

## The Economy in 2008

**Dennis P. Lockhart**  
President and Chief Executive Officer  
Federal Reserve Bank of Atlanta

Rotary Club of Atlanta  
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At this date on the calendar, it's natural to take stock and think of the year ahead. In my remarks today, I plan to provide a brief summary of last year's economic story and an outlook for 2008. I'll also share some of my personal views on Federal Reserve monetary policy during this difficult time of economic and financial transition. I'll tell you up front that my message will be a sober one, but I hope that won't prevent your inviting me back here next January to speak. I want to add that my comments are my views alone and do not represent the views of my colleagues on the Federal Open Market Committee (FOMC).

### Looking back at 2007

Let me begin by taking you back to a year ago. As 2006 turned into 2007, the economic environment appeared relatively benign compared to today. However, we now know that housing activity—measured by sales, starts, permits, and prices—began to slip in late 2005.

By mid-summer 2006, the FOMC began noting the "cooling of the housing market." The decline in housing activity coincided with a notable slowdown of economic growth through the end of 2006 and into the first part of 2007.

Throughout 2007, forecasts of housing activity were repeatedly revised downward. Despite the intensifying housing "correction," the economy grew smartly last spring and summer. U.S. gross domestic product (GDP) grew at annual rates of 3.8 percent in the second quarter and then a very strong 4.9 percent in the third quarter of 2007.

But I believe those strong numbers contain anomalous factors that probably won't be repeated soon. Taking out an inventory buildup and exports, third quarter growth was moderate—about half the GDP headline number. Fourth quarter data aren't available, but I expect growth during the final three months of 2007 to come in quite sluggish.

Evidence of slowing economic activity has been mounting. Beyond last year's sharp drop in residential investment, industrial production growth remained well below its rate of the previous year. The data in 2007 showed moderate growth of investment in equipment and software. Anecdotal reports suggest that many firms have begun—especially in the year's second half—to assume a wait-and-see posture because of rising economic uncertainty.

Also, over the past 20 or so months, year-over-year employment growth has slowed considerably. Readings on December employment released last Friday showed a small monthly increase of 18,000 jobs, with the unemployment rate moving up from 4.7 to 5 percent.

Consumer spending is watched closely because of the role of consumption in our economy, and the news here also reflects slowing. Through November, last year's growth in personal consumption expenditures fell off the pace of 2006, which in turn was below its pace of two years ago. Also in 2007, growth of real disposable personal income slowed a bit. Household spending has likely been weighed down by higher energy costs and declining house prices. Although weakening, consumer spending has not plunged.

From September 2006 through August 2007, readings on inflation were generally favorable, with consumer price inflation averaging around 2.3 percent on a year-over-year basis. But later in the year energy costs surged, increasing pressure to pass through higher prices for goods and services. The consumer price index for November increased at a year-over-year rate of 4.3 percent, driven largely by a 21 percent jump in the energy cost component.

### Reviewing the financial sector

In addition to these developments, the financial sector of our economy had an especially rough ride in 2007. You're all quite familiar with the storyline for Wall Street, so I'll skip the play-by-play and just provide highlights. During the middle months of 2007, a weakening housing sector caused doubts about subprime mortgage-backed securities. Although subprime debt is less than 3 percent of the total market for dollar debt securities, these concerns triggered a widespread repricing of risk.

Credit spreads widened, trading volume plummeted, and at various times bond and money markets froze because of concerns about counterparty creditworthiness. Accounting values of positions in subprime and other affected securities caused banks and other institutions to announce sizable losses.

Some off-balance-sheet positions in structured investment vehicles (so-called SIVs) were brought back onto sponsors' books. Uncertainty about who had what exposure caused illiquidity in interbank markets, and general illiquidity in securities markets kept trading volume low or nonexistent and values depressed.

Last year ended with fears about bank funding over year-end, fears regarding the effect of SIV exposure on money market funds, and widespread concern about a credit crunch.

It's fair to say financial markets were shaken profoundly between August and year-end, and trading conditions are still far from settled and orderly.

For a while, after markets seized up in August, financial conditions did improve. I believe a series of globally coordinated central bank liquidity injections over the final months of the year helped to ease some market strains. At meetings in September, October, and December, the FOMC cut the fed funds rate to forestall some of the adverse effects of financial turmoil on the broader economy. But these actions were not sufficient to remedy Wall Street's distressed conditions.

