Perspectives on Housing and the Economic Outlook

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Good afternoon. It is a pleasure to be in Santa Fe. In my remarks today, I want to provide my perspective on the national economy and monetary policy in the period ahead.

As you know, over the past few months, problems in U.S. housing markets have intensified and have caused severe stress in financial markets in the United States and abroad. These events have led to timely actions by the Federal Reserve and other central banks to provide stability to financial markets. In particular, to help ensure that these developments do not spill over to the broader economy, the Federal Open Market Committee (FOMC) lowered its target for the federal funds rate by 50 basis points on Sept. 18 and then again by 25 basis pints on Oct. 31, bringing the federal funds rate target down to 4.5 percent.

Since housing represents the largest risk to short-term economic growth, I will devote most of my time this evening to a discussion of the magnitude of the problems in housing, some of the causal factors behind the housing slump, and how the problems in housing are likely to affect the economic and monetary policy outlook over the next few quarters. I will then close with some brief comments on the economic outlook and monetary policy in the period ahead.

Dimensions of the Housing Slump

Let me begin by looking at the magnitude of the housing slowdown and its impact on the overall economy. Over the past year and a half, we have seen the largest contraction in U.S. housing markets since the early 1990s. Sales of new and existing homes have declined by 45 percent and 30 percent, respectively, from their peaks in 2005. Single family housing starts, which represent new construction, have fallen by 46 percent. And, as sales and construction have fallen, we have seen inventories of unsold new and existing homes rise dramatically, putting downward pressure on prices. Indeed, as measured by the Case-Shiller index of repeat home sales, home prices are falling nationally for the first time since the early 1990s.

When we look at the impacts of this housing slump on the overall economy, it is important to keep some things in mind. First, the direct effects of housing occur mainly through the value of new housing construction and sales commissions on new and existing homes. In addition, when home sales decline, consumers may also cut back purchases of other household items, such as furniture and appliances. On the other hand, in these circumstances some existing homeowners may remodel or improve their house, which tends to boost spending.

In contrast, changes in house prices do not have direct effects on economic activity because they represent capital gains or losses not associated with current productive activity. However, house price changes can have an indirect effect on economic activity to the extent that they affect consumers' wealth. While not as powerful as changes in households' earned income, these wealth effects are not insignificant. Indeed, economists now estimate that the wealth effects from house price changes may be as large as, or even larger than, the wealth effects from stock price changes.

With these points in mind, we see that the housing slump has had a significant effect on real GDP growth. Over the past six quarters, we have seen double-digit percentage declines in residential construction expenditures, which measures the direct effects of housing on GDP. Even though residential construction expenditures represent only about 6 percent of overall economic activity, the magnitude of the decline has been enough to reduce real GDP growth by a full percentage point – a large effect indeed. The indirect effects of the housing slowdown are more difficult to measure but have likely reduced other consumer spending by a somewhat smaller amount. As a result, over the past six quarters, GDP growth has averaged about 2.25 percent, considerably below estimates of potential growth of around 2.75 percent.

While the housing slowdown has contributed to slower economic growth, I believe it is important to recognize how strength in other parts of the economy has supported economic activity. In the past, housing slumps similar in magnitude to the current episode have often been associated with a recession. While growth has slowed recently, we have not come close to a recession because solid consumer spending, government spending and a boom in exports have more than offset the housing weakness. In fact, while employment growth has softened somewhat over the last year, we have seen only a small increase in the unemployment rate. Moreover, we have seen improvement in core inflation from the elevated levels of last year.

Understanding Recent Events in Housing and Financial Markets

Over the past few months, however, a new dimension has been added to the housing problem. A number of nonbank mortgage lenders have experienced difficulties, and some have gone out of business as new mortgage originations have declined and as default rates on existing mortgages have risen. Financial markets in the United States and abroad have been disrupted by investor fears that further defaults may lie ahead and that they may be more exposed to these problems than they thought. As the disruptions in mortgage markets have spread to other financial markets, the Federal Reserve and other central banks have responded to these pressures by providing additional liquidity through the Discount Window and through open market operations.

