Frederic S Mishkin: Outlook and risks for the US economy

Speech by Mr Frederic S Mishkin, Member of the Board of Governors of the US Federal Reserve System, at the National Association for Business Economics Washington Policy Conference, Washington DC, 4 March 2008.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

* * *

Thank you for the invitation to be here today. I am very pleased to be a part of this conference. The National Association for Business Economics policy conferences always focus on the critical issues facing the economy, and this conference follows in that tradition. In my remarks today I will review the current economic situation and the outlook for real activity and inflation. I will offer some specific observations about the recent deterioration in economic activity, highlight several risks facing the economy, and review recent inflation dynamics. I should note that the views I will express here are my own and not necessarily those of my colleagues on the Federal Open Market Committee (FOMC).[1]

The U.S. economy is facing substantial challenges. The housing sector continues to weaken, production and spending in other parts of the economy have decelerated, the labor market has softened noticeably, and the turmoil in financial markets has led to a reduced availability and a higher cost of credit to many households and businesses. Indeed, real gross domestic product (GDP) rose at an annual rate of only 0.6 percent in the fourth quarter, and the available data suggest that the economy has relatively little momentum going into the first quarter. Moreover, upward pressures on inflation have emerged, emanating in part from the rapid increases in prices of crude oil and some other commodities.

The strains in financial markets that emerged last summer were triggered by problems in the markets for subprime mortgages and related securities. As the financial landscape became more uncertain, a broader tightening of credit conditions took hold, with investors becoming less willing to bear risk, more concerned about the valuations of a wide range of complex financial instruments, and more concerned about counterparty credit risk. Reflecting these concerns, the functioning of the short-term credit markets deteriorated dramatically, corporate bond spreads rose, and the market value of leveraged loans and other securities fell. In addition, banks were forced to bring onto their balance sheets a significant volume of loans and other securities, and in the second half of 2007, banks took large write-downs on mortgage-related and other assets. In recent months, short-term credit markets have functioned better than in the summer but have remained strained, risk spreads on corporate bonds have risen markedly further on concerns about the near-term outlook for corporate credit quality, and equity prices have weakened considerably. Moreover, substantial uncertainty remains about the magnitude and distribution of credit losses going forward and the extent to which those losses will lead to tighter credit conditions.

To help place these developments into perspective, I would note that the turmoil in financial markets emerged at a time when the economy was otherwise in pretty good shape. Real GDP growth held up reasonably well through the summer – despite the ongoing declines in home building – and balance sheets of nonfinancial corporations remained strong. In addition, the financial system entered last summer with some strengths. Most large financial institutions had strong balance sheets and solid earnings, as delinquencies and charge-off rates on most types of loans were at low levels. At the same time, the financial market infrastructure for clearing and settlement was robust and, subsequently, performed well.

[1] I wish to thank Charles Fleischman and Dan Sichel for their helpful comments and assistance on this speech.

Moreover, as I have discussed in earlier speeches, I believe that monetary policy has helped to effectively anchor long-run inflation expectations, which in turn helped to restrain core consumer price inflation in spite of energy and other supply shocks.

In an environment of well-anchored inflation expectations, the FOMC had the scope to respond aggressively to the strains in financial markets that emerged late last summer and to the worsening economic outlook. Indeed, since September, the FOMC has cut the federal funds rate five times, for a total of 225 basis points. In addition, the Federal Reserve has taken a number of other steps to ease strains in short-term funding markets. These policy actions, along with the recently enacted fiscal stimulus package, should support economic activity and should improve the odds of avoiding more adverse outcomes.

The most recent economic projections made by Federal Reserve Board members and Reserve Bank presidents – released a couple of weeks ago but submitted around the time of the late January FOMC meeting – show sluggish economic growth this year but not a downturn in activity. The data on consumer and business spending released since the last FOMC meeting have been largely consistent with this outlook. Nonetheless, as I will discuss shortly, I see significant downside risks to this outlook. These risks have been brought into particularly sharp relief by recent readings from a number of household and business surveys that have had a distinctly downbeat cast.

