# Randall S Kroszner: Outlook and risks for the US economy

Remarks by Mr Randall S Kroszner, Member of the Board of Governors of the US Federal Reserve System, at the Institute of International Finance 2007 Spring Membership Meeting, Athens, Greece, 1 June 2007.

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Thank you for inviting me to participate in this conference and offer my views on prospects for the U.S. economy. I should note that the opinions I will express today are my own and not necessarily those of my colleagues on the Federal Open Market Committee.

After increasing at about a 3-1/2 percent annual rate from early 2003 to early 2006, the pace of economic expansion in the United States stepped down last spring, with real gross domestic product rising since then at about a 2 percent pace. Yesterday, the Department of Commerce announced that real GDP increased at an annual rate of 0.6 percent in the first quarter, a downward revision of its earlier estimate. Activity was held down in the first quarter, in part, by several factors that seem likely to prove transitory – for example, a drop in exports, a significant reduction in inventory investment, and a decline in defense spending. My view and, it seems, the view of many private forecasters is that economic growth will pick up as we move through the year, with the rate of expansion close to potential by 2008.

In recent quarters, weakness in the housing market has been the major source of the slowdown in the growth of real GDP. Indeed, declines in real residential investment held down the growth of output nearly 1-1/4 percentage points in the second half of last year and another 1 percentage point in the first quarter of this year. After an extended boom in housing, the demand for homes began to weaken in mid-2005. By the middle of 2006, sales of both new and existing homes had fallen considerably from their peak levels. Homebuilders responded to the drop in demand by sharply curtailing construction. Even so, the inventory of unsold homes rose dramatically. Sales of new homes weakened further in the first part of this year, and the inventory of unsold homes continued to rise.

The latest data for the housing market have been mixed. Sales of single-family existing homes fell 2-1/2 percent in April to a level 5 percent below the rate posted in the second half of last year. In the market for new homes, however, sales jumped in April, which brought them back in line with the average rate posted in the second half of 2006. The inventory of unsold new homes also improved a bit in April. Nonetheless, the supply of unsold homes is still quite high by historical norms, and further production adjustments by homebuilders seem likely, thereby suggesting that the drag on economic activity from the housing correction will continue in coming quarters.

Another area of softness has been business spending for new equipment, which slowed toward the end of last year and remained anemic in the first quarter of 2007. Part of the slowing reflected weaknesses in the construction industry, and also in the motor vehicle industry. While high-tech has been a bright spot, the demand in other industries generally was tepid. Still, incoming data support prospects for an improvement in investment. Orders and shipments of nondefense capital goods excluding aircraft rose in April for a second month. In addition, business sentiment – as measured, for example, by the Institute for Supply Management survey of purchasing managers – has moved higher lately. More generally, sound business financial conditions – solid balance sheets, high profits, and relatively low interest rates and credit spreads – also should support stronger investment going forward.

Let me turn now to the consumer sector. Until the early part of this year, continuing increases in employment and income helped personal consumption expenditures provide a source of strength for overall growth. More recently, consumption growth has slowed, in part because of the effects of higher oil prices on real income. Looking forward, consumer spending should be supported by the likelihood of further gains in employment. Private nonfarm payroll employment increased 63,000 in April, and the latest data on initial claims for unemployment insurance as well several other labor market indicators point to additional advances in hiring.

On the international trade front, recent readings on economic activity abroad have been quite positive. Moreover, many of the forward-looking indicators of activity suggest that prospects for further economic expansion in Europe and Japan appear good in the near term. Despite indications of moderation in some emerging-market economies, the overall pace of activity in these countries, including China, appears to be strong. These factors suggest that the demand for U.S. exports of goods and services will continue to be solid.

I will now turn from aggregate demand to aggregate supply and inflation. One important influence on aggregate supply and inflation is the trend growth rate of labor productivity. From 1995 to 2000, productivity in the nonfarm business sector increased at an average annual rate of 2-1/2 percent. It then accelerated to a rate of about 3 percent during the first half of this decade despite a recession, the fall of the dot-com market, a broad stock market correction, terrorism, and corporate governance scandals. However, in the early part of 2006, productivity growth slowed markedly, and it has increased at less than a 1 percent rate over the past four quarters.

