Joseph S Tracy: The shape of the recovery

Remarks by Mr Joseph S Tracy, Executive Vice President of the Federal Reserve Bank of New York, at the Connecticut Business and Industry Association/MetroHartford Alliance Economic Summit and Outlook 2011, Hartford, Connecticut, 7 January 2011.

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It is a pleasure to be with you this morning. As the new year begins, it is instructive to look back over 2010 to try and discern what the shape of the recovery will look like over 2011. Let me note at the outset that my comments are my own and do not necessarily reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System.

Just six months ago a topic of keen interest was whether the economy was experiencing a temporary soft patch or was heading into a double-dip recession. Real gross domestic product (GDP) growth had slowed from 5 percent in the fourth quarter of 2009 to 3.7 percent in the first quarter of 2010, and to only 1.7 percent in the second quarter. Soft patches are common in expansions but are difficult to distinguish from a more serious decline in momentum. Examples of soft patches include the expansions in 1976 and 2002 (Chart 1). Soft patches typically result when the initial boost from inventory restocking and fiscal stimulus from government spending fades and must be replaced by underlying strength in the economy. The concern six months ago was that a soft patch – amid an environment with little room for conventional monetary policy – could be particularly risky. However, growth picked up in the third quarter to an estimated 2.6 percent, and as 2010 came to an end, economists were revising upward their growth forecast for 2011. The risk that the economy will enter a double-dip recession now seems quite low. The increased optimism reflects in part the compromise on the extension of the Bush tax rates, the Federal Open Market Committee's decision to purchase up to $600 billion in Treasury securities, and stronger retail sales during the holiday season.

While there are many factors that will affect the shape of the recovery in 2011, a key factor will be the degree of improvement in the labor market. From its peak in December of 2007, employment is down by 7.4 million jobs and remains below its level in January 2000. That is, the "Great Recession" eliminated an entire decade's worth of job growth (Chart 2). Improved job growth is essential to generating the increase in disposable income that will support continued consumption growth which is so important for overall economic growth.

Leading indicators for the labor market are pointing to a likely pickup in the pace of employment gains over the course of this year. Many new hires are preceded by firms posting job openings. According to the Labor Department, at the end of October, there were 3.4 million job openings, up from 2.3 million a year earlier. As conditions in the labor market start to improve, workers are more willing to quit a job to search for a better job. While the quit rate has been unchanged at 1.5 percent for the past 8 months, quits as a proportion of total separations increased to 49 percent in October from 41 percent a year earlier. Also encouraging, employment in Temporary Help Services has increased by 494,000 since September 2009. Firms often hire temporary workers as a precursor to adding permanent staff. Finally, initial claims for unemployment insurance continue to edge downward, indicating that the risk of losing a job is diminishing (Chart 3).

There are risks associated with every economic forecast. Some risks are to the upside, while others are to the downside. An important downside risk for this year is the housing market. Recall that the housing market was the epicenter of the financial shock that resulted in the Great Recession. Unlike the real economy, which has shown recent signs of strengthening, housing markets showed some tentative signs of life early last year that gave way to further weakening later in the year (Chart 4). This pattern likely reflected in part the conclusion of tax credits supporting housing purchases.

Of particular note, house prices increased moderately early last year, but resumed their decline as the year came to a close. In October, the CoreLogic national house price index was down 3.9 percent from a year earlier (Chart 5). House price declines were reported in all but 11 states. House prices in Arizona and Florida, two of the housing boom states, declined by 8 percent. Distressed sales as a fraction of all repeat-sales increased to more than 40 percent after having declined into the low 30s earlier in the year. Some housing economists are forecasting house prices to fall by 10 percent or more this year.

The growing inventory of defaulted mortgages continues to weigh down any recovery in the housing market. According to the most recent Mortgage Metric Report by the Office of the Comptroller of the Currency and the Office of Thrift Supervision, there were 598,000 newly initiated foreclosures in the third quarter of 2010.[1] This inflow of new foreclosures exceeded the outflow due to completed foreclosures and properties sold through short sales and deeds in lieu. As a result, the foreclosure pipeline increased to 1.9 million mortgages – double the level from a year earlier (Chart 6). Efforts to modify mortgages have not managed to prevent the foreclosure pipeline from increasing. As a consequence, distressed sales are expected to grow even further over the coming year.