The outlook for real activity

Turning to some specifics, the ongoing correction in the housing market has been a substantial drag on real GDP growth over the past two years, with declines in real residential investment subtracting about 1 percentage point from the growth of real GDP last year. This weakness intensified in the second half of 2007 with the dramatic decrease in the availability of mortgage credit for nonprime borrowers and with a widening of spreads on jumbo loans. In addition, the Federal Reserve's latest Senior Loan Officer Opinion Survey on Bank Lending Practices indicates that a large fraction of reporting banks have tightened lending standards on all types of residential mortgages. By January 2008, sales of existing single-family homes had fallen to more than 30 percent below their peak in September 2005, while sales of new homes in January were more than 50 percent below their peak in July 2005.

The cutbacks in new home construction that have come in response to the weakening of demand have been substantial, but they have yet to reduce the overhang of inventories of unsold new homes. As of January, the months' supply of new homes for sale – that is, the ratio of unsold inventory to sales – was more than twice its average level from 1997 through the summer of 2005. Given that sizable backlog and the subdued level of demand, cutbacks in housing construction seem likely to continue being a drag on economic activity for some time to come.

House prices decelerated appreciably as sales began to fall, and prices are now declining in many areas of the country. Given the continued weakness in housing demand, house prices appear likely to remain under pressure. Moreover, as I will describe in a few minutes, falling house prices may not only reflect declining demand for homes but also can contribute to a further weakening in demand.

In the consumer sector, real outlays held up reasonably well for most of 2007. But spending growth slowed noticeably toward the end of the year, and the most recent readings on real consumer purchases point to a soft first quarter. More broadly, consumers are being squeezed from several directions. Very soft house prices and a weak stock market have reduced household wealth. Slowing labor demand and the steep increases in the price of imported oil have damped real income gains. And banks report that they have tightened the terms and standards for consumer loans. In this environment, consumer sentiment has been weak; it began eroding last summer and plummeted in February. Together, these factors are likely to restrain spending growth in the period ahead. This restraint should be offset somewhat beginning in the late spring, when many households will start to receive the tax rebates that are the centerpiece of the recent fiscal stimulus package.

Business investment in equipment and software also decelerated toward the end of last year, and a number of factors appear likely to weigh on spending in the near term. Indicators of business sentiment from a variety of national and regional surveys have deteriorated, on balance, in recent months. Moreover, spreads on corporate bonds across a wide range of credit qualities have been moving up, especially for riskier firms, and an increasing number of banks report that they are tightening lending standards for business loans. All told, real spending on equipment and software seems likely to be subdued in the near term. It is anticipated that investment spending should receive some help in the second half of this year from the accelerated depreciation provisions in the fiscal stimulus bill; however, based on experience with a similar tax provision in 2002 and 2003, the magnitude and timing of these effects is very uncertain.

Investment in nonresidential structures continued to grow robustly through the end of last year, with most major components contributing to the strong gains. However, prospects for the coming year are less buoyant given the tightening credit conditions as well as the slowdown in economic activity more broadly.

Turning now to international trade, export growth has been a bright spot for the U.S. economy, boosted by past declines in the exchange value of the dollar and solid economic growth abroad. Indeed, rising demand for U.S. exports has offset some of the negative effects on producers here in the United States from the deterioration in domestic spending. Although foreign economies also have been affected by financial turmoil, and growth among our trading partners is showing some signs of slowing, expanding exports should continue to help support economic activity in the United States.

In the labor market, private payrolls decelerated over the course of 2007 and were reported to have been unchanged in January. The unemployment rate, after remaining near 4-1/2 percent in the first half of last year, has moved up about 1/2 percentage point to nearly 5 percent, its highest level since late 2005. And the labor market appears to have softened further in February. Initial claims for unemployment insurance, which can be a timely indicator of labor market activity, moved up appreciably in February. Moreover, recent surveys of hiring plans have become less favorable, and households' assessments of current job availability and of expected labor market conditions have deteriorated. With the pace of economic activity expected to be sluggish in the near term, I anticipate some further rise in joblessness this year.

