

## Real Estate and the Economic Recovery

Dennis P. Lockhart  
President and Chief Executive Officer  
Federal Reserve Bank of Atlanta

National Funding Association  
Council for Quality Growth Atlanta, Ga.  
May 11, 2011

### Key Points

- Lockhart expects **GDP growth** the rest of this year and over the next couple of years in the range of 3 percent to 4 percent annually. He also anticipates a continuing gradual decline in **unemployment** to a base level that is a bit higher than prerecession levels. **Inflation**, in his view, will converge over the next two years to the Fed's de facto inflation objective of 2 percent or a bit less.
- Lockhart believes that the **real estate sector will lag an otherwise improving economy**. In his opinion, further deterioration in the residential real estate sector is a **key risk to economic recovery**. According to Lockhart, the commercial real estate (CRE) market remains weak, but there are hopeful signs it is stabilizing. The weakness in the CRE market should not present as much risk to the outlook as the single-family residential sector does.
- Lockhart believes that slowness in the **housing sector is an important headwind** that is impeding the pace of economic recovery. In his baseline forecast, residential construction will contribute only modestly at best to economic growth this year and next.



Thank you for asking me to speak here today. The name of your organization conveys that all of you care about economic growth in our community and, I'm sure, beyond. The organization's name adds a qualifier, "quality." This qualifier acknowledges that you recognize that growth—whether at the local, regional, or national level—can be more or less grounded in sound fundamentals, more or less sustainable, and more or less broad based and good for everyone.

So, what is the quality of the economic recovery that has been under way nationally now for more than seven quarters?

To answer that I will review the current state of the national economy and outlook. And I will comment on the key drags and risks that could throw the economy off track.

A sober assessment of the situation must give some attention to two areas of economic activity that are very important to metropolitan Atlanta. They are housing and commercial real estate. Neither is in the best of health at the moment.

So, a second question: can we have quality growth—a good and sustainable recovery—while these two sectors suffer? I will try to answer that question as well.

As usual, I am expressing my own views, which may not be shared by my colleagues on the Federal Open Market Committee (FOMC) or the Federal Reserve System.

### The economy and outlook

Over the last seven quarters, economic growth as measured by real (that is, inflation-adjusted) gross domestic product (GDP) has averaged 2.8 percent per quarter at an annual rate. In normal times such a modest pace would be quite acceptable. But given the depth of the recession and a loss of 8 million jobs, this recovery has thus far been too slow to substantially reduce unemployment.

The cadence of the recovery has been halting. The second half of 2009 was quite strong followed by a softer, but still strong, first quarter of 2010. Then the economy decelerated markedly in the second and third quarters of 2010 only to come back a bit stronger in the final quarter of last year. Following a relatively robust end to 2010, however, the preliminary numbers for the first quarter of 2011 showed somewhat disappointing GDP growth of 1.8 percent.

Ups and downs in quarterly growth are, in fact, normal. In the current recovery, the U.S. economy has been buffeted by a number of significant shocks. Last year there was the scare of the European sovereign debt crisis. This year there's been the run-up of commodity prices, particularly oil prices translating to higher gasoline prices at the pump. The economy has shown resilience in absorbing such shocks, but they have at times held back the pace of the recovery.

Despite the relatively weak start to this year, private sector spending appears to have been reasonably solid in the first quarter. Real personal consumption expenditures grew at a 2.7 percent annualized rate, even as gasoline prices jumped. Business investment in equipment and software expanded by 12 percent, actually accelerating compared to the fourth quarter. Exports of goods also posted quite healthy gains. Anecdotal input from many of our business contacts in the Southeast also suggests the economy was stronger than the GDP number suggests.

Last Friday's job report showed an encouraging increase in payrolls in April as well as upward revisions to the previous two months. Employment growth of the magnitude we have seen so far this year is encouraging but will still only slowly bring down unemployment in the near term. As I look ahead, I expect that the rate of job creation will evidence continuous progress in reducing joblessness.

I expect GDP growth the rest of this year and over the next couple of years in the range of 3 percent to 4 percent annually. As I noted earlier, this is a relatively modest rate of growth given the depth of the recession and still high level of unemployment.

Why the relatively modest pace of the recovery? Economic history shows that recoveries after a financial crisis tend to be quite slow. A financial crisis damages the credit circuitry of the economy, and repair simply takes time. Financial rebalancing results in a healthier economy in the long term but acts as a drag on economic expansion in the short term.