Since these recent developments are so important to the economic outlook, I would like to take a few minutes to discuss what's behind them and also place them in historical context.

From a longer-term perspective, it is important to recognize that the recent problems in housing are coming at the end of a very long-lasting and unprecedented boom in housing. Beginning in the late 1990s, we saw a significant increase in new housing construction, along with rising homeownership rates, and several years of double-digit house price increases in many parts of the country.

Some of this prior boom in housing has been attributed to speculative activity, spurred by the low interest rates and easy availability of credit in the early part of this decade. Not surprisingly, this activity has largely ceased with rising credit costs and falling house prices. However, in my opinion, the rise and fall of speculative activity is not the main story behind recent events.

The bigger part of the story is the tremendous changes we have seen in the structure of housing finance over the past two decades. We have gone from a system of housing finance centered around depository institutions, savings and loans, and banks, to a new system of market-based finance in which private investors, here and abroad, provide the financing for housing. We have also seen significant changes in the structure of mortgage contracts, which have altered the risk profile of these contracts significantly.

One key change in the structure of housing finance is the development of securitization, in which individual home mortgages are packaged together and used as collateral for a type of bond called a mortgage-backed security (MBS). These bonds are purchased by investors such as pension and mutual funds both in the United States and abroad.

In the past, mortgages were typically originated, financed and serviced by local depository institutions. With securitization, the financing can come from investors anywhere in the world. In addition, securitization has facilitated the entrance of new institutions into the housing markets that are largely unregulated because they do not fit into the existing regulatory and supervisory structure for depository institutions.

In terms of the mortgage contract itself, two important developments stand out. The first is the growth in the use of adjustable-rate loans. Adjustable-rate loans have become popular because they usually have lower payments and so may be more affordable than fixed-rate loans. However, they also place the risk of interest rate and payments changes on the borrower rather than the lender.

The second development in the mortgage contract is the use of risk-based pricing, that is, mortgage rates based on the household's credit rating. This change has allowed many households who could not previously qualify for a so-called "conventional" loan to obtain a mortgage loan. This change has fostered the rapid growth in subprime lending over the past several years.

If we combine these two developments, we can go a long way toward an understanding of the housing slump and why it spread to financial markets around the world. Let's start with subprime loans. In the last several years, their growth has accelerated, totaling an estimated 20 percent of mortgage originations in 2005-2006.

Many were made as adjustable-rate loans, and some had features, such as low "teaser" rates and negative amortization, to make them more affordable.

When these loans experienced their first rate reset, the borrowers experienced a large rate increase and much higher monthly payments. The problem was exacerbated by the rise in short-term interest rates as the Federal Reserve tightened policy from 2004 to 2006. Indeed, over the past year, the delinquency rates on subprime loans have increased considerably. As of 2007 Q2, delinquency rates on adjustable-rate subprime loans rose to more than 16 percent compared to 4 percent on prime adjustable-rate loans and only about 2 percent on prime fixed-rate loans.

But why, you might ask, did these rising delinquency rates have so large an impact on financial markets around the world? Like conventional mortgage loans, many subprime loans have been securitized in recent years. As the default rates on these loans rose, investors holding securities backed by these loans sold these securities, driving down their prices and imposing capital losses on remaining holders. More generally, investors withdrew from securities not backed by Freddie Mac or Fannie Mae guarantees. With the growth of international capital markets in recent years, many of these securities have been purchased by financial institutions and private investors abroad, including in Canada, Europe and Asia. Consequently, the effects of these disruptions in U.S. mortgage markets have spread to financial markets around the world.

Furthermore, some nonbank mortgage lenders funded their holdings of mortgages and mortgage-backed securities by issuing asset-backed commercial paper. As the mortgage market turmoil increased, these institutions found it impossible to get investors to purchase their commercial paper. These institutions then turned to banks for short-term loans, which then funded these loans in short-term money markets. As bank funding pressures increased, the Federal Reserve and other central banks temporarily provided additional reserves to meet these needs and keep money markets operating.

