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Housing, Banking, and the Recovery: The Outlook

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The economic outlook is increasingly positive, boosted by housing, banking, and labor market improvements. While the Federal Reserve recently eased its bond-buying program, indicating monetary policy is on the path back to normal, full normalization will take time and be based on economic data. The following is adapted from a presentation by the president and CEO of the Federal Reserve Bank of San Francisco to Lambda Alpha International and the Arizona Bankers Association in Phoenix, Arizona, on January 7, 2014.

It's great to be back in Phoenix again, and I'm pleased to start the year off on a positive note.

After years of fits and starts, the economy appears to be on a much stronger path than we've seen in some time. It was only 18 months ago that the satirical newspaper *The Onion* ran the headline, "Nation's Economists Quietly Evacuating their Families." That was then. More recently, the economic data have been quite encouraging, and there's reason to believe that this year, the economic recovery will gain further momentum.

Since we're being hosted by Lambda Alpha International and the Arizona Bankers Association, I'd like to talk to you today about the housing market and banking conditions. I'll also give an overview of where I see the economy and, of course, monetary policy, going.

Housing market

Some of the good news has been coming from a sector many of you know well: housing. Nationally, the housing market started its rebound in early 2012, and the recovery has been fairly steady since.

This improvement has been propelled by several forces. First, the Fed's very accommodative monetary policy supported historically low mortgage rates. Second, housing prices had seen a steep decline—and the cost of a new home is still much lower than at the market's peak. Third, as the labor market improves, household incomes are rising. That is, with low mortgage rates, cheaper houses and more money in Americans' bank accounts, housing is affordable again and the market has seen a reversal. Sales and prices are up substantially. In fact, prices on existing homes have risen at double-digit rates nationwide over the past year. They are now up by about 20% from the lows reached in 2011.

This improvement in home prices and sales has created a virtuous cycle: The rebound in the market has helped to reduce foreclosures, which are almost back to pre-crash levels. Fewer foreclosures means fewer distressed sales—which means fewer houses being sold at drastically reduced prices. Fewer distressed sales means less supply and fewer sellers willing to take a loss—which strengthens prices further. As prices strengthen and the market looks up, builders see the increase in demand, which bolsters new home

construction. That, of course, boosts businesses in related industries—like building materials, home furnishings and appliances—and creates jobs, lots of jobs.

Of course, there's always a caveat. You've probably heard the story of Harry Truman wanting a one-handed economist, because he was tired of hearing, "On the other hand...." So, "on the other hand," the recovery in the housing sector comes with concerns that prices might be rising too rapidly. I don't think this should set off alarm bells, at least yet.

First, there are important differences between circumstances now and what we saw leading into the crisis. Lending standards and financial oversight are much stricter, for one (see Swanson 2013). For another, recent price increases have in large part reversed an overreaction in the market during the housing crash. That is, house prices don't look that out of line with fundamentals overall. In addition, prices may be affected by the limited numbers of homes currently for sale. It looks as though owners have been holding off putting their houses up for sale, waiting for the market to strengthen even further (see Hedberg and Krainer 2013). That would mean there are plenty of houses ready and waiting on the sidelines. I expect to see more of these houses come back on the market, and the resulting increase in supply should help temper upward pressure on prices.

Second, other factors are keeping the rebound in check. Mortgage rates rose last year, which dampened sales, slowing momentum in house prices. And while there's been a sizable increase in housing construction, it's still low by historical standards. To put numbers to that: It looks like about 600,000-plus single-family homes were started in 2013, based on the data through November. The longer-term annual average is about 1 million per year. So, we are nowhere near "boom" levels of housing construction.

As for Arizona specifically, I don't have to tell anyone here that you felt the worst of the crash. But you have also been home to one of the earliest and strongest recoveries. Home prices in Phoenix more than doubled between 2000 and mid-2006. By late 2009, the crisis had plunged values back to almost 2000 levels and foreclosures reached nearly double the national rate.

Today, prices in Phoenix are up by about 45% over the worst lows, and Arizona's foreclosures were actually below the national rate, according to the latest data. Although Phoenix housing indicators have moderated some in recent months, as they have nationwide, the trends remain positive.

District banking sector

The banking recovery in the western states has also been improving. Just as an aside, today is a birthday of sorts for American banking. The country's first commercial bank—the Bank of North America—opened in Philadelphia on January 7, 1782.

So as an anniversary present, I'm pleased to say that banking conditions have improved steadily across the Federal Reserve's 12th District, which covers the nine westernmost states, including Arizona. This improvement reflects the recovery in the housing market and the overall economy.

