For release on delivery
9:10 a.m. EDT
October 5, 2007

Economic Outlook

Remarks by

Donald L. Kohn

Vice Chairman

Board of Governors of the Federal Reserve System

at the

Greater Philadelphia Chamber of Commerce 207th Annual Meeting

Philadelphia, Pennsylvania

October 5, 2007

The economic picture has evolved rapidly over the past few months, and on September 18, the Federal Reserve eased monetary policy, cutting its target for the federal funds rate 1/2 percentage point. I thought it might be useful this morning to give you my take on why this action was necessary and my sense of what might lie ahead for the economy. I need to emphasize that these are my views and are not necessarily those of my colleagues on the Federal Open Market Committee (FOMC).[1]

A brief recap of where the economy has been will be helpful in understanding where we are now and where we might be headed. The economy has been growing at about a 2 percent pace since the middle of 2006 despite being held back by a weakening housing market. Job gains have averaged about 125,000 per month over the past year or so, and the unemployment rate has hovered around 4-1/2 percent, a fairly low rate historically for the U.S. economy. When the members of the Federal Reserve Board and the presidents of Federal Reserve Banks made their semi-annual economic projections this past July, most of us saw growth strengthening a little next year as the drag from the housing adjustment abated, with the unemployment rate perhaps drifting up just a little. Inflation had been buffeted by large swings in food and energy prices, but underlying inflation rates had edged down since the summer of 2006; on balance, we expected relatively low inflation ahead, although we were concerned that tight labor and product markets could lead to further price pressures.

When the FOMC met in early August, this basic picture had not changed much. The housing sector had continued to weaken; indeed, with subprime mortgage markets increasingly impaired and problems becoming evident in some other segments of mortgage markets, the contraction in residential construction seemed likely to be even deeper than we had previously anticipated. And increased resistance on the part of investors to some of the terms on the loans

[1] Wendy Dunn and William Wascher, of the Board's staff, contributed to the preparation of these remarks.

and bonds that were backing leveraged buyouts was a sign that a rethinking of risk exposures might be spreading beyond mortgage markets. But output overall still appeared to be expanding at a moderate pace; jobs and incomes, although rising less rapidly than before, were still advancing reasonably well, supporting sustained expansion in household spending; and businesses had successfully worked off the overhang of inventories that had emerged at the end of 2006. In addition, strong demand from abroad was providing considerable support to our exports. The FOMC recognized that less accommodative conditions in some financial markets posed a threat to the strength of future economic growth. Nonetheless, our primary concern remained the upside risks to inflation.

Shortly after the August FOMC meeting, however, financial market conditions deteriorated considerably further, following events that shook investor confidence, particularly in complex structured credit products. The disruptions to nonprime mortgage markets became more severe and problems even extended to high-quality loans, as rates for prime jumbo mortgages jumped after the secondary markets for them shut down. Importantly, the disruptions also spread beyond the mortgage markets. Most notably, investors' concerns about exposures to subprime mortgage credit risk caused them to shun commercial paper that might be backed by such assets, in both Europe and the United States. This aversion, in turn, meant that commercial banks that had written backup liquidity lines for commercial paper programs or had other connections with these programs might have to make good on their actual or implied support by extending credit. With leveraged buyout credit and some mortgage originations also possibly staying on the balance sheet unexpectedly, the banks faced substantial, but uncertain, calls on their liquidity and capital. All this uncertainty led the banks and other short-term lenders to turn very cautious; interest rates on bank deposits and other sources of credit beyond just a few days rose steeply, funding in money markets became concentrated in the very short term, and concerned and uncertain lenders generally became much less willing to extend the credit needed for liquid and efficient financial markets.

Why the financial markets behaved as they have is a complex story that we will be sorting out for a while. For our purposes this morning, I will concentrate on the consequences for household and business borrowers and for the economy. In particular, I expect that the financial market turmoil of the past few months will leave an imprint on the cost and availability of credit to many household and business borrowers. The greatest effects have been on credit related to residential real estate; in addition to the problems with nonprime and jumbo first mortgages, second mortgages and home equity lines of credit that many households have been using to finance purchases of household durables and other consumer goods and services probably will become more expensive and less available as well. Banks are likely to be especially cautious about making new loans and financing commitments while substantial uncertainty about the quality of loans and the extent of demands from previous commitments persists. So it would not be surprising to see less-generous credit for a wide variety of loans to business and households. And, the rates for some loans are tied directly to elevated libor or other rates in term funding markets.

More generally, credit will probably not be as easily available and as inexpensive for many borrowers as it was a few months ago, even after market functioning improves. In several segments of the financial markets, compensation for taking on risk had for some time seemed too low to be sustainable. In addition, more credit is likely to flow through banks, and leverage in the nonbank sectors of the financial markets will be lower. The higher levels of capital relative to assets should form the basis for a more stable system, but the spread of lending rates over the cost of funds will need to rise so that capital can earn a competitive rate of return.

The deterioration in actual and expected financial market conditions between the August and September FOMC meetings changed our view of appropriate monetary policy. Whatever policy path previously seemed appropriate to support sustainable growth and price stability looked too high once credit conditions tightened substantially. Our policy easing was aimed at helping to offset the effects of those tighter credit conditions and thereby to encourage moderate economic growth over time. It was not intended to, nor should it, short circuit a more realistic pricing of risk and the gains and losses that the repricing will entail for market participants.