With these central bank actions, and especially following the Federal Reserve's decision to lower its federal funds rate target on Sept. 18, markets have improved somewhat. However, financial market functioning has not returned to normal even with the FOMC's decision to lower its funds rate target again on Oct. 31st. The market for conventional mortgage loans, in particular, has been functioning well, with rates on these loans moving down slightly in recent weeks. In contrast, the markets for nonconventional loans, subprime and jumbo loans, continue to experience difficulty. Moreover, since many subprime loans made in late 2005 and 2006 have not yet experienced their first rate reset, subprime delinquencies are expected to rise into next year.

Implications for the Economic Outlook and Monetary Policy

These recent events in housing markets and financial markets have led many forecasters to lower their estimates of economic growth over the next few quarters. Some commentators have suggested that a recession is much more likely, perhaps inevitable. In my remaining time, I would like to offer my own perspectives on the economic outlook and monetary policy in the period ahead. I stress that they are my own views and do not represent those of the FOMC or the Federal Reserve System.

Realistically, there are a number of avenues by which housing and financial market stress could lead to a further reduction in growth. First, as bad as the housing slump has been, it could get worse. Second, the recent difficulties in financial markets could lead to a more general tightening of credit conditions that could reduce consumer or business borrowing. Third, the housing and financial market difficulties could lead to reduced business and consumer confidence, leading to lower spending.

While I take these possibilities very seriously, my own view is that the economy should weather this storm. I do expect somewhat slower growth over the next two to three quarters coming mainly from continuing weakness in housing and somewhat tighter credit conditions. I think the effects of the financial market disruptions are unlikely to spread very far, however, in part because of the timely actions of the Federal Reserve and other central banks in meeting liquidity pressures.

Financial market conditions have improved, but they are not yet back to normal. For example, while commercial paper outstanding has generally stopped declining, volumes have not returned to preturmoil levels and currently equal their April 2006 levels. Also, while commercial paper and corporate spreads have declined from their peaks, they also are not back to preturmoil levels. In addition, the improvement has been subject to short-term reversals. For example, over the last few weeks we have seen some pullback as markets adjust to surprising news from some financial institutions. This should not be surprising in a market economy that is trying to find and then move to a new set of equilibrium prices.

Finally, as to monetary policy in the period ahead, the FOMC sets monetary policy in order to achieve its dual objective of maximum sustainable employment and stable prices.

The Federal Reserve’s easing of monetary policy, along with the recent declines in the dollar, should support growth in the near term. The FOMC has reduced its federal funds rate target by a cumulative 75 basis points over the last two months. In addition to supporting growth, the easing of policy can be viewed as an insurance policy against some of the possible adverse effects from financial stress. And, as I noted earlier, growth in U.S. exports has been a source of strength during the housing slump. The recent decline in the dollar should provide even more impetus to export growth over the next few quarters.

However, the Federal Reserve must also be vigilant about the longer-term inflation outlook. As we have learned the hard way over the last quarter-century, low and stable inflation is essential for maximum sustainable employment. In this regard, recent data on core inflation continues to be favorable, and I expect overall inflation next year will moderate as the effects of higher food and energy prices wear off and energy prices themselves level off.

Despite these recent favorable trends, though, upside risks to inflation remain. Greater dollar depreciation and higher energy and commodity prices, along with a greater pass-through from all three, could push inflation higher for a period of time. In addition, we have seen a gradual up-creep in some measures of longer-term inflation expectations.

In looking to the future, the Federal Reserve must be mindful of both objectives: conducting policy to ensure maximum sustainable employment without putting its objective of stable prices in jeopardy. Policy will need to respond to the evolution of the economy in terms of both growth and inflation. At this time, I believe the risks on both sides of this policy decision are elevated, and we need to wait, watch and be ready to act depending on how events develop.

That concludes my prepared remarks, and I would be happy to address your questions.