SPEECHES

On Real Estate and Other Risks to the Economic Outlook

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Thanks for inviting me to be your speaker for the Greater Miami Chamber of Commerce Trustee Luncheon. I appreciate this chance to speak to the business leadership here in your city.

Already this year I have given several speeches on the economy, and in my earlier remarks to other groups I provided a picture of a U.S. economy that was very weak but in a position to begin a modest recovery during the second half of the year.

Also, in these speeches I talked about a number of risks to this outlook. In my remarks today, I will elaborate on two of those risks, specifically residential and, especially, commercial real estate.

I believe this focus should interest you since real estate is a very important contributor to south Florida's economy and, for that matter, to the Southeast region overall. Problems in residential real estate are well known. But with continued economic weakness I'm increasingly paying attention to commercial real estate.

Declining commercial real estate markets could put further pressure on already strained financial institutions and markets. And overcoming problems in the financial sector is central to achieving economic recovery.

As a policymaker, I feel the need to ground my views in a sober, unvarnished assessment of reality. But I do want to leave you with a sense that the Fed is ready and able to respond decisively to emergent problems in the economy and that the Fed's actions are buttressed by other public policy programs and vice versa. Let me lay the foundation for this discussion with a summary of the state of the U.S. economy and my near-term outlook.

I must state up front that these remarks are mine alone and don't necessarily reflect the views of my colleagues on the Federal Open Market Committee (FOMC).

The economy

Looking broadly at the national economy, the recent numbers have been discouraging. Just last Friday, the U.S. Bureau of Economic Analysis announced gross domestic product (GDP) contracted by 6.2 percent in the fourth quarter of 2008—worse than the 3.8 percent decline shown in the preliminary numbers.

Other incoming data give little reason to be upbeat about the immediate future. Unemployment continues to rise. Unemployment insurance claims have been high—worse than generally expected. Consumer spending has declined sharply since last fall, especially spending on durable goods such as autos. Businesses have scaled back investment spending.

In the housing sector, January home sales reports—both new and existing—were well off December levels. Housing starts have fallen from a peak rate approaching 2 million to an annual run rate below 500,000. The pullback in new construction is probably a necessary evil to bring down elevated house inventories.

Amid this sharp drop-off in economic activity, I take some comfort in signs of improvement in strained credit markets, particularly where policymakers have provided support. Interbank lending risk spreads have fallen in recent months, and residential mortgage rates have reached levels low enough to encourage refinancing and purchases by creditworthy borrowers. Commercial paper spreads over short-term Treasury bills have declined, and investment-grade corporate bond spreads have remained generally flat for some months. Investment-grade corporate bond issuance has been healthy of late.

Notwithstanding some improvement, it's fair to say credit markets remain stressed.

All that said, I have been predicting an upturn in the overall economy beginning in the second half of 2009, with a slow and gradual return to our full economic potential. To temper that outlook a bit, uncertainty remains unusually high, and one has to be mindful of very real downside risks, including a further deterioration in real estate.

Residential real estate

As you know, residential real estate was the catalyst of problems in credit markets. Problems in housing contributed to economic weakness, but now the slowing economy is feeding back into the continued housing slowdown. South Florida has been among the hardest-hit residential markets, so let me spend a few moments discussing housing.

At the current pace of sales, the nation's supply of new homes is more than 13 months—the highest on record. Sales of new single-family homes fell 10 percent in January, and existing homes fell more than 5 percent.

Home prices here in Miami—after a steep run-up during the housing boom—have fallen 41 percent from a peak in December 2006. Nationally, house prices in 20 major MSAs have fallen almost 27 percent since their peak in the second quarter of 2006, according to the S&P/Case-Shiller index.

Other measures show smaller declines nationally. There's no doubt, though, that declining house prices have been a major driver of mortgage delinquencies, defaults, and foreclosures. What's happening is a profound revaluation of mortgage portfolios as well as securities in the global secondary market for mortgage-backed securities.