Many people had expected the Federal Reserve to follow a gradual path of rate reductions in response to financial market developments--say, 25 basis points in September and another 25 basis points in October. Such a path would be in keeping with how we have often approached our policy choices, as it has the advantage of allowing us to calibrate our policy as we see how the economic situation is evolving and responding to earlier policy moves. However, given the circumstances at the time of the September FOMC meeting, there were strong arguments in favor of the larger action of a 50 basis point decrease in the federal funds rate. For one thing, it seemed that a decrease of that size could well be necessary to promote moderate growth. We had been holding the federal funds rate at 5-1/4 percent, well above the expected rate of inflation, in part to compensate for what had been very narrow yield spreads and readily available credit. We did not know how quickly markets would recover, the extent to which credit terms and standards would be tightened, or precisely how households and businesses would respond to recent or forthcoming financial developments. But, pending further evidence, a 50 basis point easing was not an unreasonable first approximation of what might be required to keep the economy on a sustainable growth path.

In addition, I thought that economic performance would be better served by the Federal Reserve taking its chances on responding too much, or too rapidly, to the turmoil in financial markets rather than acting too little, or too slowly. Sluggish or inadequate easing risked a weaker real economy that might cause lenders to pull back even more, leading to a deteriorating situation that could prove difficult to reverse. With the news on inflation relatively favorable of late and with inflation expectations seemingly well anchored, I believed that we would be able to offset the cut in the federal funds rate--if it turned out to be larger than needed--in time to preserve price stability.

Since the September FOMC meeting, we have seen some signs of improvement in some markets that were severely disrupted. For example, investors appear to be differentiating more among risk characteristics of asset-backed commercial paper programs; term funding has become a little more readily available to banks and commercial paper issuers; and the run-off in commercial paper outstandings has slowed. But spreads in these markets are still quite high by historical standards and funding maturities are very short, leaving many markets vulnerable to unpleasant surprises. In mortgage markets, spreads for rates on jumbo prime mortgage loans over those on conforming, agency eligible, loans have come down a bit, but are still elevated. Indeed, it may be a while before market participants regain enough confidence to price and trade certain types of assets and more normal liquidity conditions are restored.

Our policy action will not be able to avert all of the weakness in the economy that may be in train for the next several months. Monetary policy works with a lag, and the effects of our easing action will have their maximum effect only after several quarters. In particular, housing markets are likely to remain depressed in coming months as housing demand is restrained by the difficulty in obtaining mortgages and perhaps also by spreading expectations on the part of buyers that house prices will fall, as they already have in a number of markets. And, although builders have reduced housing starts sharply, they have made very little progress in reducing the number of unsold new homes on the market. As a result, even absent a further deterioration in sales, residential construction would probably decline further in the months ahead, imparting a significant drag on overall growth in real gross domestic product.

Beyond housing, it is too early to tell what effect financial market turmoil is having on household and business spending, though very preliminary and partial information suggest that thus far the effects seem to be limited. Moreover, the available data indicate that the economy entered this period still expanding at a moderate pace. For example, consumption held up well this summer supported by solid growth in real incomes. And, the recent data on orders and shipments of capital goods and on nonresidential construction indicated further growth in capital outlays in August. That said, credit availability is likely to be tighter than before, consumer confidence is down, and businesses will probably be a little more cautious for a while, suggesting that these components of aggregate demand could become more subdued in coming months.

Over time, however, I anticipate that the economy will move back onto a moderate growth track. The housing market should gradually recover as the cutback in production and lower prices help reduce the inventory overhang. And, as it does, the drag on growth from the declines in residential construction will abate, providing a boost to overall economic activity. To be sure, households are likely to start to save more out of their current incomes as they come to realize that they cannot count on a rise in the value of their real estate to build their retirement nest eggs. However, households have been surprisingly resilient to recent economic shocks, and any rise in the saving rate probably would be gradual. More generally, consumer spending should continue to be supported by ongoing growth in employment and income. In the business sector, balance sheets are in good shape, and most firms are not likely to face an appreciable tightening of credit availability. As a result, I anticipate that they will expand their investment spending to keep pace with rising household demands and with strength in export markets. In sum, once we get through the near-term weakness caused by the extra downleg from the housing contraction and any spillover from tighter credit conditions, I am looking for moderate growth with high levels of employment.

But you should view these forecasts even more skeptically than usual. The FOMC emphasized the considerable uncertainty in the outlook. As I noted earlier, we do not know how financial markets will evolve, and we do not know how households and businesses will respond to financial developments. Naturally, these types of uncertainties are greatest when markets are behaving abnormally. The recovery from the problems of the early 1990s was prolonged because banks had to rebuild capital; the rebound from the market crisis of 1998 was swifter, helped along by higher productivity growth and the rise in the stock market that accompanied the optimism about high-tech profits. We will need to be nimble in adjusting policy to promote growth and price stability.

Of course, we would not have eased policy if the outlook for inflation had not been favorable. The recent data on consumer price inflation have been encouraging. Movements in energy prices have created volatility in overall inflation, but over the past twelve months both core and total prices for personal consumption expenditures rose 1.8 percent. Moreover, the near-term weakness in the economy should intensify competitive conditions in markets and reduce potential pressures on costs and prices. And, it will be critical for inflation expectations to remain well contained.

That said, I do not want to minimize the upside risks to inflation either. Rates of resource utilization are still relatively high, and the slower rates of productivity growth over the past two years, coupled with a pickup in compensation growth, have led to a noticeable acceleration in unit labor costs. Moreover, the decline in the exchange value of the dollar has put upward pressure on prices of imported goods, which have both direct and indirect effects on overall consumer prices. As a result, and as the FOMC noted in our recent statement, we will need to monitor inflation developments carefully.

Allowing inflation to rise would not be in the public interest and would be contrary to our legislative mandate for stable prices and maximum employment. Maintaining an environment of low and stable inflation facilitates planning, saving, and capital investment by households and businesses and thus is a prerequisite for allowing the economy to realize its potential. I assure you that we on the FOMC will continue to monitor economic developments closely and will act as necessary to promote both price stability and sustainable economic growth.