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The Economic Outlook and the State of Household and Business Finances

It is a pleasure to be with you today. As a relative newcomer to the forecasting profession, I must say that speaking to such an esteemed group of professional prognosticators is a bit intimidating. But newcomers often bring new perspectives, and I hope my remarks will prove informative. I intend to talk briefly about my assessment of the economic outlook and then turn to a more detailed discussion of how the evolution of household and business balance sheets in recent years is affecting economic activity.[1]

The Economic Outlook
As you know, real gross domestic product grew at an annual rate of 6 percent in the second half of 2003, and the economic fundamentals seem to be in place for another sizable advance this year. Indeed, the GDP forecasts of Federal Open Market Committee members have a central tendency range of 4-1/2 to 5 percent. Yet despite the recent strong pace of economic activity, the labor market has improved only slowly. I am cautiously optimistic, however, that job growth will pick up--perhaps substantially--over the course of this year. My business contacts tell me that companies have indeed become more optimistic about economic prospects and that their plans include some increase in the size of their payrolls. The FOMC expects the unemployment rate to fall to between 5-1/4 and 5-1/2 percent by the end of this year.

Although economic growth revived in the second half of 2003, core consumer price inflation continued to slow. Surveys suggest that inflation expectations remain stable, and extraordinary gains in labor productivity have continued to keep price pressures in check. Moreover, I expect these recent favorable price trends to continue, and I am very comfortable with the FOMC's prediction of a 1 percent to 1-1/4 percent rise in the PCE price index this year--a shade less than the increase in 2003.

Briefly putting on my hat as a monetary policy maker, I will say that the prospect of a strongly growing economy, falling unemployment, and low inflation seems to be close to a central banker's ideal. Under these conditions, we can be patient before we must, inevitably, confront the need to diminish the substantial degree of monetary accommodation now in place.

Given this broad-brush summary of the outlook, let me now take a closer look at the financial positions of U.S. households and businesses. As I will discuss, the favorable financial conditions in both sectors should support a solid increase in household and business expenditures.

Household Financial Conditions
Some commentators have expressed concern about the rapid growth in household debt in recent years. They fear that households have become overextended and will need to rein in

their spending to keep their debt burdens under control. My view, however, is considerably more sanguine. Although there are pockets of financial stress among households, the sector as a whole appears to be in good shape.

Certainly, households have taken on quite a bit of debt over the past several years. According to the latest available data, total household debt grew at an annual rate of 10 percent between the end of 1999 and the third quarter of 2003; in comparison, after-tax household income increased at a rate of 6 percent. The rapid growth in household debt largely reflects a surge in mortgage borrowing, which has been fueled by historically low mortgage interest rates and strong growth in house prices.

Despite the heavy borrowing, households have kept the repayment burden of their debt in check. Notably, many homeowners have taken advantage of low interest rates to refinance their mortgages, some having done so several times over the past couple of years. Survey data suggest that homeowners took out cash in more than one-third of these "refis," often to pay down loans with higher interest rates. The resulting drop in the average interest rate on household debt, combined with the lengthening maturity of this debt, has tempered the repayment obligation from the growing stock of debt.

The Federal Reserve publishes two series that quantify this repayment obligation. The first series, the debt service ratio, measures the required payments on mortgage and consumer debt as a share of after-tax personal income. The second series, the financial obligations ratio, is a broader version of the debt service ratio that includes required household payments on rent, auto leases, homeowners' insurance, and property taxes. Both ratios rose during the 1990s, and both reached a peak in late 2001. Since then, however, they have receded slightly on net from their respective peaks, an indication that households, in the aggregate, have been keeping an eye on repayment burdens.

Because the debt service ratio and the financial obligations ratio are calculated from aggregate data, they do not necessarily indicate whether the typical household is experiencing financial stress. Nonetheless, we have found that changes in either ratio help predict future changes in consumer loan delinquencies. Accordingly, the fact that these ratios have come off their recent peaks is a hopeful sign about household loan performance. Indeed, delinquency rates for a wide range of household loans turned down over the second half of 2003.

