

Economic Recovery, Small Business, and the Challenge of Commercial Real Estate

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I appreciate the opportunity to speak to and with this sophisticated real estate audience about the interaction between conditions in the commercial real estate (CRE) sector and the prospects for economic recovery. In earlier speeches, I have drawn attention to the exposure of the country's banking and financial system to troubled commercial real estate loans as a significant emerging risk.

But in those speeches I didn't go much beyond identification of the risk, suggesting it bears watching.

This morning I'd like to go a bit further and venture an assessment of the CRE problem's likely impact on economic recovery. I will try to give you a sense—as a policymaker concerned with the broad economy—of how I am sizing up the commercial real estate challenge. One of my themes this morning will be the links, or connectivity, between sectors and the potential for troublesome, self-reinforcing interactions.

I must emphasize that the views I'll express are my personal thoughts and are not necessarily shared by my colleagues in the Federal Reserve and on the Federal Open Market Committee (FOMC).

Economic situation

I believe an economic recovery is under way. It probably started in the summer.

The third quarter gross domestic product (GDP) growth number was 3.5 percent, the first increase in real GDP since mid-2008 and the largest gain since 2007. The primary contributor to this gain was real consumer spending, which rose at a 3.4 percent rate, largely because of the "cash for clunkers" program. In addition, federal outlays grew rapidly, and the pace of inventory liquidation slowed. Accompanying positive GDP news, inflation measures remained relatively subdued.

There are other signs of improving conditions. Home prices appear to have bottomed out and have begun to move up in some markets. House sales appear to be growing in many markets.

Some financial markets—but not all—have stabilized, and risk spreads have normalized. For example, in the very important short-term interbank lending market, one-month and three-month LIBOR rates are very close to precrisis levels as measured by the spread over the federal funds rate.

The situation is much improved, but there are sobering aspects of the economic picture. Let me cite two.

First, the economy has been supported and stimulated by several government programs. Appropriately, these programs are temporary. However, they are at various stages of removal or extension. It might be useful to go over the status of the key programs.

The \$787 billion fiscal stimulus program remains in force. Nearly \$200 billion of this amount has been paid out through the end of October.

The "cash for clunkers" program, part of the stimulus effort, has already expired.

The first-time home buyers' tax credit has been broadened and extended for another nine months.

Unemployment insurance has been extended.

The Fed's credit market support liquidity facilities are winding down on their own.

The Fed's Term Asset-Backed Securities Loan Facility (TALF) to support asset-backed securities markets is expected to expire in March 2010 with the exception of newly issued commercial mortgage-backed securities (CMBS), which is scheduled to expire in June.

The Fed's large-scale asset purchase program of Treasury securities ended Oct. 30. The agency mortgage-backed securities (MBS) and agency note purchases are scheduled to conclude at the end of the first quarter next year.

The Troubled Asset Relief Program (TARP), used to inject capital into banks, is seeing some return of capital to the government.

The FDIC's temporary liquidity guarantee program has expired.

These are by no means all of the government efforts to stabilize the economy and financial markets, stimulate activity, and treat the effects of job loss. Certainly, the Fed's maintenance of its policy rate at the so-called zero lower bound for almost a year now should not be overlooked.

A second reason to strike a note of caution about the economic picture is that both the data and anecdotal descriptions of ground-level reality are quite mixed. Data on foreclosures, unemployment, personal income, and bank failures continue to disappoint. Also, nonresidential construction continues to decline, and state and local government budgets remain severely constrained.

Along with my colleagues at the Atlanta Fed, I spend a lot of my time asking business contacts about industry conditions and the outlook for their businesses. In recent soundings we've heard frequently about weak top-line sales, continuing inventory liquidation, reticence regarding capital expenditures, and reluctance to hire.

Characteristics of this recession

Turning to the outlook from here, my baseline forecast is for a relatively subdued pace of growth beyond the current quarter and through the medium term. The potential

sluggishness of the recovery partly reflects certain unique characteristics of this recession. It was led by a crisis in banking and capital markets that was triggered by a sharp and persistent reduction in valuations of residential real estate assets.

The downturn in residential real estate did not remain contained in that sector. Trouble was transmitted to the rest of the economy via credit markets. The housing downturn triggered a crisis on Wall Street that soon became a recession on Main Street, and, as job losses mounted and delinquencies rose, fed back again to financial markets. Also, personal consumption retrenched because of the real estate price shock, tighter credit, and fear of job loss hitting close to home.