The combination of declining house prices and increasing delays in the foreclosure process will put upward pressure on default rates as well as losses on defaulted mortgages. CoreLogic estimates that in the third quarter of 2010 there were 10.8 million borrowers in negative equity where the balance on the mortgage exceeds the current value of the property. They estimated that there were an additional 2.4 million borrowers estimated to be in “near negative equity” where the borrower has less than 5 percent equity remaining. Declining house prices will push these near negative equity borrowers into negative equity. This increases the risk that these borrowers will default on their mortgages either out of necessity – say as the result of a job loss – or out of choice, which is called strategic default as borrowers determine that there is little economic advantage to keep paying the mortgage. Longer delays in the foreclosure process further increase the incentive for a borrower to strategically default by extending the period of time that they can live “rent free” in the house. In addition, declining house prices increase the expected losses on those mortgages that do default.

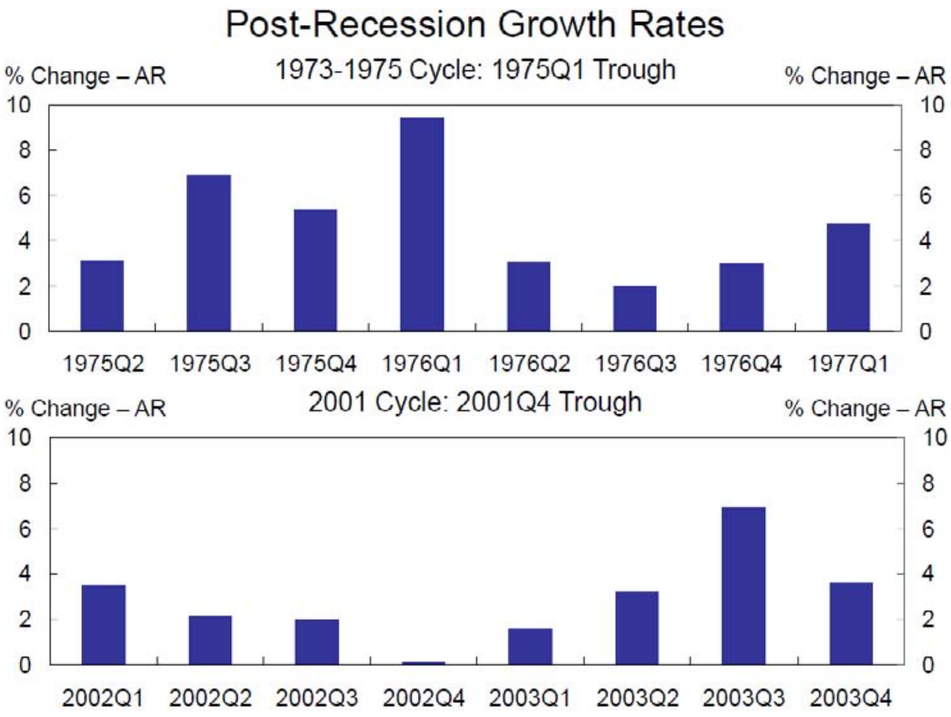
Problems in housing markets can impact economic growth. Housing directly effects growth through incentives for builders to build new houses. Housing starts will likely remain depressed as long as house prices are declining. Falling house prices can also negatively impact consumption growth to the extent that homeowners increase their savings in an effort to offset declines in their housing wealth.