As many of you know, the Federal Reserve has an appraisal system for banks' soundness that we refer to as CAMELS ratings. For the uninitiated, the letters in CAMELS stand for capital; asset quality;

management capability; earnings; liquidity; and sensitivity to market risk. Many of the 12th District's banks have seen improvement in all of these areas over the past few years. Banks are generally better capitalized, with more liquid assets; earnings have improved; and new loans have increased while past-due ones have diminished (see FRB San Francisco 2013a).

Looking more closely at local conditions, Arizona's increase in the pace of loans from late 2012 to late 2013 was among the fastest in the nation, which is great. However, the damage done by the recession is still evident in the high number of nonperforming loans (see FRB San Francisco 2013b).

Despite signs of overall improvement in banking conditions, I recognize that District banks face general challenges as well. There are two concerns I hear most often from bankers, particularly those from smaller community banks. First, banks' profits are being squeezed by narrow interest spreads. Second, there is a concern that some banks may be underestimating the risks to their health posed by future increases in interest rates.

For the nonbankers out there: The FOMC has kept short-term interest rates near zero for the past five years. That's the Federal Open Market Committee, the Fed's monetary policy decisionmaking body. We did this in order to lower interest costs to consumers and businesses and thereby increase spending to get the economy moving again.

However, low short-term interest rates have helped to keep market interest rates low in general. When interest rates are low, banks earn less money from the loans they've made. At the same time, it's hard to offset this by lowering the rate they pay on deposits. As a result, banks are worried about the gap between the return they make when they loan money and the rate they pay on deposits. That is, the "narrow interest spreads."

There's no question that these narrow interest spreads have been depressing bank earnings. However, I expect slow but steady progress on earnings as banking conditions continue to improve. As the economy strengthens, banks will make more loans, increasing the income they make.

Banks are also concerned about the risks associated with rising interest rates. The reasoning is that the value of some assets—particularly longer-term ones, like bonds—falls when interest rates rise.

This is something we and other bank regulators are keeping a close eye on. Many banks in our District, especially smaller ones, have increased their longer-term asset holdings in a "reach for yield." All else being equal, longer-term assets tend to deliver higher rates of return, and banks are looking to offset lower earnings from the narrow interest spread. There was a slight rise in longer-term interest rates seen during the second and third quarters of 2013. Consequently, the market value of longer-term securities held by banks fell. The balance sheets of community banks in our District, therefore, showed some unrealized losses on investment securities. These amounts are relatively small, so the risk remains very manageable for the time being. This is particularly true given the substantial increase in bank capital over the past few years. However, our supervision and regulation group feels that a significant minority of banks in the District is unduly exposed to this risk. They have therefore increased both supervisory oversight and resources available for bankers to manage that risk (see FRB San Francisco 2013a).

The state of the economy today

The strengthening conditions in banking and housing are signs of overall economic improvement. Economic growth picked up steadily during the first three quarters of 2013, and I expect it to pick up further this year. As I mentioned, recovery in the housing sector has helped drive consumer spending, particularly on items such as furniture and appliances. Manufacturing has also strengthened, spurred in part by a recovery in overseas demand and the resulting export growth.

This newfound momentum is partly due to an easing of headwinds that had been holding back growth over the past few years. One was the lingering effects of the financial crisis (see Jordà et al. 2011). A healthier banking sector, and improving stock and house prices, are signs of that headwind diminishing.

Additionally, government fiscal policy will be less of an issue. Further significant federal spending cuts appear to be off the table for now. State and local governments have seen substantial budgetary improvements, allowing them to hire and spend somewhat more freely. In fact, state and local government employment increased last year, showing gains for the first time in more than four years.

For a while, there was concern that the partisan bickering and brinkmanship in Washington would deal a knockout blow to business and consumer confidence. While the government shutdown did cause confidence to plummet, it quickly rebounded once the fiscal stalemate was resolved.

Hiring continued as well: The economy added about 200,000 jobs a month from August through November, a small pickup from the pace over the past few years. It appears that businesses and households are getting used to—and therefore are less alarmed by—recurring battles over Washington's spending and the debt ceiling. Uncertainty—about the economy, fiscal policy, and myriad other concerns—has been a key factor holding back the recovery. The return of some semblance of calm in Washington, D.C., accompanied by the recent budget deal, is cause for hope that some of the hostilities are easing. This should temper at least one source of uncertainty.

As a result of these various positive developments, I see growth of real, that is, inflation-adjusted, gross domestic product picking up, from about 2½% in 2013 to about 3% this year and next.

Labor market conditions

The ongoing economic recovery has fostered a steady improvement in labor markets. The unemployment rate is now down fully 3 percentage points from the worst days in 2009, when it hit 10%.

