. Declining house prices also appear to be the single biggest factor behind the recent rise in mortgage delinquencies and home foreclosures. When families face financial difficulties due to illness, job loss, or divorce, an equity cushion often allows them to get through the hard times by borrowing needed funds or even selling the house. But when home price declines have wiped out home equity or driven it into negative territory, people often end up in delinquency or foreclosure. The vitality of the subprime mortgage market appeared to depend on continued home price appreciation, and, of course, it is now

in shambles with around 20% of subprime mortgages currently delinquent or in foreclosure nationwide. Delinquency rates on prime mortgages are far lower. But they, too, are on the rise.

Financial markets

The third profound impact of the national housing market collapse has been on financial markets, and the turmoil that began last August is still alive and well. For example, spreads between the rates that must be paid by risky borrowers over those on Treasury securities remain very high. And, as you know, we've begun to see a growing number of failures of depository institutions—notably IndyMac, which represented the largest failure in decades.

In addition, many financial markets are still not operating efficiently or effectively. In particular, the market for so-called private-label securitized mortgages of even the highest quality remains moribund. These complex instruments were the primary source of financing for nonconforming residential mortgages, including subprime loans.

Outside of expanded lending by the FHA, there is now little or no lending to higher-risk residential mortgage borrowers. Jumbo mortgages for prime borrowers are available, but at historically high spreads over rates on conventional mortgages, as banks have been reluctant to make these loans. Beyond higher rates, many depositories are tightening the terms of their lending, capping or terminating some home equity loans, and in general trying to reduce their exposure to credit losses by reducing the scale of their lending. Importantly, the government-sponsored agencies—Fannie Mae and Freddie Mac, the largest of all mortgage lenders—have suffered credit losses and are having to pare back their crucial roles in the mortgage market. The result of all of this is a severe economy-wide credit crunch, comparable to the one that hit the economy in the recession of the early 1990s.

The story of how falling house prices, and, in particular, their effects on the subprime mortgage market, triggered the problems in financial markets is well known. At the most basic level, financial market participants suddenly realized that house price declines could result in substantial losses on subprime mortgages through delinquencies and foreclosures, that the extent of those losses was highly uncertain, and that the complexity of mortgage-backed securities and the collateralized debt

obligations incorporating them made it difficult to know which participants would suffer the losses.

The story of how these problems will ultimately be resolved is far less clear. Obviously, it would help a lot if house prices stopped falling. But even though the *rate of decline* of house prices has shown signs of moderating, it appears that these prices will keep heading down for some time. The ratio of house prices to rents—a kind of price-dividend ratio for housing—still remains high by historical standards, despite having fallen substantially from its historical peak in early 2006. This suggests that further price declines are needed to bring housing markets into long-run balance. Moreover, large inventories of unsold homes can be expected to continue to put downward pressure on housing prices. In view of these factors, it's not surprising that the futures market for house prices predicts further declines this year.

Going forward, the ability and willingness of commercial banks and other intermediaries to extend credit depends in part on their capital levels. Capital has been depleted by large losses, but it is encouraging that financial institutions have raised a considerable amount of new capital over the past year. Even so, balance sheet pressures and broader financial market dislocations may well be with us for some time. My guess is that market functioning will improve in 2009, but things could get worse before they get better. One major concern is that home prices could fall more than markets now expect, leading to larger losses for financial institutions, which would further impair their ability to make new loans. The deepening of the credit crunch could then lead to further declines in house prices, intensifying the adverse feedback loop that seems to be operating in our economy.

Commodities

Beyond the many repercussions of falling house prices, another factor putting a damper on economic activity has been surging prices for commodities, including energy, food, and metals. There's plenty of debate about where this surge in commodity prices came from. Some have argued that speculative trading in commodity markets is the main cause but, personally, I'm not persuaded by that explanation. For example, if speculators were important in driving prices up, then inventories would have risen as these speculators sought to profit from future sales at higher prices. However, inventories have instead been declining in most

commodity markets, apparently reflecting high fundamental demand from buyers who actually use the commodities in the production of other products.