The recent deceleration raises the possibility that the trend has slowed significantly. If the trend has slowed, that could have important implications for the conduct of monetary policy. But the deceleration also could reflect, at least in part, cyclical dynamics in response to a slowing economy. Indeed, estimates of trend productivity from a variety of outside forecasters, which generally range from 2 percent to 2-3/4 percent, point to the possibility that much of the recent weakness will prove transitory. Of course, the middle of this range would suggest a modest slowdown from the consensus estimate from a year or so ago, which was around 2-1/2 percent. In any event, the possibility of a slowing in trend productivity is a risk to the outlook that I will continue to monitor.

Another potential influence on inflation is the degree of pressure on resources.[1] In the labor market, the unemployment rate declined over the course of 2006 from about 5 percent to 4-1/2 percent, and so far this year it has remained close to that level. Reflecting the tightening of the labor market as well as the pressure on top-line inflation from increases in energy prices in recent years, the rate of increase in hourly compensation, although volatile, appears to be moving up. But the markup of prices over unit labor costs is still high by longer-run standards, and the wide margin implies that firms have the capacity to absorb increases in unit labor costs, at least for a while.

As for price inflation, over the twelve months ending in April, the consumer price index excluding food and energy was up 2.3 percent, the same increase as in the preceding twelve months. Inflation as measured by the price index for personal consumption expenditures excluding food and energy rose 2.1 percent over the twelve months ending in March (the latest available data). The most recent consensus forecast for total CPI inflation (on a fourth-quarter to fourth-quarter basis) is 3.0 percent in 2007 and 2.4 percent in 2008.[2] The anticipated moderation in inflation apparently reflects the expectation that the impetus from energy and other commodity prices will wane. In addition, inflation pressures should be restrained by the cumulative effects of monetary policy actions and other factors restraining the growth of aggregate demand.

Perhaps most important for the inflation outlook, inflation expectations appear to remain contained. Median long-run inflation expectations from the Reuters/Michigan survey moved up to 3.1 percent in April, but this level is still in the narrow range seen over the past few years.[3] Long-run inflation compensation derived from spreads between yields on nominal and inflation-indexed Treasury securities stood at 2.4 percent on May 30 (ten-year, adjusted for carry effect), in the middle of the range observed since the turn of the year.

Let me close with a few comments on what I see as some of the more important risks to the outlook for the U.S. economy. One potential upside risk is that consumer demand, which has show resilience in the face of high energy prices and the challenges in the housing market, grows at a faster pace than expected, thereby increasing pressures on resource utilization. One risk on the downside is the possibility that new home construction will weaken substantially further or that weakness in the housing market will spill over to other sectors and dampen aggregate demand significantly. Such an outcome could be prompted by a more pronounced weakening of home sales, a larger-than-expected drag on the housing market from the inventory of unsold homes, or more adverse developments in financial markets.

Although developments in nonprime mortgage markets are causing hardship for many individuals and families, to date these challenges do not appear to be having a broad impact on economic activity. As you know, delinquency rates on subprime variable-rate mortgages have sharply increased. However,

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[1] Kroszner, Randall S. (2007), "The Changing Dynamics of Inflation," speech delivered at the 2007 Annual Washington Economic Policy Conference of the National Association for Business Economics, Arlington, Virginia, March 12, www.federalreserve.gov/boarddocs/speeches/2007/20070312.

[2] *Blue Chip Economic Indicators* (2007), May 10 (New York: Aspen Publishers), p. 3.

[3] Richard Curtin (2007), "April 2007 Survey Results," *Reuters/University of Michigan Surveys of Consumers* (Ann Arbor: University of Michigan), April.

subprime variable-rate mortgages account for, at most, one in ten home-loan borrowers, and delinquency rates for most other types of residential mortgages remain low. Thus, relative to the broader *housing* market, the troubles in the subprime market should remain contained.

Furthermore, the effects of rising subprime delinquencies have not seriously spilled over to the broader *financial* markets. Risk premiums on subprime residential-mortgage-backed securities (RMBS) and derivative products have widened considerably, as investors are requiring higher returns. However, the issuance of subprime RMBS has slowed only moderately. Lenders have tightened standards and terms, but much more so on subprime and nontraditional mortgages than on prime loans.[4] Risk spreads on corporate bonds and premiums on credit default swaps for investment banks with some exposure to subprime markets have risen only slightly. Moreover, we see no serious effects on banks or thrift institutions; for the most part, the troubled lenders have not been institutions with federally insured deposits.