Despite marked improvements in financial markets from a year ago and improved flow of private capital to banks in recent months, the banking system has not fully recovered—far from it. Bank credit losses are still climbing, and many banks are still capital constrained. It almost goes without saying that recovery of the banking system is crucial to the recovery of the overall economy.

To draw insights from the recession relevant to the future, it's instructive to consider the connectivity among sectors and the potential of a self-reinforcing negative feedback loop involving multiple sectors.

Today, I'm particularly concerned about the interaction among bank lending, small business employment, and CRE values.

To elaborate, there is a tight linkage between CRE values and jobs. In a mid-September conference at the Atlanta Fed, CRE practitioners, investors, and academics agreed that the evolution of the CRE picture will depend greatly on the path of employment. This point was strongly reinforced in the Urban Land Institute's "Emerging Trends in Real Estate" report at this conference.

Small business impact

Let me go on to show the link between jobs and small business credit. During the last two economic expansions, small firms (those with fewer than 50 employees) contributed about one-third of net job growth. But the depth and duration of this recession have taken a substantial toll on small businesses. In the 2001 recession, small firms held up reasonably well and accounted for only 9 percent of net job loss. In this recession, however, small firms have accounted for about 45 percent of net job losses per our most recent data through the end of 2008.

Small businesses tend to depend greatly on the banking sector—especially community and regional banks—for financing. A Federal Reserve survey earlier in the decade showed that more than half of smaller firms had a credit line or loan with a bank. In addition, about half of these businesses used a personal or business credit card to finance working capital. In this recession, credit standards have tightened for all businesses, including small businesses.

At this juncture, it's hard to be encouraged about a fast rebound in job growth. As you know, last week's employment report pushed the official unemployment rate to 10.2 percent, the highest since May 1983. Net job losses continue on a monthly basis but at a declining pace. Because employment growth tends to lag recovery from a recession and because of factors such as small business credit constraints, my current outlook for employment is one of very slow net job gains once the trend reverses, in all likelihood sometime next year. If this view is correct, this job growth outlook doesn't help the commercial real estate situation.

So how serious is the CRE problem for the financial system and the broad economy?

First, let me provide some overview comments: While the CRE problem is serious for parts of the banking industry, I don't believe it poses a broad risk to the financial system. Compared with residential real estate, the size of the CRE debt market is smaller, and the exposure is more concentrated in smaller banks.

However, I am concerned about the potential impact of CRE on the broader economy. Unlike residential real estate, there is not the same direct linkage from CRE to household wealth—and therefore consumption—caused by erosion of home equity. However, there could be an impact resulting from small banks' impaired ability to support the small business sector—a sector I expect will be critically important to job creation.

To add some detail: At the end of June 2009 there was approximately \$3.5 trillion of outstanding debt associated with CRE. This figure compares with about \$11 trillion of residential debt outstanding.

About 40 percent of the CRE debt is held on commercial bank balance sheets in the form of whole loans. A lot of the CRE exposure is concentrated at smaller institutions (banks with total assets under \$10 billion). These smaller banks account for only 20 percent of total commercial banking assets in the United States but carry almost half of total CRE loans (based on Bank Call Report data).

Many small businesses rely on these smaller banks for credit. Small banks account for almost half of all small business loans (loans under \$1 million). Moreover, small firms' reliance on banks with heavy CRE exposure is substantial. Banks with the highest CRE exposure (CRE loan books that are more than three times their tier 1 capital) account for almost 40 percent of all small business loans.

To repeat my current assessment, while the CRE problem is very worrisome for parts of the banking industry, I don't see it posing a broad risk to the financial system. Nonetheless, CRE could be a factor that suppresses the pace of recovery. As the recovery develops, the CRE problem will be a headwind, but not a show stopper, in my view.

It's appropriate to be a bit tentative in the assessment of CRE risk to the financial system, however. In 2007, many underestimated the scale and contagion potential of the subprime residential mortgage-backed securities problem. With this experience in mind, my assessment should continue to be refined.

That said, I do see the process of CRE adjustment and resolution as a pivotal element of economic rebuilding. Toward these ends, on Oct. 30, financial regulators issued guidance addressed to both bank examiners and financial institutions. The guidance called for a balanced and pragmatic approach to CRE loan workouts and examiner loan classifications, consistent with accurate and timely recognition of losses.

In my view, now that growth has resumed, the overall objective of economic policy should be to bring about a durable recovery and an environment that reduces unemployment as quickly as possible while containing inflationary pressures. The process of achieving this objective will necessarily involve judicious removal of government supports and the normalization of monetary policy. As policymakers consider these decisions, attention to the state and trends in the commercial real estate sector will be essential.

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