SPEECHES

Progress Report on the Recovery

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For my remarks today, I plan to speak about the current economic situation and outlook and comment on some of my concerns as I assess the sustainability of the recovery under way.

The views I will express are mine and are not necessarily shared by my colleagues on the Federal Open Market Committee (FOMC).

The economy today
The economy is well into recovery, perhaps as much as 10 months. This view is based on quarterly gross domestic product (GDP) growth data as well as improvement in major economic indicators such as consumer spending, manufacturing activity, and job growth. Positive trends are evident in a number of data points that are the vital signs of the economy. I should add that anecdotal feedback from contacts across the Southeast and elsewhere conveys improving confidence.

The Atlanta Fed's base case forecast for the near term looks for growth to continue. The pace of growth will probably be somewhat slow. I expect moderate growth because the economy is working through some formidable adjustments that act as drags on growth.

At this juncture, financial markets—including many credit markets—are functioning effectively, but I should add that substantial deleveraging is taking place in the household and private business sector. This process is natural and healthy but is not painless or quick.

The lackluster pace of growth I'm expecting leaves the economy somewhat vulnerable to shocks or setbacks that might derail the recovery. At the same time, the recovery thus far has been a testament to the economy's capacity to move forward despite serious damage done by the recession and the repair required in its aftermath. So far, so good.

Here in Pensacola a maritime military metaphor should be a comfortable device for exploring factors that could set back recovery. Looking out to the horizon, imagine a squadron of hostile torpedo boats aimed at us ashore. Today I want to address each of the threats I can identify at the moment and assess their individual potential to torpedo the recovery.

Housing
First, the housing sector. This sector was "ground zero" in the financial crisis, and the sharp falloff of construction and employment contributed greatly to the ensuing recession. It's a widely held view that stabilization of the home sales market—and the housing sector more broadly—is essential for a sustained recovery. I agree with that view.

During the recession, we experienced large declines in residential construction, house prices, and sales. In recent months, the housing sector appears to have leveled out and is bumping along a low bottom.

Total housing starts have begun to make modest gains from their low point in April 2009.

Home prices stabilized during the second half of 2009, and early readings this year have shown that prices are holding relatively steady, with slight declines and increases, depending on the market. Although foreclosures have abated somewhat, nearly a quarter of all residential properties with mortgages were in negative equity at the end of last year, a slight increase from a year earlier. Looming foreclosures could continue to dampen a rise of home prices.

New and existing homes sales rose sharply in the second half and then fell off just as sharply. The supply of homes for sale, as measured by months of inventory, declined during the second half of last year but then increased again.

Clearly, it is difficult to know with certainty the true health of the housing market in the absence of government support, specifically the homebuyer tax credit.

My overall conclusion is that we should not expect a full return to precrisis levels of construction activity, prices, or homeownership for some time. But I do think the needed housing sector stabilization is in process. And stabilization is a necessary precondition to rebuilding some of the sector's previous strength.

Commercial real estate
Let me turn to commercial real estate (CRE). I've been watching developing challenges in this sector for well over a year, and I think much of the adverse impact remains ahead of us. The loss of occupancy, the loss of operating cash flow, and the resulting loss of property value is colliding with loan maturities in banks and securities. Much restructuring is required.

Commercial real estate is a general concern because of its potential spillover effects to the broad economy for at least the medium term. I have spoken in earlier talks about the linkage of CRE losses to the banking system—particularly small and regional banks—and credit flows to businesses and consumers.

We know it's going to be bad for the parties directly involved. The question is, How bad will the spillover effects be?

Let me summarize the situation in commercial real estate. While delinquencies and loan losses on commercial mortgages are expected to continue to rise, there is evidence that some property markets are stabilizing.

Investment demand for certain property types appears to be increasing. Commercial mortgage originations steadily increased in 2009, and property sales increased toward the end of the year. There are indications that private capital is returning to commercial real estate markets.

Even with the recent evidence of improvement, prices are down more than 40 percent from their peak. The decline in prices creates significant challenges for borrowers and lenders trying to refinance the $1.4 trillion in loans that are expected to come due over the next four years, half of which are currently underwater.

These problem loans will greatly strain banks whose balance sheets are heavily concentrated in CRE, and the FDIC expects the result to be more bank failures this year than last. Smaller banks will have the toughest time because of their greater relative exposure to CRE. The loan portfolios of small banks—with less than $10 billion in assets—have three times the exposure of CRE loans relative to their capital base compared with the exposure of larger institutions, with more than $50 billion in assets.

So, to return to the spillover question, my view today is that commercial real estate will be a drag on the economy but won't torpedo the recovery. In the context of the national economy, the problem is manageable and will be managed. I am encouraged that, so far, the stakeholders—borrowers, banks, creditor groups, and new investors—are working the problem and executing restructuring solutions.

Greece

A third concern arises from the daily headlines, and this is Greece and the European Union's (EU) handling of the Greek fiscal crisis. The news has alternated between comforting and disquieting almost on a day-to-day basis. The Greek sovereign debt story is a concern because it feeds anxiety about another shock to the global banking system—particularly European banks—as well as the potential of a broad retreat from sovereign debt exposure affecting interest rates and recovery prospects here in the United States.

The latest news is that EU leaders have agreed to a backstop plan—a combination of EU bilateral loans and International Monetary Fund assistance—that will be implemented if Greece runs out of market-oriented fund-raising options.

Recently, the concern has centered on a potential bank liquidity crisis. Depositor and investor focus has expanded from the public sector alone to more general Greek exposure. At the moment, it is unclear how threatening these liquidity problems are.

