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The Outlook for the Economy and Real Estate[1]

Thank you very much Sheila. It's a great pleasure to see you again and to join all of you this morning. I want to express my appreciation to Sheila for her excellent service as a member and as deputy chair of the San Francisco Federal Reserve Bank's board of directors from 1999 to 2004. I am very pleased to have the chance to speak to a group of professionals dedicated to advancing the understanding of land economics. As you know, problems in real estate were central to the financial crisis and ongoing developments in this sector bear importantly on the economy's prospects for recovery. So my comments will focus on the economic outlook and I will emphasize the role of real estate in shaping it.

Throughout my remarks, I will compare the situation in the nation as a whole with that here in Phoenix. I'm always struck when I visit Phoenix by the beauty of your natural setting and the great vitality of the city that has grown in this magnificent place. Phoenix demonstrates a spirit of entrepreneurship, a sense of optimism about the future, and an eagerness to build something new. But, as the housing market collapsed and the nation fell into financial crisis and recession, your desert metropolis was set back on its heels. Just as you grew faster than the nation as a whole during the boom years in the middle of the decade, so did you fall harder when the bust came. I can only imagine what it's like for those who've been blessed with one of the

[1] I would like to thank Fred Furlong, John Judd, David Wright, and Sam Zuckerman for assistance in preparing these remarks.

nation's most vibrant economies to suffer a setback of this magnitude. I'm pleased to say that I think you will find much in my message this morning that is encouraging.

This is the first talk I've given since the economy has officially been reported to be growing again. The economy's return to growth after a year and a half of recession marks a major turn and it looks like more than a flash in the pan. It seems to me that the economy has entered a sustained period of expansion. We've seen meaningful upturns in areas as diverse as housing, consumer spending, industrial production, and foreign trade. And, a number of factors bode well for the future, including a better functioning financial system, low mortgage interest rates, a resurgent stock market, a stabilization of house prices, and stronger growth abroad.

All the same, I am not going to paint an entirely rosy picture for you. The strength and durability of the expansion is in question. Some of the rebound is due to temporary government programs and a swing in inventory investment that will not provide an ongoing source of growth. Financial conditions have improved markedly in some respects, but many financial institutions are still hobbled with bad loans. The outlook for consumer spending is in doubt because households remain burdened with debt, and they have taken enormous hits to their wealth from declines in house and stock prices in recent years. And it's particularly sobering that labor markets continue to deteriorate badly, leaving many millions of our fellow Americans unable to find jobs. Just last week, we found out that the unemployment rate passed 10 percent in October. The 10.2 percent jobless rate is the highest since 1983. Today I will consider this mixed picture in some detail and focus on two subjects of professional interest to many of you—the residential and commercial real estate markets. I want to stress that my comments are my own and do not necessarily reflect the views of my Federal Reserve colleagues.

As we look at the national economy, it's important to keep things in perspective. It's not fun to ponder a subdued recovery. But a year ago, after the near collapse of the global financial system, there was a real possibility of an outright depression. Fortunately, we avoided that. But what we did suffer through was bad enough—the worst downturn since the Great Depression of the 1930s. The recession began at the end of 2007. Economic output has dropped by just over 3½ percent. Over seven million jobs have been lost in the nonfarm sector of the economy. And the unemployment rate has soared by over five percentage points. Few, if any, parts of the economy were unscathed. The labor market was devastated, and housing, consumer spending, business investment, exports, and imports all fell off the table.

Phoenix was particularly hard-hit. In May 2007, the area unemployment rate was an extraordinarily low 2.9 percent. By September 2009, the rate had roughly tripled to 8.5 percent. That's lower than the national rate, but it's a huge 5.6 percentage point swing. Construction represented a higher-than-average share of the Arizona economy, and the drag from real estate over the past two years has been especially severe in the state.

Against this backdrop, the nation's third-quarter return to growth was a great relief. Real gross domestic product—which is the economy's total output of goods and services—increased at a solid annual rate of 3½ percent. The recession hasn't officially been declared over, but a wide array of data suggests that the corner has been turned. In the third quarter, residential investment—which was at the center of the downturn—rose at nearly a 25 percent annual rate, albeit from a very low level. Home sales, prices, and housing starts are once again climbing. Meanwhile, manufacturing is also beginning to show signs of strength. This was helped by a rebound in motor vehicle production, boosted by the government's temporary cash-for-clunkers

program. Our exports surged as growth abroad picked up. And, importantly, consumer spending finally is growing.