Efforts to prevent foreclosures appear to have had only modest success so far.[1] There are many reasons this might be the case, but among them is the obstacle posed by securitization agreements to loan modifications. To date, payment-reducing modifications have been the exception rather than the rule. As a result, redefault rates have been high, and new foreclosures continue to add downward pressure on housing prices.

I should also comment on the weakening multifamily residential real estate picture. No two rental markets are exactly alike. But to generalize, those markets trending the worst probably share one or more characteristics. They had excessive condo construction or condo conversion activity. Such markets are seeing unsold units return as rentals. They had very high home price appreciation in the years 2004—07 with large amounts of speculative house construction activity. Today, in several markets, houses compete with apartments as rentals. And they have been experiencing high and rising foreclosure rates.[2]

Commercial real estate

While historically smaller than residential real estate, commercial real estate (or nonresidential structures) accounts for a not-insignificant portion of the American economy—at least 4 percent of GDP directly and perhaps more, depending on estimates. Also, commercial real estate is important to the financial sector. And a rejuvenated financial sector is essential for economic recovery.

There are currently some $2.5 trillion of commercial property loans on the balance sheets of financial institutions and in commercial mortgage-backed securities (CMBS) markets. In contrast, residential mortgage debt amounts to about $11 trillion.[3]

Some 25 percent of commercial real estate debt is securitized, compared with 60 percent of outstanding home mortgage debt. The volume of CMBS has more than doubled since 2003, a bit faster than the growth of overall commercial real estate debt.

There are several subsectors of commercial real estate: retail, office, hotel, and industrial. All are facing problems.

There is a growing imbalance of retail space for several reasons. A lot of new retail space was added in areas that saw a high level of home construction, much of which has not been absorbed.

This imbalance is aggravated by general weakness in the retail industry. Established retail centers are seeing rising vacancy rates. When an anchor tenant leaves a shopping center, or overall occupancy falls below a threshold level, other tenants are often free to cancel their leases. Industry data indicate that abandoned retail store expansions and store closings have reached levels not seen since the recession and real estate slump of 1991–92.[4]

The hotel subsector is facing excess supply in the face of soft demand. Occupancy rates declined about 8 percentage points in the fourth quarter of 2008, according to industry sources.[5] Summer tourism was hurt by high gas prices, and now business travel is declining as companies scale back in a weak economy.

Also, with the decline in the economy and rising unemployment, office and industrial vacancies have been rising. In virtually all segments of commercial real estate, there is downward pressure on property values because of new construction coming on stream—construction started before the recession fully set in—coupled with the effects of the economic downturn.

Interestingly, the only property type currently withstanding downward pressures is warehouse. This seems to be, perversely, at least partly because of the back-up of inventories resulting from weak consumer spending and adverse retail and manufacturing conditions.

Financing pressures

Given eroding demand for commercial space, financing pressures in commercial real estate are cause for concern. Vacancy, property value, and financing are connected, of course.

Banks are a primary source of construction financing for commercial properties. Various financing models have evolved. The largest construction loans on "trophy properties," for example, are typically syndicated among very large banks with equity provided by institutional investors. When construction is completed and the property's operating cash flow has stabilized, the loan is placed with an investment fund, with an institutional investor, or in the CMBS market.

For other large properties, banks lend for the construction of new projects or to refinance existing loans and then look to the CMBS market to provide the longer-term funding. For smaller properties, many regional and community banks do not use the CMBS market on a regular basis, often keeping the mortgages on their books.

The National Association of Real Estate Investment Trusts estimates that about $400 billion of commercial mortgages are set to mature this year, raising concern about maturity defaults.

Commercial real estate finance challenges could further complicate efforts to stabilize the banking system and credit markets. Banks that financed the construction of commercial properties may end up keeping those loans if the properties cannot achieve the cash flow needed to service new permanent debt. Loans maturing face a CMBS market that virtually shut down in the latter part of 2008 and a banking industry that is already saddled with bad assets from the residential sector.

Public policy response

As a Fed policymaker, I must consider whether we have tools in place to soften the impact of emerging weaknesses.

The Fed has a number of tools at our disposal and has been using them aggressively.