As I prepare for each FOMC meeting, I gather real-time anecdotal economic intelligence from a variety of sources. I talk to, among others, bankers, hedge fund managers, and other financial market players. Most recently, they have given me the Wall Street perspective: that is, serious concern about further—and spreading—market deterioration and potential spillover into the broad economy.

I also talk to people whose address is Main Street. From these sources, I get the impression of an economy that is slowing but demonstrating resilience. Having said that, I think we're at a time of heightened uncertainty.

Looking to 2008, I believe the pivotal question—the central uncertainty—is the extent of current and future spillover from housing and financial markets to the general economy. The dynamics I'm watching—stated simplistically—are the following. First, there's the effect of dropping house prices on the consumer and in turn on retail sales and other personal expenditures. And second, I'm watching the effect of financial market distress on credit availability and, in turn, on business investment, general business activity, and employment.

My base case outlook sees a weak first half of 2008—but one of modest growth—with gradual improvement beginning in the year's second half and continuing into 2009. This outcome assumes the housing situation doesn't deteriorate more than expected and financial markets stabilize. A sober assessment of risks must take account of the possibility of protracted financial market instability together with weakening housing prices, volatile and high energy prices, continued dollar depreciation, and elevated inflation measures following from the recent upticks we've seen.

I'm troubled by the elevated level of inflation. Currently I expect that inflation will moderate in 2008 as projected declines in energy costs have their effect. But the recent upward rebound of oil prices—and the reality that they are set in an unpredictable geopolitical context—may mean my outlook is too optimistic. Nonetheless, I'm basing my working forecast on the view that inflation pressures will abate.

To a large extent, my outlook for this year's economic performance hinges on how financial markets deal with their problems. The coming weeks could be telling. Modern financial markets are an intricate global network of informed trust. Stabilization will proceed from clearing up the information deficit and restoring well-informed trust in counterparties and confidence in the system overall.

To restore market confidence, leading financial firms, I believe, must recognize and disclose losses based on unimpeachable valuation calculations, restore capital and liquidity ratios, and urgently execute the strenuous task of updating risk assessments of scores of counterparties. The good news is that markets can return to orderly functioning and financial institutions can be rehabilitated quickly. With healthy disclosure, facing up to losses, recapitalization, and the resulting clarity, I believe there is hope for this outcome.

#### **A look at monetary policy**

For monetary policymakers, the overriding concern must be the broad health and balance of the general economy going forward. In my view, recent Federal Reserve policy moves appropriately processed information (both data and anecdotes) that painted a mixed but slowing picture.

As you know, during our last meeting Dec. 11, the FOMC lowered the fed funds rate 25 basis points to 4.25 percent. The FOMC began cutting the fed funds rate in September following the announcement in August that "the downside risks to growth have increased appreciably." At that point, financial markets were in turmoil, and the fed funds rate was 5.25 percent.

The decision to lower the fed funds rate was a response to acute stress in financial markets that had the potential to threaten economic growth.

The fed funds rate is the foundation of a structure of interest rates mostly set by the market. It has been described as a blunt instrument in its influence over the broad economy over time. It is not a targeted policy instrument capable of reducing illiquidity in specific debt markets—for example, the interbank lending market. For this reason, the Fed—along with foreign central banks—has put in place in recent weeks more targeted facilities to provide liquidity when and where needed.

For instance, in December the Fed announced the Term Auction Facility. With this program, depository institutions bid to borrow money from the Federal Reserve on a fully collateralized basis. Since participants are bidding for funds, there is none of the usual stigma about turning to the lender of last resort, the Fed's discount window, for liquidity.

I have been encouraged by the early results of these auctions and the other efforts by central banks in Europe to keep markets functioning.

#### **Responding to developments**

The future—even in stable times—is hard to read. At this juncture, the times present even greater uncertainty than usual. The negatives in our economy may be gaining momentum. I think these circumstances call for policymakers to be prepared to respond pragmatically to whatever developments arise.

Clearly, adjustments—some quite painful—are under way in housing markets, mortgage markets, and money markets. These adjustments are needed to fix imbalances. This is what markets do—rebalance imbalances. I believe this process began in 2006, continued in 2007, and needs much of 2008 to play out. I will be watching the process of these necessary adjustments closely as I work with my colleagues to determine the appropriate monetary policy actions.

Thank you for your attention today.

**Contact:** [Jean Tate](#) 404-498-8035

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