To me, the explanation for this turnaround is clear: Massive and concerted responses by governments and central banks around the world rescued the financial system, brought down interest rates, provided emergency support, and broke the economy's downward spiral. On the monetary policy side, the Fed has pushed its traditional interest rate lever—the federal funds rate—close to zero. And, in order to provide additional stimulus, we put in place an array of unconventional programs to spur the flow of credit to households and businesses. These measures provided funding to banks and restored liquidity to a range of markets. We've increased the flow of credit for securities backed by small business loans, consumer loans, and other assets. Our large-scale purchases of Fannie Mae and Freddie Mac debt and mortgage-backed securities (MBS) helped lower mortgage rates and bolstered the housing market. We've also bought longer-term U.S. Treasury debt to help bring private borrowing rates down.

These initiatives appear to have eased financial conditions. Clearly, the financial system is not yet back to normal, but it has bounced back notably. The stock market has soared since its low in the winter. That rally has helped households recover some of their lost wealth and provided a much-needed psychological boost. Investors perceive that economic risks are not as dire as they once seemed to be. Interest rates on corporate bonds—especially for less-than-prime firms—have dropped sharply and issuance has been brisk. And the markets that financial institutions and corporations rely on for short-term funding are functioning reasonably well again, due in part to Fed intervention.

Federal government policies also have contributed, including the fiscal stimulus program passed by Congress in February. Tax cuts have raised disposable income and government spending is directly adding to payrolls. Much of the stimulus money authorized by Congress remains to be spent and will spur growth in coming quarters. Other government initiatives contributed to the third-quarter expansion as well, including the cash-for-clunkers program and the $8,000 tax credit for first-time homebuyers.

The normal dynamics of the business cycle have also turned more favorable. Demand for houses, durable goods such as autos, and business equipment is beginning to revive as households and businesses replace or upgrade needed equipment and structures. A particularly hopeful sign is that inventories of unsold goods, which have been shrinking rapidly, now seem to be in better alignment with sales. Manufacturers had slashed production dramatically in the face of slumping sales. Recent data suggest that this correction may be near an end, setting the stage for more production.

The big issue is how strong the upturn will be. With such enormous reservoirs of slack in the form of high unemployment and idle productive capacity, we need a strong rebound to put unemployed people back to work and get underutilized factories, offices, and stores humming again. Unfortunately, my own forecast envisions a less-than-robust recovery for several reasons. As the impetus from government programs and inventories diminishes in the quarters ahead, private final demand will have to fill the breach. The danger is that demand may grow at too anemic a pace to support vigorous expansion.

First, it may take quite a while for financial institutions to heal to the point that normal credit flows are restored. The credit crunch hasn’t entirely gone away. In the face of massive

loan losses, banks have clamped down on underwriting and credit terms for both businesses and consumers. Smaller businesses without direct access to capital markets are particularly feeling the pinch. Lenders have had to run hard just to stay in place: Rising unemployment, business failures, and delinquencies in real estate markets have fed additional credit losses and made it more difficult for financial institutions to get their balance sheets in good order.

Second, households have been pummeled and prospects for consumer spending are cloudy. Consumers have surprised us in the past with their free-spending ways and it's not out of the question that they will do so again. But I wouldn't count on them leading a strong recovery. They face high and rising unemployment, stagnant wages, and heavy debt burdens. Their nest eggs have shrunk dramatically as house and stock prices have fallen, and their access to credit has been squeezed.

It may be that we are witnessing the start of a new era for consumers following the harsh financial blows they have endured.[2] We often hear the word "deleveraging" used to describe the push by financial institutions to scale back debt and build equity. Households too have now begun to pay down debt and rebuild their savings. This phenomenon can be seen not only in the United States, but in most countries that experienced similar housing booms. The United States was hardly the only country where households borrowed heavily just before a severe housing bust set in. And those countries with greater increases in debt relative to income before the crisis experienced greater declines in consumption spending once the crisis began.

In the United States, the personal saving rate, which had fallen to an incredibly low 1 percent in early 2008, has averaged 4 percent so far this year and may well rise higher. In the

[2] See Glick and Lansing (2009).

current environment, such belt-tightening makes great sense from the standpoint of individual households. In fact, some households may have no other option because their access to credit has been crimped. Over the long run, higher saving is surely a good thing for our economy because it provides capital that can be devoted to modern infrastructure, technology, and other productive investments that enhance our standard of living. All the same, the transition to a higher saving plane could be painful if it reduces the growth rate of consumer spending for an extended period.

Weakness in the labor market is another factor that may keep the recovery sluggish for quite some time. Payroll employment has been plummeting for more than a year and a half, and, even though the pace of the decline has slowed, unemployment now stands at its highest level since 1983. In addition, many workers have seen their hours cut or are experiencing involuntary furloughs. To bolster earnings in the face of weak revenue growth, employers have been aggressive in cutting labor costs and jobs, and my business contacts say they will be reluctant to hire again until they see clear evidence of a sustained recovery. Weak demand for workers is also putting a lid on paychecks. Wages are barely rising. A well-known measure of overall employment costs rose by only 1¼ percent over the past year, the smallest increase in the history of the series. High unemployment, weak job growth, and paltry wage increases are a recipe for sluggish consumer spending growth and a tepid recovery.