Another often-cited indicator of household financial conditions is the personal bankruptcy rate. Movements in the bankruptcy rate, to be sure, partly reflect changes in the incidence of financial stress, but the rate has been trending up for more than two decades for a variety of other reasons. The Bankruptcy Reform Act of 1978 made bankruptcy a more attractive option for most households by increasing the amount of wealth that households could retain after bankruptcy. Other factors that have likely contributed to the upward trend are the decrease in the social stigma of filing for bankruptcy and the growing access to credit in the United States. As lenders have become more sophisticated in their ability to assess the riskiness of borrowers, they have extended loans to households that were previously denied credit. These households are more likely to default on their obligations than the typical borrower, but this increased risk is priced into loan terms. Although the bankruptcy rate remains elevated, it has edged down on balance in recent months, likely because of the pickup in economic growth in the United States since mid-2003.

This relatively upbeat assessment of household credit quality seems to be shared by lenders and by investors in securities backed by consumer debt. According to the Federal Reserve's survey of senior loan officers, banks have not materially changed their lending policies for consumer loans over the past couple of years. This behavior certainly does not point to much concern about household loan performance. Moreover, one gets an even more positive message from the credit spreads on securities backed by auto loans and credit card receivables. In recent months, the spreads between the yields on these securities and swap rates of comparable maturities have narrowed across the credit spectrum.

Thus far, I have focused on the liability side of the household balance sheet, but there have been favorable developments on the asset side as well. Equity prices rallied strongly last year and have continued to rise this year, reversing a good chunk of the losses sustained over the previous three years. In addition, home prices appreciated sharply during each year from 1997 to 2002. Although the increases in home prices have slowed somewhat lately, the cumulative rise since the late 1990s has exceeded the growth in per capita income by a wide margin. All told, the ratio of household net worth to disposable income--a useful summary of the sector's financial position--recovered last year to stand at a level slightly above its long-term average.

Before I turn to the business sector, let me address two concerns that have been voiced about the prospects for households. The first of these regards the low level of the personal saving rate. During the past several years, the personal saving rate has been in the neighborhood of 2 percent, well below its earlier post-World War II average of nearly 8 percent. Such low personal savings rates raise concerns that households may not be saving enough to meet longer-run needs, such as for retirement or college education of their children.

What might be behind this paucity of personal saving? As recently as the early 1990s, the saving rate was near its long-run average. One reason that the saving rate fell during the 1990s was the rising stock market. Higher equity prices led consumers to feel wealthier, which boosted spending relative to income and thus reduced the saving rate. In addition, the greater household wealth brought about by higher equity prices meant that any saving goals a family might have--such as for education or retirement--were closer to being fulfilled. Hence, households would need to save less to achieve those goals.

By this logic, we might have expected to see some increase in the saving rate in the aftermath of the sharp declines in equity prices in 2000, 2001, and 2002. It is true, as I noted earlier, that rising house prices cushioned these losses. But, on net, household wealth took a hit during these years without any commensurate rise in the saving rate.

A key factor that has likely boosted spending--and thus held down saving--has been the low level of interest rates. The low interest rates have worked directly by stimulating spending in interest-sensitive sectors such as consumer durable goods. In addition, they have facilitated the restructuring of the household sector's balance sheet, with a positive indirect effect on expenditures. In particular, over the past few years, homeowners have extracted a large amount of home equity through cash-out refinancing and home sales, which helped to support consumption despite the decline in equity prices.

As I noted earlier, I do not think that the household sector is overextended, and thus I do not believe that a large, autonomous increase in the personal saving rate is a serious risk to the economy. However, I would not be surprised to see the personal saving rate move up gradually over time to levels more consistent with its historical average. This rise presumably would be consistent with the expected shift in the pattern of growth in our economy--from an expansion that has been led mainly by the household sector to one led more by business spending.

The second concern often expressed is that a bubble may have developed in house prices after several years of rapid increases. Some of the measured price rise results from improvements in the quality of houses: Houses are bigger and have more amenities than in the past, two characteristics that will lead to rising average house prices over time. But even after controlling for quality, increases in home prices have been outstripping general price inflation by a considerable margin in recent years.