Risks to the outlook for real activity

For the reasons cited, I continue to expect a period of economic weakness in the near term that should be offset to a degree in future quarters by the monetary easing already in place and the fiscal stimulus package. Nonetheless, the economy faces significant downside risks that could contribute to a worse outcome. Key among those risks is a worse-than-expected outcome in the housing market as a result of more adverse housing-price dynamics.[2] In particular, declines in housing prices, rather than stimulating demand, could further depress home purchases, at least for a time.

An often-expressed idea is that buyers are reluctant to buy into a falling market. This notion can be made more precise by organizing ideas around the standard neoclassical model of capital investment. In this framework, the so-called user cost of capital is an important determinant of the demand for any investment good – including housing. When the user cost

---

2 This material draws heavily from the paper I delivered at last summer’s Jackson Hole conference (see Mishkin, 2007b).

of housing rises, the demand for housing will decline, everything else being equal. The user cost will increase when, among other things, the purchase price of housing rises relative to the prices of other goods and services or mortgage interest rates move up.

In addition to these factors, Case and Shiller (2003) have emphasized that changes in expected house prices can play an important role in the demand for housing through the user-cost channel. When relative house prices are expected to increase, the user cost is reduced, stimulating the demand for housing. This factor presumably contributed to the robust demand for housing during the period when house prices were rising rapidly and were expected to continue doing so. Conversely, when relative house prices are expected to decline, the user cost is higher. Indeed, a drop of 1 percentage point in the expected rate of change in real house prices, all else being equal, is equivalent in the user-cost framework to an increase of 100 basis points in the after-tax mortgage interest rate. Consequently, if house prices fall more than expected, and that condition leads to more adverse expectations for future changes in house prices, then housing demand could fall as a result.

A second risk to the economy is that larger-than-expected declines in house prices would be expected to lead to a larger-than-expected drag on consumer spending through the usual wealth-effect channel, as a lower path of household net worth restrains consumption. Moreover, during periods of financial distress, the effects of falling house prices on consumer spending could be greater than that suggested by conventional estimates of the wealth effect. Because prospective borrowers typically have more information about their ability to repay the loan than do lenders, homeownership can play a role in reducing the problems of asymmetric information in consumer credit markets by providing collateral that reduces those information problems. Good collateral increases the borrower's incentive to repay the loan and significantly reduces potential losses to the lender upon borrower default. Consequently, a decline in house prices will reduce the value of the collateral backing mortgage loans, thereby increasing the problems of asymmetric information and potentially decreasing the access of households to credit.

The same idea is expressed another way in a paper by Ben Bernanke and Mark Gertler (1995), who suggested that a decline in house prices can increase the wedge between the default-free interest rate and the effective interest rate facing the homeowner. That is, in the eyes of the lenders, declining house prices diminish the quality of the borrowers' collateral, which effectively reduces the availability of credit to households that can be used to finance consumer purchases. This effect is another reason to be concerned about the possible consequences of greater-than-expected house price declines. And, to my view, the credit-constraint channel provides a more credible link between house prices and consumer spending than does mortgage-equity withdrawal, a story about which I have previously expressed serious doubts (Mishkin, 2007b).

Another significant risk to the outlook is that lending standards could tighten more than expected not only for mortgages but for other types of credit as well. As I have noted, the January 2008 Senior Loan Officer Opinion Survey highlighted the fact that many banks are tightening lending standards and terms in a number of credit markets. At the same time, capital at some banks has come under pressure, as institutions have been forced to bring some loans and other securities back onto their own balance sheets. Because this process is still unfolding, it poses a risk that credit standards for households and businesses could tighten more than expected and significantly crimp spending.

Finally, I would note the possibility of a feedback loop between financial market disruptions and deterioration in the real economy that I have emphasized in previous speeches (Mishkin, 2008a, 2008b). Because economic downturns typically result in even greater uncertainty about asset values, such episodes may trigger an adverse feedback loop whereby financial disruptions cause investment and consumer spending to decline, which, in turn, causes economic activity to contract. Such a contraction then increases uncertainty about the value of assets, and, as a result, the financial disruption worsens. This development then causes economic activity to contract further in a perverse cycle.

