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The U.S. Economic Situation and the Challenges for Monetary Policy[1]

Good afternoon, everyone, and thank you for coming. It is always a pleasure to visit Salt Lake City. Our branch office was established here in 1918, and the Fed's ties to this community are long and deep. This morning, the directors of our Salt Lake City Board met with their counterparts from Seattle and Portland to discuss economic trends and to share insights on factors affecting the outlook for both our region and the nation as a whole. The Fed's Twelfth District comprises nine western states, 20 percent of the American population and economy, and one-third of the country's landmass. We are by far the largest and most diverse Reserve District in the nation, so we rely extensively on our directors—those of our four branches and of our head-office Board in San Francisco—and members of the larger business communities we serve to help us identify emerging economic trends. The main focus of my remarks today will be on conditions in the U.S. economy as a whole and their implications for monetary policy. But I will touch on some of the unique factors that are affecting the Utah economy as well.

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

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intermediaries are continuing to delever by scaling back their balance sheets and shrinking their lending activity. Indeed, some sources of funding have completely dried up. 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.

Before I turn to a brief review of where the U.S. economy stands now, I want to remind you that my remarks represent my own views and not necessarily those of my colleagues in the Federal Reserve System.

Housing

Because the "boom and bust" cycle in the housing market was the trigger for many of the developments I'll be discussing, I would like to start there. Since the end of 2005, outlays for residential construction have been falling at double-digit rates, in inflation-adjusted terms, and house prices have fallen by 15 to 20 percent, depending on the measure you use. In what may be a ray of hope for the future, sales of new homes show tentative signs of stabilizing—albeit at a level that is a mere 40 percent of their 2005 peak—and the pace of price declines has slowed in the past several months, although these prices are still down substantially from year-ago levels.

Behind these national figures, of course, lies considerable geographic diversity. Salt Lake City and Utah have fortunately done much better than the national average in terms of prices; house prices continued to rise at a healthy pace in 2007, and show only modest declines thus far in 2008. Nonetheless, the state is not immune from the housing slump. The pace of home sales in Utah is down substantially since peaking in 2006, and new home construction plummeted at the start of this year.

The effect of the collapse in the national housing market on our economy has been profound. First, the decline in the pace of housing construction directly subtracted a full percentage point from overall real GDP growth in 2006, 2007, and the first half of this year, and slower economic growth has pushed up the national unemployment rate to 5.7 percent—almost 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, the volume of sales, as I noted, remains quite weak.

Second, the drop in house prices has weakened the financial condition of many consumers because 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. Indeed, the vitality of the subprime mortgage market appeared to depend on continued home price appreciation, and, of course, it is now in shambles. After posting delinquency rates in the single digits in 2005, around 20 percent of subprime mortgages are currently delinquent or in foreclosure nationwide. Delinquency rates on prime mortgages, which are far lower, are nonetheless also on the rise.

Utah has been fortunate that mortgage delinquencies barely budged during 2007 and early 2008, remaining at historically low levels while they were rising precipitously in other parts of the nation. Home foreclosures in the state have risen over the past few quarters, though, and further increases are likely before the slowdown ends.

Financial Markets

The third profound effect of the national housing market collapse, of course, has been felt in the financial markets since last August. Unfortunately, the turmoil is still alive and well, and conditions remain very fragile. For example, spreads between the rates that must be paid by risky borrowers over those on Treasury securities remain very high. The debt ratings for several important bond insurers have been cut, and stock prices for financial institutions have plummeted. 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 still 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, suggesting 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, which have been harmed by large losses, and their capacity to expand equity capital. 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. Indeed, some have argued that speculative trading in commodity markets is the main cause. Personally, I'm not yet 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.

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 most likely fallen in response to a weakening of economic growth in many industrialized countries. Economic growth of industrialized countries slowed markedly in the second quarter. In fact, growth was only barely positive in the OECD bloc as a whole. The OECD is a Paris-based organization comprising 30 developed nations. 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 percent for Japan, the euro area, and the total of 30 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 appreciation of their currencies against the dollar will tend to dampen 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 percent 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 percent in July. Part of the reason for the difference is that the European Central Bank's mandate requires it to focus on controlling headline inflation, which reached 4 percent for the twelve months ending in July—a rate well above its official objective of below, but close to 2 percent. 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.[2] 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.

[2] According to the ECB, wage indexation exists for roughly 13 percent of workers in France, 2/3 in Spain and Cyprus, and 100 percent in Belgium and Luxembourg ("Wage growth dispersion across the euro area countries," ECB Occasional Paper No. 90, July 2008). In other cases, wages are indirectly linked to inflation through collective bargaining agreements. For example, the IG Metal trade union negotiated a 5.2 percent wage increase in the German steel industry. Other sectors, such as the automotive industry or the civil service, also won wage increases above 4 percent.