The unemployment rate is often seen as the best indicator of labor market health; it is therefore a number we rely on heavily. However, there are also encouraging signs from the other measures of labor market conditions. We see a rising number of households that say they feel jobs are abundant and available. More small businesses say they are having difficulty filling open positions. And more people are quitting their jobs. That may not sound like good news, but it is! People obviously don't quit jobs if they're not confident they can find other, better ones. So we're seeing a much more upbeat outlook from workers and employers.

The one indicator that remains stubbornly low is the share of the population with a job. Since the recession ended, that number has been stuck near its lowest level in 30 years. This is partly because the economy has not fully recovered all the jobs it lost during the recession. But, importantly, it is also

because of longer-term factors that monetary policy cannot address. There is the aging population, for one. For another, there is the rising number of working-age people receiving permanent disability benefits. This has been a growing phenomenon as the labor market stayed stubbornly unfriendly to low-wage workers for a number of years (see Autor and Duggan 2006). When we adjust for these factors, we actually see that the employment-to-population ratio is telling basically the same story as the unemployment rate and other labor market indicators.

Monetary policy

All these economic improvements affect how we set monetary policy. People often think of the Fed's responsibility purely in terms of managing, or fighting, inflation. In fact, we have a dual mandate from Congress: stable prices, yes, but also maximum employment. In its simplest terms, there should be enough jobs for everyone and your paycheck should hold its value.

As you know, the FOMC recently scaled back on our bond purchases, moving from \$85 billion a month to \$75 billion. This bond-buying program is generally referred to as "quantitative easing" or "QE" by people outside the Fed. Inside the Fed, it's less elegantly referred to as LSAPs. That stands for large-scale asset purchases.

This program was part of our response to the financial crisis and slow recovery. During the worst days of the recession, the economy was struggling despite the fact that the Federal Reserve had lowered short-term interest rates to near zero, in order to encourage spending. However, lowering the funds rate wasn't enough to get the economy back on track. We couldn't move short-term interest rates lower, because interest rates can't fall much below zero.

With the economy still sluggish, we turned to unconventional methods, including the large-scale asset purchases. This program of buying assets has proven to be a very useful complement to our conventional policy tool of setting short-term interest rates. By buying bonds, we pushed up the price of these assets. As a result, rates on longer-term loans like auto loans and home mortgages came down.

When interest rates are low, people are more likely to make purchases—particularly more expensive items that require loans. Cars and appliances, for instance, and working capital in the case of businesses. As demand for goods and services goes up, businesses can expand, purchasing more supplies and hiring more workers. Businesses down the supply chain then grow, newly hired workers have more money to spend, and it all gets money flowing back into the economy. With the economy having improved so much and the future looking brighter, it was time to start taking our foot off the accelerator and ease up on the monetary stimulus.

Assuming the economic recovery plays out as we expect, we will likely continue to reduce the pace of those purchases, and eventually eliminate them, over this year. This will be an important first step towards eventually bringing monetary policy back to a more normal setting.

As the FOMC has said repeatedly, these policy steps will depend on prevailing economic conditions and the economic outlook, rather than on some fixed date on the calendar. As far as those conditions go: While there have been significant improvements, unemployment remains above what we usually see in a sustained economic recovery. The current rate of 7% is well above the typical estimate of the sustainable level of unemployment, which is between 5 and 6%.

The other half of our mandate is price stability. Inflation has been too low for some time now. I know that sounds odd to some people; high inflation is generally thought to be the danger. Those of us who lived through the 1970s and early 1980s remember the havoc it can wreak: spiraling energy and food prices, incredibly high interest rates, and paychecks eaten up by the ever-increasing cost of living.

Excessively low inflation, however, is also a problem. The Fed defines price stability as an inflation rate of 2% (see Board of Governors 2012). Both overall inflation and core inflation—which is the measure after we strip out the volatile energy and food components—have been running below 2% since April of 2012. It does appear that inflation has finally bottomed out, and will move back to where we want it over the next few years. However, I expect it will take time for inflation to get back to 2%.

In a nutshell, the combination of too-high unemployment and too-low inflation calls for continued monetary accommodation. In this regard, I want to stress that scaling back on asset purchases is not a retreat from accommodative monetary policy. The federal funds rate will remain near zero for the foreseeable future. Specifically, as the FOMC put it, “well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the committee’s 2% longer-run goal.” That’s actually one of our shorter policy sentences—the Fed isn’t known for its brevity. In other words, we’re starting to ease off the gas, but we’re nowhere near hitting the brakes yet.

Conclusion

In conclusion, things are definitely looking up. We’re still not where the economy should be, but we’re well on the road to recovery, and I see things getting better in the year ahead.

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