The Greek fiscal crisis is unfolding in real time and remains, at this juncture, unpredictable. So far the problem has been isolated to Greece even though there are other countries under serious fiscal debt stress. A generalized investor retreat from sovereign debt has not materialized. The Greek drama has not threatened U.S. Treasury auctions, and the U.S. banking system has very limited direct exposure. However, the financial crisis has taught us that we can't be relaxed about stresses in financial markets, no matter how distant and isolated they appear to be.

For that reason, the situation should be watched carefully.

State and local fiscal stresses

Closer to home, there is appropriate concern about our own fiscal stresses and their possible negative effect on the recovery. I'm referring to fiscal problems at the state and local government levels in particular. The government sector overall makes up about 20 percent of GDP. State and municipal governments represent about 12 percent of GDP.

State and municipal governments across the country are now implementing painful spending cuts and tax increases to close large budget gaps. The federal stimulus package, rainy day funds, and lowered contributions to pensions and other accounting adjustments have forestalled some of these cuts. But now—with a lag—the potential drag on local economies is materializing.

States still had budget gaps in excess of 10 percent for fiscal year 2010. As federal government aid to states is waning, states are working to close an additional 11 percent gap in the coming fiscal year and project shortfalls of a similar magnitude in 2012.

At the same time, cities confronted budget gaps of roughly 3 percent last year, according to a survey conducted by the National League of Cities. Because of lags in adjustments to the property tax digest and continuing declines in funding from state governments, cities aren't expected to begin recovery until 2012.

Despite these challenging problems, I see state and local government belt tightening as a long-term drag on the recovery with varied effects at the regional, state, and local level, but not an outsized near-tem vulnerability. Fiscal adjustment is occurring, fortunately, in the context of a now growing private economy. Adjustment will proceed but shouldn't imperil broad improvement of economic conditions.

Private spending

Private spending will certainly have a big impact on the fate of the recovery. Private spending has two dimensions: personal consumption and business investment spending. The confidence that underpins consumer behavior is linked to employment conditions and household wealth. Growth prospects and the degree of medium-term uncertainty shape business spending.

As regards the factors influencing consumer spending, unemployment rose last fall to above 10 percent, the highest since the 1981–82 recession. Declines in home values and equity prices put significant pressure on the balance sheets of consumers. Through the fourth quarter of 2009, the net worth of households was about 18 percent below its peak in the second quarter of 2007.

While consumer spending contracted sharply during the recession, the consumer is coming back. Real personal consumption expenditures (PCE) rose in February for the fifth consecutive month.

Much depends on the labor market. Income follows employment, and consumer spending follows income. The jobs picture seems to be gradually strengthening. The private sector added nearly 50,000 jobs monthly on average during the first quarter of 2010, but, clearly, stronger growth is needed to bring down the unemployment rate.

Recent data also suggest that the second component of private spending—business investment—is likely to continue growing. Spending on equipment and software grew at a solid pace in the fourth quarter, and durable goods orders, which are forward looking, suggest continued expansion.

For the general economy, I'm encouraged by growth in both categories of private spending. However, powerful forces are still restraining consumption and investment spending, and consequently I don't think it's realistic to expect spectacular growth in either in the coming year. But I do expect solid advances in private spending to be one of the key economic stories of 2010.

Inflation
My final concern is the risk of a surge in inflation and its advance warning, inflation expectations. Understand this is not in my forecast, but the concern is that unwelcome price developments could limit the Fed's ability to provide policy support for a gradual recovery.

As the global economy has moved into recovery, the prices of energy, metals, and other raw material commodities have risen. These market movements have led some analysts to fear greater pressure of pass-through of commodity price increases, which could add a cost-push dynamic to the inflation picture.

While some categories of prices have gone up, aggregate measures of prices are indicating disinflation and not rising inflation. For example, yesterday's consumer price index (CPI) report indicated that retail price growth remains in check. The overall index for last month rose 2.3 percent on a year-over-year basis, and the core CPI was up just 1.1 percent.

Additionally, large amounts of resource slack have given businesses little pricing power, and underlying wage and price trends have continued to ease. Our directors and business contacts around the Southeast have confirmed anecdotally this view on current inflation pressures.

Despite the lack of evidence of current inflationary pressures, some have expressed concern about the potential inflationary consequences of the Fed's very aggressive monetary measures taken in response to the financial crisis and recession. As a result of those measures, the Fed's balance sheet more than doubled in size.

Discussion among market participants and Fed observers has focused in recent months on whether the Fed can engineer a policy exit, that is, an optimal shrinking of the balance sheet. Much planning, market testing, and consultation has already been performed in anticipation of an eventual exit. I am very confident that the Federal Reserve will be able to manage the normalization of its balance sheet with appropriate timing and pace. I do not expect inflation to change the course of economic recovery over my forecast horizon.

So far, the public seems to agree. The stability of long-term inflation expectations, in my view, is signaling confidence in the Fed's ability to conduct a successful exit from stimulative policies.

Monetary policy comments
Let me close with some thoughts on the implications of the views I've expressed for the stance of monetary policy.

As a central banker, I keep a worry list. A good part of this talk has been a survey of my concerns. These points of vulnerability have been identified in recent months and weeks by many other public officials and commentators. Such public recognition of a problem, a risk, a vulnerability often sets in motion focused efforts to address it by a variety of relevant actors. And often the outcome is better than the original estimates of potential impact precisely because the problem is being worked.

Given the current state of the economy, I am very comfortable taking a personal position that is neither sanguine about these potential torpedoes nor unduly alarmist or defeatist. I take comfort that each big problem that is actionable is being addressed, and the recovery is moving forward. As I said earlier, so far so good.

Having said that, I believe the recovery requires continued support of accommodative monetary policy. I think there is risk associated with starting a process of tightening too soon. In my view, the strong medicine of low rates should remain in place to facilitate adjustment processes that are by their nature gradual.

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