Once again, the low interest rates are probably an important factor. Houses, like other assets, generate an expected stream of future benefits. With low interest rates, these future benefits are discounted less heavily, which raises the asset's price today. Low interest rates also push up house prices by boosting the demand for housing. Of course, some of that increased demand is being met by the rapid pace of construction of new housing. But building houses takes time, and in the interim, higher demand will push up the price of existing houses.

Although we can identify the key forces behind the rise in house prices in recent years, we cannot be sure that the increases are fully justified by the prevailing fundamentals. Still, we need to keep the recent increases in house prices in perspective: Although house prices have been outstripping broad measures of inflation--even after adjusting for quality improvements--their rise is nothing like the increase in equity prices in the late 1990s.

In fact, the speculative forces that can sometimes drive equity prices to extremes are less likely to emerge in housing prices. First, buying and selling houses is a lot more expensive and cumbersome than buying and selling equities, which makes taking a speculative position in houses much more difficult. Second, housing markets are much more local than equity markets, which are national, if not global, in scope. So if any speculative frenzy emerged, it would be much less likely to spread in the housing markets than in equity markets. Finally, financial institutions have a much more disciplined process around the housing and construction lending market than they did in past housing cycles. Lenders today are cautious about lending for speculative purposes, and appraised values undergo more scrutiny than in the past. The expansion of credit to higher risk households may also have driven banks to strengthen their underwriting procedures.

That said, it is certainly possible for local housing markets to become overvalued and then to experience sharp price declines. House prices fell significantly in several parts of the country in the early 1990s. But because the transactions costs are much higher in the housing market than in the equity market, and because the underlying demand for living space is much more predictable than are the prospects for any given firm, the large rises and declines often observed in the stock market are less likely to occur in the market for houses. In addition, lenders are much more responsive to local economic conditions, and generally become more cautious in loan underwriting when unsold homes or local unemployment increase.

Financial Conditions of Businesses

The change in the economy that caught my attention in the second half of 2003 was that the decline in business fixed investment had finally ceased. Capital spending by businesses posted a solid increase in the second half of last year, and orders for nondefense capital goods--a key indicator of equipment spending--point to further sizable gains. Moreover, the tenor of anecdotes from the corporate sector has become comparatively upbeat, with corporate managers seeing stronger revenue growth and a much improved and accommodative financing environment.

Four important factors have contributed to this improvement in financial conditions: low interest rates, a widespread restructuring of corporate liabilities during the past few years, a sharp rebound in corporate profitability from its trough in 2001, and a substantial narrowing in market risk premiums. In addition, the burden of underfunded pension plans, perhaps the most prominent negative financial factor that remains, has eased of late. I will discuss each factor in turn.

First, firms are continuing to benefit from the accommodative stance of monetary policy. With the federal funds rate at 1 percent, short-term borrowing costs remain very low. For longer-term debt, the combination of low yields on benchmark Treasury securities and reduced risk spreads has kept borrowing costs attractive. Indeed, the yield on Moody's Baa corporate bond index is at its lowest sustained level since 1968.

Second, in response to low long-term rates and to nervous investors who were burned by some high-profile, unanticipated meltdowns, firms have greatly strengthened their balance sheets. Many firms have refinanced high-cost debt, which has reduced the average interest rate on the debt of nonfinancial corporations more than 1 percentage point since the end of 2000. The average cost of servicing debt would have fallen even further if not for a second major trend--the extension of debt maturities. Businesses replaced a substantial portion of their short-maturity debt with long-maturity debt, both to lock in low rates and to improve their ability to withstand a liquidity shock (since long-term debt does not need to be continually rolled over). In addition, many firms--especially in the most troubled industries--have retired debt through equity offerings and asset sales, which limited the growth of nonfinancial corporate debt in 2002 and 2003 to the slowest pace since the early 1990s.