In fact, in general, I'm more persuaded by arguments based on the fundamentals of demand and supply—and I think they explain not only much of the run-up in commodity prices, but also the recent declines. In the run-up, demand was boosted by rapid worldwide economic growth, with China and other developing countries accounting for a good deal of the increase. At the same time, new supplies of oil have been harder to come by. As for food prices, supply has been constrained by a number of factors, including drought conditions that hampered wheat production in Australia, and demand for biofuels that has diverted crops away from food usage.

As I said, the fundamental forces of supply and demand can also explain the drop in energy and some other commodity prices since June. Most important is that the demand for commodities has probably fallen in response to a weakening of economic growth in many industrialized countries. In the second quarter, it was only barely positive in the 30-country OECD bloc as a whole, and Japan, France, Germany, and Italy all experienced outright contractions. Moreover, prospects for growth do not appear to be that good for the second half of this year; for example, the OECD Economic Outlook projects growth of only 1¼% for Japan, the euro area, and the total of OECD countries in this period.

Several factors are behind the worsening outlook abroad. First, as in the U.S., higher oil and food prices have cut into consumer spending. Second, although most of Europe had little subprime lending of its own, deteriorating U.S. financial market conditions have affected banks and markets abroad that invested in structured products originated in the U.S.; this is particularly true for banks in the United Kingdom, Switzerland, Germany, and France. As in the U.S., this exposure has led to higher funding costs, tighter bank lending standards, and wider spreads for riskier borrowers. Third, several countries, including Spain, Ireland, and the U.K., have experienced their own housing booms and downturns, creating further stress on their banking sectors. Fourth, slower growth in the U.S. and the depreciation of the dollar against their currencies have dampened European and Japanese exports.

Finally, monetary policy in Europe has been less accommodative during this period than in the U.S. For example, while the Fed cut its target interest rate substantially to 2% during the course of the credit crisis that began last summer, the European Central Bank kept its policy interest rate steady throughout, and then tightened by 25 basis points to 4¼% in July. Part of the reason for the difference is that the European Central Bank's mandate requires it to focus exclusively on controlling headline inflation, which reached 4% for the 12 months ending in July—a rate well above its official objective of below, but close to, 2%. In addition, even though much of the recent increase in inflation is attributable to commodity prices, and therefore likely to be a temporary phenomenon, the central bank has been worried about second-round effects on inflation expectations, wages, and other costs, and justifiably so. The euro zone has a greater degree of wage indexation and collective bargaining than the U.S. So it is more likely that higher headline inflation will fairly quickly get built into wages there, setting off a wage-price spiral that could be persistent and difficult to stop.

Now that growth appears to be weakening outside the United States and prospects for inflation have improved with recent declines in commodity prices, financial markets have revised down expected future levels of interest rates in the euro zone and elsewhere. As a result, in recent months the course of the dollar has changed from the steady decline over the prior six years to an appreciation. A stronger dollar will tend to weaken demand for our exports, reinforcing the effects of weaker growth abroad.

U.S. outlook

Turning back to our own economy, it was recently reported that growth in the second quarter came in at a fairly robust rate of 3¼%. And this seems like good news—especially considering what the economy has just been through. Growth slowed sharply in the fourth quarter of last year, and, indeed, the data show that activity actually contracted slightly. Though growth turned positive in the first quarter, it was tepid at best.

While one might be tempted to interpret the recent strong numbers as a sign that things are turning around, there are three important reasons to think that the strength will not hold up, and that economic performance will be decidedly subpar

in the second half of the year. First, consumer spending in the second quarter came in at only a moderate rate, even though it was boosted by substantial tax rebates. But there are no plans in place to repeat those rebates, so by the fourth quarter, the economy will no longer benefit from that fiscal stimulus.

Second, export growth alone contributed one-half of the total real GDP growth registered in the second quarter. This element has been an important source of strength in our economy for over a year, buoyed by strong growth abroad and by the weakening of the dollar. However, the dollar has rebounded some in recent months and, as I noted, economic growth in many of our industrialized trading partners has slowed or even turned negative, suggesting that exports will no longer give much of a boost to the pace of our economic growth.

Third, the problems in the housing markets, financial markets, and labor markets continue to be a drag on growth and employment. Fortunately, the recent fall in commodity prices should help to cushion some of this downward pressure on activity.

