Speeches

Adjusting to the Next Stage of the Housing Cycle

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It's nice to be invited back here. I last spoke to your group in April 2001, and at that time I focused my remarks on the sudden decline in economic growth we were seeing, a slowdown that turned out to be our last recession. Now, five years later, we're moving into the fourth year of an economic expansion. As policymakers and business and community leaders, we're all continuing to try to evaluate the economic forces that are currently at work and what they may suggest for both the local and national economies as well as for monetary policy over the period ahead.

My guess is you're looking for me to offer my view of the U.S. economic outlook and how monetary policy might be expected to respond. Over the next few minutes, I will take some time to provide you with my thoughts on those issues. But I also want to devote part of my remarks to housing, which has been an important driver of economic activity during and after the last recession. I know many of you in this room have a stake in the housing business, and the subject is especially important and fascinating to many of us here in the Atlanta area, where we've seen so much population growth and new home construction.

Recent economic experience
Housing, of course, depends very much on underlying economic and demographic fundamentals. So let me begin by providing you with a look at the current economic climate. Some of us may fondly remember the 1990s, a decade that brought us the longest economic expansion in U.S. history. Between 1993 and 2000, the U.S. economy created an average of nearly 3 million jobs per year. And our broadest measure of economic activity, gross domestic product (GDP), grew at an annual rate of more than 3½ percent during that seven-year period.

Since the economic downturn in 2001, we've been through terrorist attacks, two wars, and rising energy prices. Yet, even with these and other economic shocks, it's easy to overlook that our recent economic performance compares well to the late 1990s. Since 2003, we've had average GDP growth of about 3¾ percent, and our expansion is getting support from almost all economic sectors. Since job growth turned positive in late 2003, the U.S. economy has added nearly 5 million jobs.

Over the past three years, consumer spending has been very strong. Business profits have grown on average 16 percent per year, and spending on equipment and software has averaged about 11 percent. Government spending also has contributed to growth. I don't want to spend time today discussing our nation's federal deficit, but the long-term outlook for government spending is, in my view, worrisome. Finally, residential investment between 2003 and 2005 was exceptionally strong.

But even as I think good growth will likely continue, I think it's also reasonable to expect adjustments in some sectors. In the first quarter of this year, you'll recall we had GDP growth of almost 5½ percent. After our May 10, 2006, Federal Open Market Committee (FOMC) meeting, we issued a statement that anticipated "growth as likely to moderate to a more sustainable pace." Personally, I agree with that consensus outlook, and I think the new data suggests we are beginning to see the expected moderation.

Part of this moderation in growth is coming from some easing in the extraordinary pace of home construction, sales, and price appreciation—a development we've been expecting for some time. Don't get me wrong. I do not expect a sharp residential real estate correction, but I believe we should recognize that a slowdown in housing activity is very likely—and may have begun already.

Factors behind the housing boom
We're fortunate to live in a country with a housing stock that offers great selection and affordability. The rate of homeownership in this country has climbed toward 70 percent—near-record levels. For most of us, our home is our most valuable asset. In a certain sense, housing is part of our economic DNA.

As I suggested a moment ago, the demand for housing depends on underlying demographic trends and the overall economic climate. For the past 15 years, the sale of new homes has climbed steadily. Since 2000, residential investment increased at an average annualized quarterly growth rate of 5½ percent and increased slightly even during the 2001 recession.

Clearly, a major contributor to increased housing activity in recent years has been the low cost of mortgage credit, which is influenced by the fed funds target rate. From 2002 to 2004, the Fed kept short-term interest rates very low, at or just above 1 percent. But even after the FOMC began raising short-term rates two years ago, mortgage rates stayed low and are still less than 7 percent, which by historical standards is relatively low.

In addition to the attractiveness of interest rates, the financial services industry in the past decade has introduced a wide range of new mortgage options with the potential to increase buying power. For instance, we've seen the emergence of high loan-to-value mortgages, subprime mortgages, interest-only mortgages, pay-option mortgages, and most recently 40-year and even 50-year mortgages. These so-called affordability products allow borrowers to qualify for a first home or a more expensive home they couldn't have otherwise purchased.