In the euro zone, 18 percent of private sector workers and 22 percent of all workers are unionized. In the U.S., 7.5 percent of private sector workers and 12 percent of all workers are unionized. Moreover, in Europe, big unions often engage in centralized negotiations with employer associations to set wages for large sectors of the labor force (WSJ, Aug. 22, 2008).

U.S. Outlook

Now let me turn to the outlook for our own economy, starting with a brief look at conditions in Utah. This state had been among the nation's fastest-growing in recent years; indeed in 2007, the pace of real GDP growth here—5¼ percent—placed it first among all states. Not surprisingly, Utah also has had one of the lowest unemployment rates in the nation over the past few years. However, the national slowdown now seems to have caught up with Utah's economy. Growth in the state has slowed noticeably this year, and the more general slowdown in national consumer spending and travel activity has been reflected in a drop in visitor counts and hotel occupancy rates in the state in recent months.

Turning to the national economy, it was recently reported that growth in the second quarter came in at a fairly robust rate of 3¼ percent. 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, being buoyed by strong growth abroad and by the weakening of the dollar. However, as I discussed, in recent months the dollar has risen somewhat and economic growth in many of our industrialized trading partners has slowed or even turned negative, suggesting that we can no longer count on exports as an important source of strength.

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. 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, especially if it intensifies the sagging consumer and business confidence we've seen.

Now let me turn to inflation where recent performance has been a serious concern. As of July, the headline PCE Price Index was up by a whopping 4¼ percent over the past year, compared to 2½ percent 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. Moreover, the rise in commodity prices raised the costs of the wide array of businesses 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 percent over the past twelve 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.

What can we expect going forward? Headline inflation is likely to remain much higher than I would like for a quarter or two as previous increases in commodity prices boost the prices paid by consumers for food and energy. With regard to core inflation, I wouldn't be surprised if it runs modestly higher for a while, too, as businesses pass on some of their higher energy, transportation, and other costs to customers. However, for several reasons, I expect both headline and core inflation to move down to a much more moderate rate of just over 2 percent next year.

One obvious reason is the recent decline in commodity prices, and the prospect that they will remain at present levels, thus ceasing to put direct upward pressure on headline inflation. Indeed, commodity prices may drop further. While this is by no means certain, it does seem more likely than it did just a few months ago since the odds have risen that activity in most industrialized economies will weaken further, translating into downward pressure on commodity prices. Furthermore, the current slack in labor and product markets —together with prospects for more slack in the future—will impart some downward pressure on the growth of labor compensation. The pace of wage and salary increases has been modest and stable in recent years and a weak labor market may cause it to decline even further.

But there is more to inflation than these direct pressures. We also have to pay close attention to inflation expectations and the dynamics that they can generate. 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. First, the reports of our directors and business contacts are consistent with the view that no such dynamic has taken hold. Outside of a few booming sectors such as energy, we hear no reports of escalating wage pressures even though higher food and energy prices have eroded the real incomes of American workers. Our contacts note that high unemployment is holding down labor turnover, suppressing the need to raise wages more rapidly. 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 percent. For the period from 5 to 10 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 FOMC'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 percent, which is more than 3 full percentage points below where it was just last summer. Today, there is a great deal of debate about just how accommodative the stance of policy actually is. This issue is especially acute given that the Fed has been facing a difficult policy choice, with risks to both economic activity and inflation.

In measuring the stance of policy, it's common to look at the real federal funds rate —the nominal rate less a measure of the rate of inflation that is likely to prevail over the period ahead. For inflation, I have tended to use *core* PCE price inflation, that is, without the effects of food and energy prices. Of course, food and energy are important costs faced by consumers, but I think it appropriate to exclude them in this computation because, as I argued, their effects on overall inflation are likely to be temporary. As a result, recent core inflation is often a good indicator of future overall inflation. In my view, this is true right now. As I said earlier, core PCE price inflation averaged 2½ percent over the past year, well below the 4¼ percent headline number, but I'm expecting both core and headline inflation to come in a bit over 2 percent in 2009 as a whole.

Doing the math leaves us with a slightly negative real federal funds rate. Does this mean that policy is highly accommodative? Normally, a negative real funds rate would imply that the answer is "yes" because it is typically associated with low borrowing costs and easy credit terms—that is, easy overall financial conditions. But, as I discussed, overall financial conditions are probably more restrictive now than when the financial crisis struck a year ago, so the slightly negative real funds rate does not imply a highly accommodative policy stance. In other words, policy must be calibrated to push through the substantial headwinds the economy faces. While the economy did well in the second quarter, that strength, as I indicated, is likely to prove ephemeral. My forecast is for sluggish growth in the second half of this year, with substantial downside risks—especially emanating from the financial system.

Overall inflation over the past year has been unacceptably high. But, the prognosis going forward is favorable. Inflation expectations remain relatively well contained, reducing the chance that a wage-price spiral will develop. Moreover, if new lower commodity prices hold, even at today's high levels, we are likely to see improvements in overall and core consumer inflation coming through the pipeline soon.

In summary, 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.