

Remarks on Economic Slowdown, Market Fallout, and the Path to Financial Recovery

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My thanks to Artemis Kirk and the Georgetown Library for sponsoring this event. I'd like to organize my remarks this evening around three questions suggested by the title of the session. First, I will comment on the current state of the financial markets and the general economy. Second, very briefly, I'll review the path to our current situation—how we got here. Third, I'll offer some views on the path to financial and economic recovery and the likely preconditions and requisites for sustained recovery.

The current circumstances seem to me to be best described as an intersection of three serious and interacting challenges—weakness in the general economy, uncomfortable levels of inflation, and continuing threats to financial stability. Economic weakness is demonstrated in growth rates well below potential and deteriorating unemployment measures.

Headline inflation numbers reflect the rising cost of oil and other commodities. The turmoil and dysfunction in financial markets, although less in the last few weeks, have not completely receded. These pressures present policy makers with tactical trade-offs in the short term. They are not in conflict, however, over the long term.

The current economy and financial situation

The domestic economy has performed better in the first half than many expected. After two quarters of very strong growth in the middle of 2007, we saw a severe drop-off in economic activity in the fourth quarter, giving rise to a forecast at the beginning of the year for a weak first half followed by gradual improvement in the second half. First quarter GDP growth recently was revised up twice to 1 percent, and the second quarter is expected to come in substantially above that number.

Employment conditions have weakened gradually since last year as the slowdown has taken hold. The headline unemployment number now stands at 5.5 percent, up a percentage point from the middle of last year. Half of this jump occurred in May. Nonetheless, the economy has been eliminating nonfarm jobs at an average rate of 38,000 a month in April and May, following a monthly average of 82,000 in the first quarter.

A sizeable portion of the job losses has been in residential housing construction, though job declines have been broad-based. The wrenching correction underway in the housing sector is at the center of our current financial and economic difficulties. House prices continue to fall. The April Case-Schiller index of house prices in 20 cities was down 15.3 percent from a year earlier. The OFHEO index showed a 12-month decline of 4.6 percent through April.

The continuing decline of house prices has influenced buyer reticence, which has been compounded by the difficulty of selling existing homes and finding financing. As a result, inventories of new and existing homes on the market have been hovering at around 11 months' supply for several months, well above a normal, healthy level.

Home sales in May came in close to the average level of the past several months at an annualized rate around half a million units. Building permits and housing starts declined in May to annualized rates just below one million. The home building slowdown—while painful—is widely considered a prerequisite for reduction of house market inventories.

Consumer activity has held up better than expected in light of the weak economy. The growth of consumer spending has been decelerating since 2006 but by one measure jumped up in May after upward revisions for March and April. The May number suggests the rebate checks associated with the fiscal stimulus package are having some effect. About half the rebate checks went out in May.

This better-than-expected personal consumption performance contrasts starkly with consumer confidence. The Conference Board's index of consumer confidence for June fell to a 16-year low.

Also, business investment in recent months has been soft. The rate of investment in equipment and software in the first quarter was flat and is projected to remain weak in the second quarter.

Net exports have been a positive contributor to the economy, compensating for domestic weakness. Solid, though somewhat weaker, growth overseas combined with the effects of dollar depreciation has kept exports growing.

Turning to the inflation picture, annual headline inflation in recent months has been high and rising. Energy and food commodity prices have pushed headline consumer price index (CPI) inflation to 4.1 percent year-over-year. Finished goods producer prices—as captured in the headline producer price index (PPI)—rose at an annual rate of more than 7 percent as of May.

These "headline" measures have diverged somewhat from the more stable "core" measures that exclude the effects of energy and food prices. The year-over-year core CPI rate in May increased 2.3 percent—above my personal comfort level—but well below and less volatile than headline numbers of late.

Measures of expectations of future inflation have edged higher, with short-term expectations moving up more than long-term ones. So far, there is little indication that higher actual inflation or inflation expectations have factored into wages and salaries.

Let me complete the current picture with comments on the financial markets, particularly the credit markets. There is widespread anecdotal and hard evidence of a credit contraction in both bank lending markets and credit capital markets. Investment-grade corporate credit markets seem to be functioning, but other credit markets (mortgage-backed securities, leveraged loans, other consumer credit structured securities, and municipal finance) remain fragile and vulnerable.

Very importantly, interbank credit markets continue to be stressed, reflecting concern over exposure to still volatile and declining asset values. The banking system now exhibits some signs of stress at all levels—large financial institutions, regional banks, and community banks.

How we got here

The story of how the economy arrived at its current state is familiar but worth re-examining for clues about the path to recovery.

If one takes a long view, the salient points are these:

six years of economic expansion from December 2001 through 2007 fueled in part by a surplus of global savings and ample liquidity;
the growth of structured finance capital markets in the context of a three-decade evolution of our financial system from bank-centric to market-centric;
large amounts of global liquidity finding an outlet in housing investment, pushing prices ever higher; and
pricing of risk through last summer showing symptoms of ever onward-and-upward market psychology...until last August!

The shorter view is a story, beginning last summer, of the subprime mortgage-backed securities and foreclosure crisis, spread of illiquidity to several markets, a retreat from and radical repricing of risk, distrust among counterparties in the essential interbank credit markets, and the resulting rapid delevering of the financial system across the board.

The Fed responded by providing liquidity through a number of different facilities to encourage the orderly functioning of financial markets. And since last September, the federal funds rate has been lowered from 5.25 percent to the current level of 2 percent.

What's ahead

I know you are most interested in the path from here—the path to recovery in the financial markets and, by my inclusion, the broader economy. My base case forecast for the economy involves a stronger-than-expected first half of 2008 with growth of 1 to 2 percent but not much pickup in the second half. The drag of high energy costs, continuing financial market stress, and a still-declining housing sector may continue for a while with gradual improvement of growth in 2009.

There is much uncertainty surrounding this outlook. More adverse alternative scenarios are entirely possible. Self-reinforcing progressive deterioration could continue in the housing market, in turn affecting the financial markets. And neither the financial markets nor the overall domestic economy is protected from surprise events around the world.

Like many, I believe stabilization of the housing sector is required for recovery to proceed. There are early and tentative signs that a bottom may be forming in some housing markets. Having said that, a sober approach to calling the future must allow for an additional period of house price decline, a slow housing sector recovery, and, as a result, a quite choppy progression to better markets and economy.

Eyes on inflation

In closing, let me emphasize that I'm taking the recent inflationary pressures very seriously. A path to recovery involving stronger growth but with higher and persistent inflation would fit the old adage about winning the battle but losing the war.

For that reason, in my view, the current set of circumstances calls for being especially vigilant and attentive to public and business psychology as regards costs and prices. Policy needs to react decisively against signs of the onset of formal compensating practices, including contracts, that treat inflation as a persistent reality—in other words, something that must be lived with. Such signs are not apparent, and I don't expect them to materialize.

Thank you.

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