Inflation and inflation dynamics

Let me turn now to inflation and inflation dynamics. Over the twelve months ended in January, the price index for total personal consumption expenditures (PCE) rose 3.7 percent, up from 2.1 percent during the comparable period twelve months earlier. Recently, headline inflation has been pushed higher by sizable increases in food and energy prices; crude oil prices have surged, and food prices have risen significantly, reflecting strong global demand in general as well as hefty demand in particular for corn for use in ethanol production.

Even excluding food and energy, recent readings on inflation also have been elevated, although over the past year core PCE prices decelerated a touch from 2.4 percent to 2.2 percent. The recent observations on core inflation suggest that higher energy costs and the lower exchange value of the dollar may have been sources of upward pressure on core inflation. However, the recent bump up in inflation also likely reflected a reversal of unusually low readings earlier last year for apparel, prescription drugs, and so-called nonmarket items in the index, and the contribution of these items to core inflation is likely to wane.

In my view, long-run inflation dynamics are influenced importantly both by prospects for the future balance of aggregate supply and demand, as well as by longer-run inflation expectations (Mishkin, 2007a). By a range of measures, longer-run inflation expectations appear to have remained reasonably well contained even as recent readings on headline inflation have been elevated. The median expectation of inflation five to ten years ahead in the Reuters/University of Michigan survey stands in the middle of the range that has been evident over the past couple of years, although the expectation for year-ahead inflation from this same survey has moved up recently, presumably in response to the higher rates of actual inflation. In addition, although the measure of long-run expectations for consumer price index (CPI) inflation from the Survey of Professional Forecasters ticked up in February, this measure remained at essentially the same value that has prevailed since 1998.

As for inflation compensation derived from spreads between yields on nominal and inflation-indexed Treasury securities (known as Treasury Inflation-Protected Securities, or TIPS), the implied rate of inflation compensation from five years ahead to ten years ahead (the so-called five-to-ten-year-forward rate) has risen somewhat since the beginning of the year. Does this rise in forward inflation compensation indicate that long-run inflation expectations have risen by a similar amount? My best guess is that much of the rise in inflation compensation reflects other factors.

To begin, recall that inflation compensation measured by using TIPS yields is not the same thing as inflation expectations. Rather, movements in inflation compensation reflect not only changes in inflation expectations, but also changes in an inflation risk premium and in the relative liquidity of TIPS and similar maturity nominal Treasuries.[3] To see that these components are distinct, recall that during the period of heightened concerns about *deflation* in 2003 and 2004, forward inflation compensation rose substantially to an unusually *high* level amid concerns about an unwelcome *fall* in inflation; that earlier episode, in particular, underscores the fact that we must be careful in using the forward rates of inflation compensation as a gauge of long-run inflation expectations. To see this distinction another way, consider a scenario in which inflation uncertainty increased but inflation expectations

---

[3] For additional background, see Gürkaynak, Sack, and Wright (2008). They discuss the decomposition of inflation compensation into these distinct components and argue that far-forward rates of inflation compensation are too volatile to be pure measures of long-run inflation expectations.

did not. In that case, the midpoint of inflation expectations would remain the same, but the range around the midpoint would increase.

Turning specifically to the recent experience, consider the sequence of one-year-forward rates of inflation compensation – that is, decompose ten-year inflation compensation into a sequence of one-year-forward rates. The one-year-forward rate ending about five years from now has moved up, but the forward rate ending in ten years has climbed more than twice as much. This pattern suggests an important role for factors other than rising long-run inflation expectations in explaining recent movements in inflation compensation as one might suppose that any tendency toward higher inflation would be expected to show through within five years. And survey measures of long-run inflation expectations – including that from the Survey of Professional Forecasters – have moved relatively little. But respondents to the latest Survey of Professional Forecasters indicated that they were more uncertain about the future trajectory of inflation. Altogether, the evidence points toward the inflation risk premium as the likely cause of much of the rise in five-to-ten-year-ahead inflation compensation. Although a distinctly different concept from inflation expectations, policymakers need to be concerned about any widening of inflation uncertainty. Indeed, an increase in inflation uncertainty would likely complicate decision making by consumers and businesses concerning plans for spending, savings, and investment.