The U.S. experienced so-called jobless recoveries following the previous two recessions in 1991 and 2001, when job creation remained weak for several years following the business cycle trough. In both cases, output growth was less robust than in the typical recovery and, unfortunately, things seem to be shaping up similarly this time around.

Now I'd like to take a close look at real estate markets, both residential and commercial. You may be getting weary of my "on-the-one-hand, on-the-other-hand" message, but I'm afraid I have more of that to offer when it comes to housing. To put it bluntly, the outlook for the residential market is uncertain. And uncertain is much better than the prospects for commercial real estate, which clearly are weak.

Let me begin with housing. We have gone through many boom-and-bust cycles, but none in the past half century have had such far-reaching effects as the wild ride of residential real estate during this decade. House prices soared from 2002 through 2005, moving dramatically out of line with fundamentals. By one measure, house prices on average peaked more than 50 percent above the level that could be supported by underlying rental values. Since the market top three years ago, the nation has experienced roughly a 30 percent collapse in average house prices, depending on the index used. That's a terrible plunge, but there's some good news in it for the future: Prices are approaching a range where valuations are more in line with fundamentals. Such an adjustment is essential for a sustained revival of housing activity.

Indeed, there are indications that the sickening market plunge has ended, with prices beginning to edge up. At the same time, home sale volumes are advancing briskly. The supply of new houses on the market has been brought down from over 12 months to about 7½ months. That's still well above the four-month supply that was typical in the period right before the bust, but the adjustment seems to have been enough to kick some life back into construction. In the third quarter, real residential investment surged, though from an admittedly low level. For the first time in more than three years, housing construction actually added to GDP growth.

What I've said about the national housing market can be seen in even sharper relief here in Arizona, and especially in the Phoenix area. The metropolitan area's residential boom-and-bust cycle was considerably more pronounced than that of the nation as a whole. Gains in house prices were simply spectacular. Fast population and job growth following the 2001 recession explains part of the story. However, the truly exceptional price jumps in 2004 and 2005, just before the collapse, look to be outsized even given the strong demographic and labor trends. Subprime loans represented an especially high proportion of mortgage lending in the region. Not surprisingly, the house price collapse in this area has been especially severe. Price declines are as high as 50 percent or more, about 1½ times that of the nation, bringing values back to 2001 levels.

Fortunately, things are beginning to look up in Arizona as they are for the nation. Existing home sales are up sharply in recent months, although a large share of those are foreclosed properties. In the Phoenix area, home prices are now above their lows. A widely watched forecasting survey predicts that 2009 will be the trough for housing permits in Phoenix and that 2010 will see significant increases.[3]

Still, the Phoenix housing market is nowhere near a return to health. In the face of high and rising unemployment, mortgage delinquency and foreclosure rates are still increasing in the area. The share of mortgage loans in foreclosure or 60 days or more past due is nearly three times the national median. And this is by no means largely a subprime problem. Prime borrowers now account for the lion's share of new foreclosures.

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[3] Blue Chip Economic Forecast Phoenix, Arizona State University, Third Quarter 2009. http://wpcarey.asu.edu/bluechip/phoenix/index.cfm

Meanwhile, developers and their creditors have been caught with excess raw land, lots that are partially completed, or completed but still vacant. Values for finished but vacant lots across the country are reported to be off about 50 percent from their peak, with some hard-hit regions in the West down even more. Over the past year and a half, developers and their bankers have been working through this inventory and recognizing the associated losses. As write-offs on these loans flow through community and regional banks, we can expect more failures.

Turning back to the national picture, the bottom line is that the outlook for housing has turned up in response to favorable mortgage rates, lower house prices, and a lower overhang of unsold houses. And growth in this sector should contribute to the overall economic recovery. These developments represent real gains, but it's important not to get carried away. Some of the advance reflects temporary government support in the form of tax credits for first-time home buyers, and the impact of loan modification programs and foreclosure moratoriums that reduced the pace of distressed sales. Moreover, foreclosure notices surged earlier this year and distressed property sales may rise once again in the months ahead. If so, we could see renewed pressure on house prices. Of course, continuing high unemployment will also fuel additional foreclosures. And the supply of credit for nonconforming mortgages remains extremely tight. Financial institutions are reluctant to place them on their books when they are trying to reduce leverage and we have yet to see any revival of the market for private mortgage-backed securities.

When we turn to commercial real estate, the prospects are worrisome. Commercial property didn't turn down until well after housing did. The sector's problems appear to stem in large part from the effects of the recession and the credit crunch, rather than the type of building boom and lax underwriting standards that tripped up housing. Still, there are some parallels between the two sectors. As in the residential market, commercial real estate values posted

enormous price gains, with office values roughly doubling from the end of the 2001 recession to the peak. Since then, values have plunged an estimated 35 to 40 percent and vacancy rates are rising for office, retail, warehouse, and other income-producing properties. In Arizona, office vacancy rates started moving up in the second part of 2006 as job growth decelerated abruptly from an exceptionally fast pace. Vacancies in Phoenix are near 25 percent, about a 13 percentage point rise from the recent low.