Even so, foreclosure starts are rising so an increasing number of homeowners face the prospect of losing their home. Before continuing my assessment of the macro risks, I would like to take a moment to describe some of the current regulatory responses to the problems of elevated delinquencies and foreclosures. First, the Federal Reserve Board and the other federal financial institution regulators have already been encouraging the banks and thrifts that they supervise to work with borrowers who may be having trouble meeting their mortgage payments and for whom workouts are in the interest of both parties.[5] The federal regulators also issued draft supervisory guidance earlier this year to remind lenders of the importance of sound underwriting standards and clear disclosures, particularly in the case of subprime variable-rate mortgages.[6] In addition, we are actively considering how to make mortgage disclosures more effective and empower consumers to make better-informed decisions to achieve their financial goals.[7] We will, for example, review whether advertisements adequately disclose the limits of low initial rates and potential payment changes.

Finally, on June 14, I will be chairing the fifth in a series of hearings on how the Board might use its rulemaking authority under the Home Ownership and Equity Protection Act, or HOEPA, to address concerns in the mortgage lending market. The purpose of the hearing is to gather information to evaluate how the Federal Reserve can prevent predatory lending in a way that also preserves incentives for responsible lenders to continue to lend. The Federal Reserve will do all that it can to prevent fraud and abusive mortgage lending practices. However, any new rules should be drawn clearly to avoid creating legal or regulatory uncertainty that could have the unintended consequence of restricting consumers' access to responsible subprime credit.

Another area of possible financial risk that we are watching is leveraged lending.8 Business borrowing for mergers and acquisitions and for corporate refinancing has been quite robust over the past few years as firms have taken advantage of relatively low interest rates to reduce their cost of capital. As underwriters have brought these deals to the market, the good earnings of corporate borrowers and several years of very low defaults have encouraged lenders and investors to fund hundreds of billions of dollars in leveraged loans. However, with this growth we are seeing some trends in the leveraged loan market that warrant closer monitoring: Deals continue to be structured with thin pricing, more leverage, and looser covenants than is typical for non-investment-grade borrowers. Further, originating banks are capitalizing on the strong investor demand for these loans by underwriting to distribute them, including

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4 Board of Governors of the Federal Reserve System (2007), “The April 2007 Senior Loan Officer Opinion Survey on Bank Lending Practices,” May, www.federalreserve.gov/boarddocs/SnLoanSurvey/200705.

5 Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2007), "Federal Regulators Encourage Institutions to Work with Mortgage Borrowers Who Are Unable to Make Their Payments," press release, April 17, www.federalreserve.gov/boarddocs/press/bcreg/2007/20070417.

6 Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision (2007), "Agencies Seek Comment on Subprime Mortgage Lending Statement," press release, March 2, www.federalreserve.gov/boarddocs/press/bcreg/2007/20070302.

7 Randall S. Kroszner (2007), “Creating More Effective Consumer Credit Disclosures,” speech delivered at the George Washington University School of Business, Financial Services Research Program Policy Forum, Washington, June 1, www.federalreserve.gov/boarddocs/speeches/2007/20070523.

8 A leveraged loan is commonly defined as a syndicated loan, typically to a riskier borrower, with an interest rate of at least libor plus 125 basis points.

through securitization, while holding only nominal exposures themselves. Although defaults and other indicators of borrower distress still remain low, and banks' exposures are so far quite manageable, supervisors are mindful that high levels of leverage can lead to credit problems relatively quickly for both borrowers and lenders when conditions turn. We want to ensure that any adverse events do not materially affect the banking industry and hope to encourage market participants to employ more-realistic expectations and structures in underwriting riskier corporate loans.

Turning to inflation risks, the high level of resource utilization continues to have the potential to put additional upward pressure on inflation. And, of course, higher oil prices and the possibility of further increases also pose an upside risk to inflation. With these concerns in mind, the latest statement issued by the Federal Open Market Committee again highlighted the risk that inflation could fail to moderate as expected, and I believe that the risks to the inflation outlook are primarily to the upside. The statement also noted that future policy adjustments will depend on the evolution of the outlook for inflation and economic growth, as implied by incoming information. I will continue to monitor these developments, as well as those in financial markets, very closely.