Overall, I anticipate that real GDP growth in the second half of this year will come in below the growth of potential output, which implies that the unemployment rate will rise further. On its own, this obviously is not good news. And its interaction with the housing and financial markets raises the potential for worse news—a deepening of the adverse feedback loop I've been describing: more unemployment causing more people to fall behind on their mortgage payments, leading to further delinquencies and foreclosures, tighter credit conditions and further downward pressure on activity and employment. This kind of process represents a downside risk for the economy, and the September 5 jump in the unemployment rate highlights that risk.

Finally, let me turn to inflation, where recent performance has been a serious concern. As of July, the headline PCE price index—a comprehensive measure of consumer prices—was up by a whopping 4¼% over the past year, compared to 2½% over the prior year. An important reason why inflation was so high, of course, was because of the steep increases we experienced in food and energy prices. On top of that, the rise in commodity prices boosted the costs of the wide array of busi-

nesses that use them as inputs, and some have responded by passing those cost increases through to their own prices. The consequence is that core inflation, which excludes food and energy, is also up. The core PCE price index rose by 2½% over the past 12 months, which is somewhat above the range that I consider consistent with price stability, but close to its pace of increase over the last several years.

As bad as inflation has been, I am very hopeful that inflation will come down quite substantially, though perhaps not as fast as I'd like; we probably need to live through another quarter or two of higher inflation, as previous increases in commodity prices boost the prices paid by consumers for food and energy.

One reason for inflation to come down thereafter is the recent decline in commodity prices. As long as they don't keep going up, they will cease to put direct upward pressure on headline inflation. Furthermore, the slack we now have in labor and product markets will impart some downward pressure on the growth of labor compensation. The pace of wage and salary increases has been stable and quite modest in recent years and a weak labor market may cause it to decline even further.

Another important factor in the inflation outlook is inflation expectations. If the public were to conclude that the recent experience of high inflation will be long-lasting and not temporary, then workers might demand higher compensation and firms might satisfy those demands, setting off a wage-price dynamic that would be costly to unwind. I argued earlier that such a wage-price spiral was less likely here than in Europe because our economy has less wage indexation than exists in the euro area. However, that does not mean that we can afford to ignore the risk that such a damaging spiral could develop here.

Fortunately, I do not see signs of this development at this point. Outside of a few booming sectors such as energy, there are no real signs of escalating wage pressures, and the two broad measures of national labor compensation that we monitor have shown remarkably small increases recently and over the past year. Taking productivity growth into account, growth in labor costs per unit of output in the overall economy has been quite modest. Moreover, various measures of longer-

term inflation expectations suggest that they remain relatively well contained. With the recent decline in commodity prices, inflation expectations for the next five years have edged down slightly in both the Michigan Survey of households and the Philadelphia Fed's Survey of Professional Forecasters. Furthermore, since June, compensation for inflation and inflation risk over the next five years—as measured in markets for Treasury Inflation Protected Securities—has dropped noticeably and is now under 2%. For the period from five to ten years ahead, compensation has dropped a bit and remains at the lower end of its trading range of recent years. In summary, it seems clear that inflation risks have diminished somewhat in recent months as commodity prices have come down from their highs. But they have by no means disappeared and are very much at the forefront of the Federal Open Market Committee's attention.

Monetary policy

This brings me to my views on monetary policy. The Committee responded to the difficult economic conditions that emerged last year by easing monetary policy substantially, cutting the federal funds rate to 2%, which is more than three full percentage points below where it was just last

summer. Although this rate is low by historical standards, I still don't consider the stance of monetary policy to be excessively stimulatory. In light of all of the disruptions to the financial system I described, I consider financial conditions to be more restrictive overall now than when the financial crisis struck a year ago. Policy must be calibrated to push through the substantial headwinds the economy faces.

So, to summarize the outlook, while the economy did well in the second quarter, that strength is unfortunately likely to prove ephemeral. I anticipate sluggish growth in the second half of this year. Overall inflation over the past year has been unacceptably high. But, the prognosis for the not too distant future is favorable. The recent drop in commodity prices has improved the policy choice facing the Committee. However, going forward, it is clear that we must keep a close eye on both inflation and inflation expectations to ensure that we continue to earn the inflation credibility that we have built up over the past two and a half decades.

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