As I indicated, credit market conditions are weighing heavily on this sector. Risk premiums on commercial real estate financing remain elevated, although they're down a bit from the peak of the financial crisis. Average commercial real estate capitalization rates have seen risk spreads more than double over the past two years to more than 4 percentage points over 10-year Treasury securities. The market for commercial mortgage-backed securities (CMBS) remains deeply distressed and issuance is meager despite support from the Fed's Term Asset-Backed Securities Loan Facility (TALF) and the Treasury's Public-Private Investment Program (PPIP). Banks and thrifts, which account for more than half of commercial real estate financing, have significantly raised rates and tightened credit terms. That, combined with higher investor demands for returns and weakening operating income, points to further downward pressure on property values.

Commercial real estate borrowers are increasingly hard-pressed to stay current on their loans. CMBS delinquency rates rose from about half a percent in August 2008 to over 3 percent this July. Weakening loan quality is particularly damaging in Arizona where commercial real estate accounts for a much larger share of the average bank loan portfolio than in the nation. A large volume of commercial real estate loans and securities are coming up for renewal over the next several years. This will prompt lenders and investors to review terms for continued

extension of credit. In many instances, banks are asking borrowers to either repay loans, provide more equity, or agree to modified terms and conditions. These adverse trends recently prompted federal regulators to issue guidance on commercial real estate to banks and thrifts, with a focus on sound practices for loan workouts.

Nationwide, the commercial real estate downturn has been a drag on economic growth, subtracting about 1 percent at an annual rate over the first three quarters of this year, compared with a roughly neutral effect in 2008. All indications are that commercial real estate will continue weighing down the recovery going forward.

When the weakness of the commercial property market is combined with the muted outlook for housing and consumer spending, you can see why I believe that the overall economic recovery is likely to be gradual and remain vulnerable to shocks. It's popular to pick a letter of the alphabet to describe the likely course of the economy. The letter I would choose doesn't exist in our alphabet, but if I were to describe it, it would look something like an "L" with a gradual upward tilt of the base. With such a slow rebound, unemployment could well stay high for several years to come. In other words, our recovery is likely to feel like something well short of good times.

This brings me to inflation, a topic that has been hotly debated.[4] Some people worry about the long-term inflationary implications of sustained federal budget deficits. Others fear that economic slack and downward wage pressure are pushing inflation below rates that are consistent with price stability. I am in the second camp. Persistent large budget deficits may be harmful once the economy recovers because they are apt to boost interest rates and absorb

[4] See Leduc, Rudebusch and Weidner (2009).

private savings that would otherwise finance productive investments. But experience teaches us that budget deficits do not cause inflation in advanced economies with independent central banks that pursue appropriate monetary policies.[5] As for the Fed, you can be 100 percent certain that price stability will remain our objective, regardless of the stance of fiscal policy.

I believe that the more significant threat to price stability over the next several years stems from enormous slack in the economy that is pushing inflation lower. Today, inflation is already very low. Over the past 12 months, consumer prices as measured by the personal consumption price index actually fell by one-half percent. After removing the effects of volatile food and energy prices, core prices rose by 1¼ percent. That’s below the 2 percent rate that I and most of my fellow Fed policymakers on the Federal Open Market Committee (FOMC) consider an appropriate long-term price stability objective. The public’s inflation expectations, which can independently influence inflation, remain well anchored, which is appropriate given the Fed’s record and its commitment to price stability. And with slack likely to persist for years and wages barely rising, it seems probable that core inflation will move even lower over the next few years.

This landscape presents clear challenges for monetary policy. We face an economy with substantial slack, prospects for only moderate growth, and low and declining inflation. With the federal funds rate already at zero for all practical purposes, the Fed’s traditional policy tool is as accommodative as it can be. To provide more stimulus, the Fed has used unconventional policy tools, including emergency lending programs to promote liquidity and push longer-term interest rates lower. However, many of these programs are winding down or nearing completion. That

[5] See Fischer, Sahay, and Vegh (2002) and Catao and Terrones (2005) for analysis of the relationship between deficits and inflation in the post-World War II period.

is why the FOMC stated that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period" following our meeting last week.

At some point, of course, we will have to tighten policy—and we certainly have the means and the will to do so. We are—and always will be—steadfast in our determination to achieve both of our statutory goals of full employment and price stability. Until that time comes though, we need to provide the monetary accommodation necessary to spur job creation and prevent inflation from falling any further below rates that are consistent with price stability. Thank you very much.

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