With the emergence of financial turmoil, starting in the latter half of 2007, and weakening growth, the FOMC aggressively lowered the short-term policy interest rate—the federal funds rate—from 5.25 percent in September 2007 to a range just above zero today. The federal funds rate is the foundation rate of the whole spectrum of private market rates of varying tenors and loan purposes. By influencing the yield curve, the fed funds rate acts to stimulate general economic activity.

The Fed also introduced a number of targeted credit facilities aimed at easing liquidity pressures faced by financial institutions and restoring the functioning of key capital markets. Examples include facilities for commercial paper and money market mutual funds.

Recently, the Fed has begun directly purchasing assets in securities markets. The Fed has authorized the purchase of up $100 billion of debt of federal housing finance agencies, such as Fannie Mae and Freddie Mac, and another $500 billion of agency guaranteed mortgage-backed securities. To date, about $195 billion has been expended in this program. The provision of such liquidity has served to lower yield spreads on these securities, which ultimately can translate into lower mortgage rates for consumers.

With continued illiquidity in securitization markets, the Federal Reserve—in cooperation with the U.S. Treasury—recently announced that it is prepared to expand its forthcoming Term Asset-Backed Securities Liquidity Facility (TALF) from $200 billion to up to $1 trillion. This program was originally designed to support consumer and small business finance through lending on securities backed by small business loans, student loans, auto loans, and credit cards. An announcement yesterday also said that the Fed and Treasury are looking into accepting CMBS and other types of AAA-rated, newly issued ABS.

I also want to mention measures taken to stem preventable foreclosures. Here in south Florida, for example, our staff created and co-chairs a homeownership preservation task force of nearly 80 organizations to promote dialogue between lenders and foreclosure counselors. Since foreclosure prevention is not always possible, we are also providing data and analysis to local municipalities as they prepare to purchase, rehabilitate, and sell properties to help protect neighborhood integrity.

Near term and long term

It's fair to ask: Will these efforts be effective? There are no guarantees, but I take comfort from several aspects of the public policy response. First, policymakers have acted forcefully to address the economic and financial sector crises.

As mentioned earlier, Fed interventions have had success in credit markets where we've introduced specific facilities to address acute market stress. I look forward to the day these programs are no longer necessary, but they can be kept in place as conditions require.

Second, other public policy organizations have also acted. For instance, the U.S. Treasury Department has announced a multipronged financial stability plan, which includes measures to strengthen the capital position of banks, remove bad assets from bank balance sheets, and other actions. And the new administration has recently released its comprehensive Homeowner Affordability and Stability Plan that is designed to lower actual payments for many homeowners. In addition, Congress recently passed a large economic stimulus package with measures intended to stop net job destruction and kick-start job creation.

With regard to the longer run, it will be important to take a very careful look at what went wrong during this period. Many observers have expressed doubts about the securitization process. They have pointed to incentive conflicts within the originate-to-distribute model of financial intermediation, along with concerns about the ability of lenders and the rating agencies to properly measure risk.

In my view securitization markets need reform but in the end will be a substantial part of the nation's total credit system. Securitization has provided cost benefits to consumers and other borrowers and liquidity to loan originators, including commercial banks. It's essential that securitization markets get brought back to life.

One more thought in closing: Public policy and the resilience of our citizens are being tested. With respect to public policy, I want to assure you that the Fed has the capacity to act, even with the federal funds rate near zero, with the aim of returning the country as quickly as possible to its enormous potential for growth and prosperity.

Footnotes

1. Macroblog, http://macroblog.typepad.com/, "Foreclosure Mitigation: What We Think We Know," by Kristopher Gerardi, research economist and assistant policy adviser at the Atlanta Fed.

2. Axiometrics market report. "Industry data indicate that the nationwide average apartment vacancy rate ended 2008 at 7.5%, up a full percentage point from the prior year-end."

3. Flow of Funds of the United States, Z.1 Release, Table L 220 (includes retail, office and industrial real estate) and Table L 218 (home mortgages). Federal Reserve Board of Governors, http://www.federalreserve.gov/releases/z1/Current/.

4. Dodge Pipeline and the ICSC (International Council for Shopping Centers).

5. Smith Travel Research.

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