What does this mean for the inflation outlook? I expect inflation pressures to wane over the next few years, as product and labor markets soften and the rise in food and energy prices abates. In addition, I continue to believe that long-run inflation expectations remain consistent with increases in PCE prices in the neighborhood of 2 percent per year.[4] Accordingly, I anticipate that over time core PCE inflation will move back to around 2 percent. The risks around this outlook appear to me to be balanced, although the uncertainty surrounding the outlook may have widened recently, consistent with the apparent rise in the inflation risk premium. The risks associated with higher oil and commodity prices are a concern as is the possibility that past cost shocks may have a more pronounced effect on core inflation than has been apparent to date. Working in the opposite direction, with the risks to the real economy and resource utilization skewed to the downside, there are accompanying risks that inflation may be subject to some additional downward pressure. Regardless of how these risks play out, a commitment to a strong nominal anchor will be crucial to the success of monetary policy. Any tendency for longer-run inflation expectations to become unanchored would pose a significant problem for monetary policy makers, and the FOMC will be closely monitoring inflation and inflation expectations in coming months.

To summarize, with the economic outlook having deteriorated significantly and financial markets under considerable stress, the FOMC will face significant challenges. As noted in the statement following the January meeting, the FOMC "will continue to assess the effects of financial and other developments on economic prospects and will act in a timely manner as needed" to address risks facing the economy (FOMC, 2008). The FOMC's critical challenge will be to calibrate monetary policy in a way that best achieves its dual objectives of maximum employment and price stability.

Thank you for your time and attention. It has been a pleasure to be with you today.

[4] As I described in an earlier speech (Mishkin, 2007a), this figure is sensitive to a variety of assumptions, so one should not overstate its precision. Note that expectations for CPI inflation must be adjusted to convert them from a CPI basis to a PCE basis.

References

Bernanke, Ben S., and Mark Gertler (1995). "Inside the Black Box: The Credit Channel of Monetary Policy Transmission", *Journal of Economic Perspectives*, vol. 9 (Autumn), pp. 27-48.

Case, Karl E., and Robert J. Shiller (2003). "Is There a Bubble in the Housing Market?" *Brookings Papers on Economic Activity*, vol. 2003 (no. 2), pp. 299-362.

Federal Open Market Committee (2008). "FOMC Statement and Board Approval of Discount Rate Requests of the Federal Reserve Banks of Boston, New York, Philadelphia, Cleveland, Atlanta, Chicago, St. Louis, Kansas City, and San Francisco", press release, January 30.

Gürkaynak, Refet S., Brian Sack, and Jonathan H. Wright (2008). "The TIPS Yield Curve and Inflation Compensation", Finance and Economics Discussion Series 2008-05. Washington: Board of Governors of the Federal Reserve System, February.

Mishkin, Frederic S. (2007a). "Inflation Dynamics", speech delivered at the Annual Macro Conference, Federal Reserve Bank of San Francisco, San Francisco, March 23.

Mishkin, Frederic S. (2007b). "Housing and the Monetary Transmission Mechanism", Finance and Economics Discussion Series 2007-40. Washington: Board of Governors of the Federal Reserve System, August.

Mishkin, Frederic S. (2008a). "Monetary Policy Flexibility, Risk Management, and Financial Disruptions", speech delivered at the Federal Reserve Bank of New York, New York, January 11.

Mishkin, Frederic S. (2008b). "The Federal Reserve's Tools for Responding to Financial Disruptions", speech delivered at the Tuck Global Capital Markets Conference, Tuck School of Business, Dartmouth College, Hanover, N.H., February 15.