I also expect a continuing gradual decline of unemployment to a base level that is a bit higher than prerecession levels. At the gradual pace I'm expecting, it could take up to three years to get employment back to prerecession levels.

Let me turn to inflation. Higher food and energy prices have pushed up headline consumer inflation. The increase in inflation this year appears to reflect pressures that were largely the result of growing global demand and some supply-side or geopolitical shocks. The inflationary impact of some supply shocks is likely to be temporary. In fact, prices of several commodities have either leveled off or declined recently.

The latest run-up in the prices of commodities has been a drag on the economy. Consumers and businesses have had to devote a larger share of their budgets to food and gasoline, reducing spending on other goods and services.

It's the Federal Reserve's responsibility to ensure that short-run increases in the rate of headline consumer inflation do not turn into a persistent inflationary trend over the medium and longer term. Confidence in the Fed's ability to deliver on this responsibility is closely tied to the inflation expectations of households, businesses, and investors. At the moment, longer-term measures of inflation expectations are reasonably stable. I anticipate that over the next two years inflation will converge to the Fed's de facto inflation objective of 2 percent or a bit less.

This fairly optimistic outlook—continued expansion with moderate inflation—is subject to several downside risks. Key risks include, for example, a further spike in oil prices and intensified fiscal stresses both here and in Europe.

Another key risk is a further deterioration in the real estate sector. Given the importance of this sector to the U.S. economy and the Atlanta region, I would like to devote my remaining time to developments in residential and commercial real estate.

### **Residential real estate**

The residential real estate market remains depressed. In my baseline forecast, the housing sector will contribute only modestly at best to economic growth this year and next.

The housing sector impacts economic growth in two basic ways—one direct and one indirect. The direct effect primarily comes through the construction of new homes and production of building materials and household products. Indirectly, the housing sector contributes to growth through its effect on household balance sheets, which can influence consumer spending. Another indirect effect relates to banks' balance sheets and the health of the financial system.

To assess how direct and indirect effects will play out, let me provide some perspective on the state of the residential sector.

Home sales have not shown any clear trend of improvement since the end of the recession, except for a short pick-up during the period of the federal tax credit last year. From the peak five years ago, sales of existing homes are down nearly 50 percent and are close to the 1998 level. New home sales have fallen almost 80 percent from the peak and are at levels not seen since these data were first collected in the early 1960s.

Why such weak sales? There are several explanations. Tougher underwriting standards have shrunk the pool of potential homebuyers. Entry-level homebuyers, who typically have the weakest credit histories, continue to experience the most difficulty in obtaining mortgage financing. And anecdotal information suggests this could be a longer-term issue. At the same time, many potential move-up buyers are blocked because they're either underwater in their current mortgage or don't have enough equity to meet the down payment requirements for a new mortgage. The real estate analytics firm CoreLogic estimates that about 23 percent of residential mortgages are underwater.

On the supply side, existing home inventory levels remain elevated, in part due to the great number of distressed properties on the market. These include bank-owned properties and properties where the loan is in default or the property is in the process of foreclosure.

According to the firm Lender Processing Services, as of March, 3.7 percent of mortgages were in foreclosure and 7 percent of homeowners weren't current on their loans. Delinquencies have been declining since early 2010 but remain high. Defaults and foreclosures are likely to remain elevated for some time.

In contrast to the supply of existing homes, the inventory of new homes is near a historical low due to the sharp reduction in new housing construction since the downturn began. This reduction in construction is clearly evident in Atlanta. High unemployment and a large decline in migration to the region have severely affected demand for new homes here.

Because of the factors I've discussed, I do not expect significant new residential construction nationally. Thus, it's unlikely that residential real estate will directly contribute much to GDP growth this year or next.

I mentioned earlier that the housing sector also has indirect impacts on the economy. In particular, the direction of home prices is important for the economy because changes in home prices affect the health of both household and bank balance sheets.

S&P/Case-Shiller data show that home prices are down more than 30 percent from their peak. While prices appeared to stabilize in 2009 and 2010, today prices appear to be under renewed pressure from the increasing supply of distressed properties that are selling at a deep discount.

