

The Economy in 2008

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I'm honored by the invitation to speak at the University of Alabama's 2008 Economic Outlook Conference. It's a pleasure to visit Montgomery and get an up-close and personal look at the activity transforming this community. Alabama's economy has changed dramatically since business first brought me to the state in the late 1970s and 1980s.

A generation ago, Alabama's economy was far more dependent on "old economy" industries and less integrated into the broader national economy. Alabama at that time depended to a large extent on low-productivity manufacturing, agriculture, and military spending. During the 1990s, global competitive pressures, reduced defense spending, and technological change contributed to the loss of many jobs in Alabama—including thousands of jobs in textiles and apparel.

But despite some painful structural changes, Alabama has become more and more economically diverse. In the past few years, the state has benefited from growth in business services, aerospace, health care, education, and other expanding industries. Investment in auto manufacturing also has had a significant economic impact in the state. I will add that a highly productive and efficient auto industry has taken root in a number of states in the Southeast.

By the Southeast, I'm referring to the six states that encompass the Federal Reserve's Sixth District, which is home to some 45 million people. Looking at subregions of our district, economic performance has varied widely. For instance, post-hurricane rebuilding has affected growth along the Gulf Coast. Also, the housing downturn has been quite severe in Florida. In that state, which is the largest in our region, the declining housing market has affected consumer incomes, spending, and employment as well as state government finances. This dynamic has been evident in other parts of the Sixth District as well. The housing sector is a serious concern nationally and regionally, although certain areas in Tennessee and notably Alabama have been somewhat less affected so far.

Taken as a whole, the Southeastern economy has experienced solid growth in recent years. Because of its size and diversity, the composition of the Southeast economy closely matches that of the nation as a whole. Therefore, the region can be a useful barometer for activity in the broader U.S. economy.

For the rest of my remarks this afternoon, I plan to provide a brief summary of last year's U.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 adjustment. I'll tell you up front that my message will be a sober one. 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, and prices—began to slip in late 2005. Single-family housing starts peaked in the first quarter of 2006 at 1.7 million units on an annualized basis, compared with slightly less than a million units in the third quarter of 2007.

By midsummer 2006, the FOMC started 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 be modest.

Evidence of slowing economic activity has been mounting. Beyond last year's sharp drop in residential investment, growth in manufacturing output remained well below its rate of the previous year. Also, spending on equipment and software showed only moderate growth in 2007. Commercial real estate has held up surprisingly well, but the signs are that it will proceed more slowly going forward. Anecdotal reports suggest that many firms have begun to assume a wait-and-see posture because of rising economic uncertainty, especially in the year's second half.

Also, over the past 20 or so months, year-over-year employment growth has slowed considerably. Readings on December employment released on January 4 showed a small monthly increase of 18,000 jobs, with the unemployment rate moving up from 4.7 to 5 percent. Historically, abrupt increases in the unemployment rate have been associated with economic downturns.

Recent employment data affected many observers' assessments of the risks to the economic outlook. Moreover, analysis by my staff suggests that the employment picture for 2007 was weaker than recent statistics indicate.

Of course, labor markets affect consumers. So let me turn to consumer spending, which is watched closely because of the significant role of personal consumption in our economy. 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 2005. Also in 2007, growth of real disposable personal income decelerated a bit. Retail sales results for the fourth quarter, released Tuesday, showed further slowing. Household spending has likely been weighed down by higher energy costs and declining house prices. Yet despite these pressures, consumer spending has not plunged.

From September 2006 through August 2007, readings on overall inflation were generally favorable. But later in the year food and energy costs surged, increasing pressure to pass through higher prices for goods and services. For 2007, the consumer price index increased 4.1 percent—the largest calendar-year increase since 1990. The core CPI (excluding food and energy costs) increased 2.4 percent, which is above my comfort zone.

Reviewing the financial sector

In addition to these developments, the financial sector of our economy had an especially rough ride in 2007. By now, I'm sure you're all quite familiar with the story from Wall Street, so I'll be brief. 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. When financial assets bearing risk are repriced, credit spreads adjust and securities change value in relation to one another.

These developments happened after August of last year. 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. Further losses have been announced this week based on year-end values.

Some off-balance-sheet positions in structured investment vehicles (so-called SIVs) were brought back onto their 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. In my most recent conversations in December, they voiced serious concern about further—and spreading—market deterioration and potential spillover into the broad economy. From my contacts in the nonfinancial world, I generally get less strident impressions of current economic circumstances. Not long ago, I heard qualitatively different perceptions from Main Street versus Wall Street. But in recent weeks almost all were quite worried about the economic outlook.

There is always uncertainty, but the New Year has opened with conditions of heightened uncertainty. For 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, the effect of declining house prices on the consumer and in turn on retail sales and other personal expenditures and, second, the effect of financial market distress on credit availability and, in turn, on business investment, general business activity, and employment.

That said, 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 that the housing situation doesn't weaken more than expected and that financial markets stabilize. A sober assessment of risks must take into account the possibility of protracted financial market instability together with a deep decline in house 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, which has been pushed up by higher energy and food prices. A confluence of factors on the demand and supply side and the potential for slowing global economic growth have led many forecasters to believe energy prices will moderate. But the reality that these prices 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.

Equally important is the state of inflation expectations. The United States and much of the world have enjoyed many years now of very moderate inflation. Even if recent pressures from gasoline, energy in general, and food prices have been troubling, I believe the American public expects the inflation rate to gravitate to lower levels over the long term.

To a large extent, my outlook for this year's economic performance hinges on how financial markets deal with their problems. The coming days and 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, seek investors where necessary to restore capital ratios, and urgently execute the strenuous task of updating risk assessments of scores of counterparties. This process appears to be happening. 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 then 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 is not a targeted policy instrument capable of dictating credit spreads and 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, last month the Fed announced the creation of 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. Since the beginning of 2008, credit spreads have narrowed markedly in the bellwether interbank markets here and in Europe.

In his speech on January 10, Chairman Bernanke suggested that the Term Auction Facility may become a permanent component of the Fed's policy toolkit.

Responding to developments

The future—even in stable times—is hard to read. At this juncture, the times present even greater uncertainty than usual. Recently, negative information has been exceeding expectations. I think these circumstances call for policymakers to be prepared to respond pragmatically. In my view, pragmatism in the face of growing weakness in the general economy may very well require additional moves to lower the federal funds rate.

As a policymaker, I feel acutely the tension between the need to promote growth and guard against the specter of higher prices. Implicit in my view is the forecast that inflation will moderate, allowing policy to focus on the very apparent near-term risks to the broad domestic economy.

Clearly, painful adjustments are under way in housing markets, mortgage markets, and money markets. I believe this process began in 2006, continued in 2007, and needs much of 2008 to play out. In the weeks and months ahead, I will be watching the process of these necessary adjustments closely as I work with my colleagues to determine the appropriate monetary policy actions.

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