Demographics also have played a big role in the patterns of recent home purchases. Recently, the oldest of some 70 million baby boomers began to reach retirement age—a trend that's no doubt boosted the demand for second homes. The market for vacation homes on the waterfront has been especially active. To illustrate the dimensions of the second-home phenomenon, in 2000 about 7 to 8 percent of mortgage-financed home purchases were not owner-occupied. In 2004, the percent of non-owner-occupied homes purchased and financed (including investment and vacation homes) had more than doubled to almost 16 percent of all home sales.

Included in the non-owner-occupied homes data I just gave you are a large number of investment purchases, as many investors who left the stock market after its adjustment a few years ago turned to real estate as a vehicle for greater appreciation. I suspect some of you in this room have bought condos or vacation properties strictly as investments, counting on strong price appreciation to provide you the opportunity to “flip” the properties for a nice gain. For many seasoned and novice investors alike, that approach for the past few years has been profitable.

Nationally, home prices appreciated 13 percent in 2005, and that strong performance followed a similar rate of growth in 2004. Going back a bit further, national home price appreciation from 2000 to 2003 each year averaged about 7½ percent, better than in the 1990s. By most any measure—price appreciation, home sales, construction, you name it—2005 was a great year for housing.

Implications of an adjustment in housing

So, now that we’re in the fifth year of a housing boom, can we expect this extraordinary performance to continue? In my view, probably not. And I say that because what we’ve been experiencing was driven by a confluence of the special circumstances that I described earlier.

Along with somewhat higher mortgage rates, the inventory of unsold new single-family homes has increased steadily to nearly six months at current sales rates. Recently, I’ve heard reports of investors dumping properties for which they had contracted but not yet closed, especially in some coastal markets that were so attractive for many years. And I’ve heard more stories of potential buyers “waiting out” sellers because they believe prices are likely to keep falling. All of these developments have contributed to a slowing of house price appreciation—depending of course on the location.

In my 42 years at the Fed, I’ve seen a few real estate cycles, and I’m sure others here remember some of those ups and downs in the housing market. Having lived through those times, I can point to some concerns that I believe warrant attention.

For instance, the mortgage credit innovations that have made homes more affordable to buyers, at least, in the short run, have not been fully tested in a period of rising interest rates and a moderating economy. I suspect—based on what I’ve heard from anecdotal reports—that lenders and borrowers have not always asked all the “what if” questions that are basic to risk management. It’s quite likely that some borrowers will have a hard time handling their payments in different circumstances. To underscore these concerns, the banking regulators, including the Fed, has circulated “Interagency Guidance on Nontraditional Mortgage Products” to remind bank lenders of these risks.

And there are the housing speculators. It’s probably fair to assume that many of those speculators include high-wealth individuals who can afford the risk of potential price adjustment. But other less sophisticated investors may get stuck with properties they can’t sell for a decent profit or even have to unload at a loss. Those investors who may never have intended to close on their purchases may have to walk away from deposits for properties in developments that only a few months ago appeared to be “nearly sold out.” In hindsight, some speculators may wish they had paid closer heed to some pretty obvious warning signs such as the emergence of Web sites designed strictly for “condo flippers.”

Finally, and in some ways most basically, there’s the still unanswered question of how developers, builders, and lenders will respond to an adjustment in housing activity—if, in fact, that’s what is under way. I remember a longtime Fed policymaker—a veteran observer of housing cycles—used to describe the housing industry as a big group of independent thinkers. Regardless of the warning signs, he observed that each developer, builder, or lender would decide there’s room enough for one more project—his or her project, of course. At the same time, dozens of others in the same business in the same markets were making the same decisions. I tell this story not because I feel qualified to offer advice on how to run a residential development business but rather as commentary on how our market economy works.

I don’t pretend for one minute to be able to judge the condition of your individual housing markets—nor do I know what special factors will influence future housing activity in each area. Instead, I’m closely watching the larger housing market across our region and nation with the goal of understanding how developments in the residential business shape the larger economy and Fed policy.

And let me say that on a macro level I believe the housing adjustment most likely will be orderly and with a limited impact on the overall economy. I say this for a number of reasons. For one thing, depository institutions in the United States are well capitalized and hence well positioned to absorb any housing lending losses they may incur. Also, it’s worth mentioning recent changes with respect to capital markets and mortgage finance. More and more of the credit- and interest-rate-related risks associated with mortgage finance can be easily traded and have gravitated to those institutions best positioned to manage the risks. Today more than half of the nation’s $9 trillion in mortgage debt outstanding is securitized.