Third, firms have significantly tightened their belts. Over the past two years, the drive to cut costs has generated rapid productivity gains. This greater efficiency boosted corporate profitability in 2002 and 2003 despite rather tepid revenue growth. Moreover, a pickup in revenue growth in the second half of last year helped companies leverage those productivity gains, producing a dramatic recovery in overall corporate profitability. Over the course of 2003, operating earnings at S&P 500 corporations surged almost 25 percent, bringing profit margins to their highest levels in several years.

Fourth, risk premiums fell substantially last year as corporate governance scandals receded and investor sentiment turned markedly more positive. The recovery in stock prices reflects this brighter view. In addition, spreads on corporate bonds have narrowed appreciably--especially for the riskiest firms--and they now stand at the lowest levels in several years. This decline in spreads has been helped along by the beneficial effect of the balance sheet improvements that I mentioned a moment ago. Indicators of corporate financial stress such as bond rating downgrades and default rates have returned to levels normally associated with economic expansion. Delinquency rates on business loans at commercial banks have also declined, and our surveys indicate that, on balance, banks have recently eased the terms and standards on such loans.

In another sign of improved sentiment, money has been flowing into riskier securities. For example, equity mutual funds have registered strong net inflows for nearly a year, as have high-yield bond funds. The more favorable tone in the bond market has been associated with a notable pickup in junk-bond deals amid a surge of corporate bond issues. Over the past two quarters, the market for initial public equity offerings has also come back to life; investors appear to be increasingly receptive to new issues, though (fortunately) they still appear to be more selective than during the boom in the late 1990s.

These four points all suggest that financial conditions are capable of supporting a sustained, healthy pickup in economic growth. The much improved profitability can help finance expansion directly out of internal funds or indirectly by supporting firms' borrowing capacity. Furthermore, firms will be able to draw on their liquid assets that have accumulated over the past couple of years. And given the successful efforts to pare costs, firms are set to benefit from new investment in plant and equipment.

Perhaps the biggest hurdle still facing many corporations is the burden of underfunding in their defined-benefit (DB) pension plans, but even here we have seen some improvement from the situation a year ago. At that time, the value of pension assets had been significantly eroded by stock market losses, and sharply declining interest rates had raised the present value of plan liabilities. Just among the firms in the S&P 500, the combined effect was to subtract nearly *half a trillion* dollars from the net asset value of DB pension plans during 2000, 2001, and 2002. As a result, 90 percent of S&P 500 plans were underfunded at the end of 2002, with a net shortfall that exceeded more than $200 billion. Most companies with DB plans thus needed to make additional contributions to their pension plans, in some cases quite substantial contributions. For many, this situation was a sea change from the multiyear contribution holiday they experienced during the 1990s.

Indeed, in 2002, S&P 500 firms contributed $46 billion to their pension plans--three times more than in either of the previous two years--and total contributions are estimated to have been even higher in 2003. But this drain on cash resources is likely to decline, or at least not worsen, over the next few years. DB pension assets have benefited from robust returns in equity markets since early last year, and pension liabilities are estimated to have risen only modestly in 2003. Automakers, in particular, have already bitten the bullet; together with the solid returns earned on plan assets last year, their cash contributions have apparently helped to wipe out much of their funding deficit.

So what is the longer-term prognosis for firms with DB pensions? Assuming current discount rates and normal pension asset returns, S&P 500 firms would eventually need to make about $150 billion in contributions to close the remaining funding gap. And once the current funding hole is filled, these firms would still need to make contributions to cover their rising liabilities. Indeed, DB plans are increasingly concentrated in mature industries with aging workforces, for which the growth rate of liabilities is relatively high and rising. This longer-term challenge will remain even if the current favorable market conditions are sustained.

Conclusion

In summary, recent indicators suggest that the pace of economic activity remains solid, while inflationary pressures continue to be subdued. In addition, the household and business sectors are, by and large, in good financial shape. Although uncertainties remain, I believe the fundamentals are in place to generate sustainable economic growth.

Footnotes

1. The opinions that I will be expressing are my own and do not necessarily reflect those of my colleagues on the Board of Governors or Federal Open Market Committee. Return to text

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