Based on CoreLogic calculations, price discounts on distressed properties rose from an average of 26 percent in 2008 to 37 percent by the end of last year. In addition, the percentage of distressed sales in the market, according to CoreLogic, reached a high of 28 percent at the end of 2010. Some estimates are even higher.

Declines in home prices have also created problems for banks. As home prices continue to drop, banks further mark down the balance sheet valuation of their assets. Smaller banks, whose lending was disproportionately concentrated in real estate, are likely to be affected the most, which can impair capacity to lend.

Some economic forecasters in the Blue Chip survey are more optimistic than I am. Among these forecasters, there's about a half a percentage point difference between the more optimistic and the less optimistic as regards 2012 GDP growth. One source of the difference is their relative views of how soft the direct impact of the housing sector will be. The indirect influence of the housing sector on consumer activity and bank lending would almost certainly aggravate housing's impact on growth. As I said, my forecast for residential construction puts me among the less optimistic.

### **Commercial real estate**

Let me now briefly discuss the situation in the commercial real estate sector. Commercial real estate (CRE) encompasses property types such as office, retail, hotel, and warehouse as well as multifamily residential.

The downturn in commercial real estate lagged the single-family housing market and the broader economy in the recent recession. While home prices peaked in 2006, commercial real estate prices rose until early 2008. They then declined more rapidly and by a larger magnitude than did single-family home prices. The price index published by Moody's with the firm Real Commercial Property is now down about 45 percent from its peak.

The weakness of the CRE sector exerts a drag on the broader economy primarily through lower construction activity. But an indirect effect is felt through the banking channel. In particular and similar to the residential sector, the concentration of troubled commercial property loans in the banking system, especially in smaller banks, can impede lending.

There are hopeful signs that the CRE market is stabilizing. Improvement, however, has been uneven across property classes and submarkets. The multifamily (including apartments) sector has fared better than others—not surprising given the reduction in home ownership. By contrast, the retail segment has not recovered.

The Atlanta CRE market has been very slow to improve. Similar to national trends, apartment occupancy rates have risen but are still well below national levels. Weak job creation and employment growth are constraining demand for office space. Atlanta office vacancy rates remained above 20 percent in the first quarter, according to CB Richard Ellis.

Overall, slow employment growth appears to be the primary factor limiting demand for commercial space. But the weakness in the CRE market, in my view, does not present as much risk to the outlook as the single-family residential sector does.

### **A high-quality recovery?**

In closing I want to circle back to the questions I posed at the outset. First, what is the quality of the recovery? At the beginning of my remarks, I hinted at a definition of quality for the purpose of venturing an answer to this question. A high-quality recovery, in my mind, has sound underpinnings in the sense that economic fundamentals are improving as expansion proceeds. Said differently, a high-quality recovery is one where major imbalances are being alleviated and economic resilience is accumulating. A high-quality recovery is sustainable, durable, and broad based. With such a recovery, the rate of unemployment should be shrinking materially.

By this definition, I would argue the current recovery is demonstrating clear evidence of improving quality. The recovery has been sustained now for over 22 months. Employment is now growing at a meaningful pace. There is evidence of improved economic performance across a variety of sectors—manufacturing, exports, business investment, and many components of the service economy. The savings rate is higher, and both households and business firms are deleveraging. Large corporations are cash rich, and their outlook is increasingly positive. The banking system is mending and better positioned to provide credit, the lifeblood of the economy.

Very importantly, the country's fiscal imbalances are now on the radar screens of public officials. I think hope is justifiably rising that the nation will come to grips with our unsustainable fiscal situation.

Overall, I think the case can be made that the recovery under way is meeting some of the tests of quality. I understand, however, that it doesn't feel that way to all of us. The recovery is a work in process.

The second question was: can we have high-quality growth while the residential real estate and commercial real estate sectors continue to be so weak? Not completely, in my opinion. The recovery will progress, but it will not be robust until we work through the economy's serious imbalances, including those in the real estate sector.

As I look ahead, I think the most reasonable assumption is that improvement of the real estate sector will lag an otherwise improving economy. But I am encouraged by the fact that the economy is increasingly on firmer footing.

**Contact:** [Jean Tate](#) 404-498-8035

**RELATED LINKS:** [PDF version](#) • [Dennis Lockhart's biography](#) • [Speaker's Bureau](#) • [Atlanta Fed Speeches](#)