It’s also true that many jobs depend on home-related construction and mortgage businesses, and important industries in our regional economy such as durable goods and carpet production also rely on housing construction. But even if there were no growth in housing construction, the level is high enough now to support strong ongoing demand for home products and related goods. Furthermore, consumers will continue to remodel existing homes and replace worn-out appliances and furniture. Looking at the broader context of our diverse and dynamic economy, direct residential investment is only about 6 percent of GDP.

Finally, a slowdown in house price appreciation could affect consumer spending. For example, higher interest rates have deterred refinancing and extraction of home equity for other spending. For several years during the era of low interest rates, cash-strapped consumers used their homes like ATMs. But, as home price escalation slows, consumers can be expected to feel less confident about gains in wealth and may well begin to feel inclined to save more and spend less. These indirect effects of a housing slowdown are embedded in my forecast of some slowing in the growth of consumer spending.

Evaluating monetary policy

With that digression on the housing business, let me return to my own beat—monetary policy. I was trained as industrial engineer, and I spent some of my early years working to develop banking technology. That was a pretty straightforward business where you could often use formulas to get very specific answers to key questions. But with monetary policy making, I find that answers are more often in shades of gray instead of black and white. When it comes to monetary policy, uncertainty and forecast “error bands” are a fact of our business.

Congress has given the Fed a so-called dual mandate—to use monetary policy to help achieve sustainable growth but also to help achieve price stability, another term for low and steady inflation. As policymakers, we make our best forecast of growth and inflation over the coming quarters, then choose a fed funds setting that we think is most likely to nudge the economy in the desired direction, with the realization that our policy actions impact the economy with a lag. As my earlier discussion would suggest, we are shooting at a moving target as various new developments affect the economy in different ways.

I have already talked about some factors—including a housing adjustment—that are likely to contribute to the moderation in the rate of growth we expect. I have not yet talked about the outlook for our second objective: inflation. There are many factors at any time that work either to hold down price pressures or add to the inflation risks we've noted in recent FOMC statements.

Headline measures of inflation of late have been bothersome, with higher oil prices contributing to much of the run-up in those broad readings. Core inflation, which excludes volatile food and energy costs, has moved into the upper end of—or beyond—the range I consider acceptable over time. Global competitive forces and good U.S. productivity growth should help to ease further upward movement in inflation, and we may get some relief from stabilizing or possibly falling energy prices over time.

Still, I view current inflation risks to be elevated for three reasons. First, we have been expecting and have not yet seen secondary pass-through of energy prices to core inflation. Secondly, some key components of core inflation such as services have been moving at rates that warrant continued concern. Finally, some measures of inflation expectations recently have edged upward.

If we're on target with our present forecast for growth to moderate to a sustainable pace and for inflation to fall back within acceptable bounds, I would say that monetary policy is now close to where it should be. But, as I have already suggested, the FOMC's job is to continue to update that outlook as we get new data and anecdotal information. So we have to remain open to rethinking our policy setting as that outlook changes. One of the challenges of this process is interpreting new data and distinguishing between transitory factors—or, in other words, "noise"—and the more significant underlying trends.

On June 28, I will be among the 19 members of the FOMC, including Fed Chairman Ben Bernanke, who will gather around the table in Washington to consider what we've learned since our last FOMC meeting. During our discussions, we take account of the analysis by our respective teams of professional economists, and we will exchange anecdotal information gathered from business and community contacts around the country. After taking account of new information and adjusting our forecasts if that is called for, we will vote on how to set our fed funds target rate to match that updated outlook.

Putting it all together

In summary, I have tried to paint a picture of an economy that has performed quite well over the last four years, and one that I expect will continue to grow while moderating to a more sustainable pace. And I have tried to get you to think with me about the particular contribution of housing to recent economic growth, and the adjustment that may be taking place as this economic expansion continues.

During the past five years since I last spoke here, our economy has been tested on numerous occasions. No one can predict the surprises the next five years will bring. But we should remember that our economy had demonstrated amazing resilience. Today—even with the inevitable adjustments we face—the economy is on a solid footing, and the Fed remains committed to its mission to foster an economic climate where inflation and inflation expectations are low and stable.

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