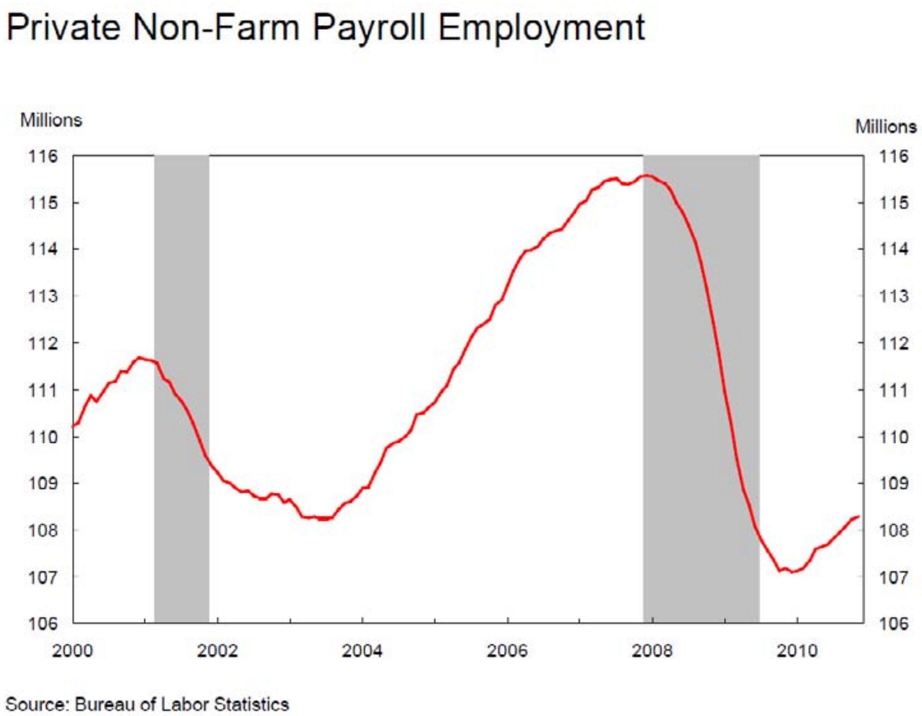
The degree to which housing markets deteriorate over 2011 and the impact that this will have on overall growth is hard to predict with any accuracy. The most likely outcome is that the economy will continue to improve as the year progresses despite the ongoing drag from housing. However, the protracted process of resolving the overhang of negative equity resulting from the overvaluation of housing during the boom will remain a headwind restraining economic growth for several years to come.

Let me conclude with an observation regarding the housing outlook for Connecticut as compared with the nation. Connecticut home prices grew less than the nation during the housing boom and subsequently declined less during the housing downturn (Chart 7). As a

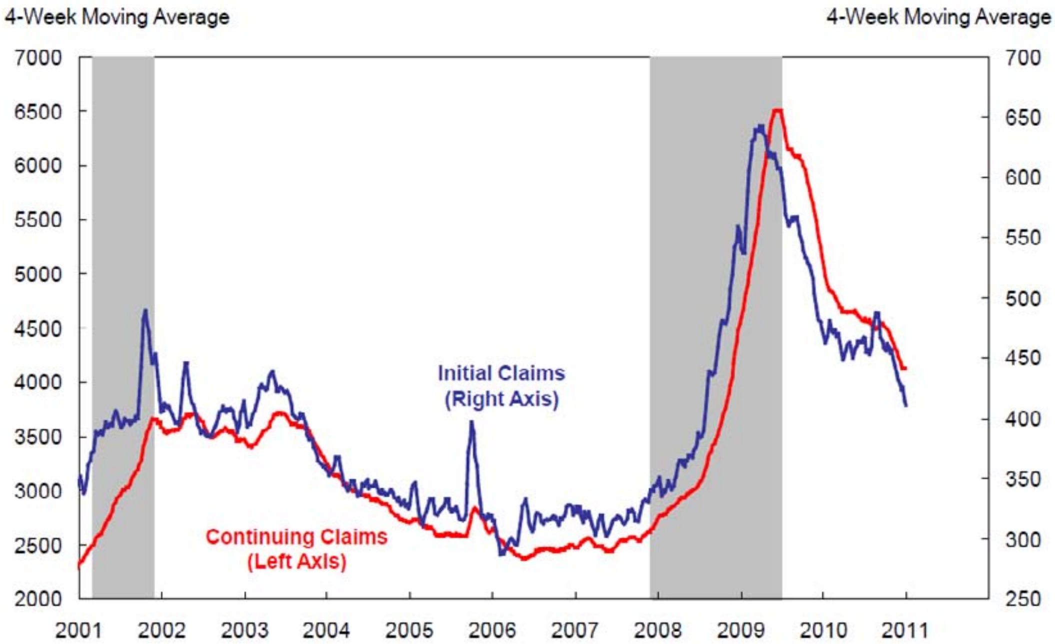
[1] This number is the reported number of newly initiated foreclosures (383,000) adjusted to reflect the coverage of the survey (64 percent of the total market).

result, the cumulative change in Connecticut house prices since January 2000 is now very similar to the nation as a whole.





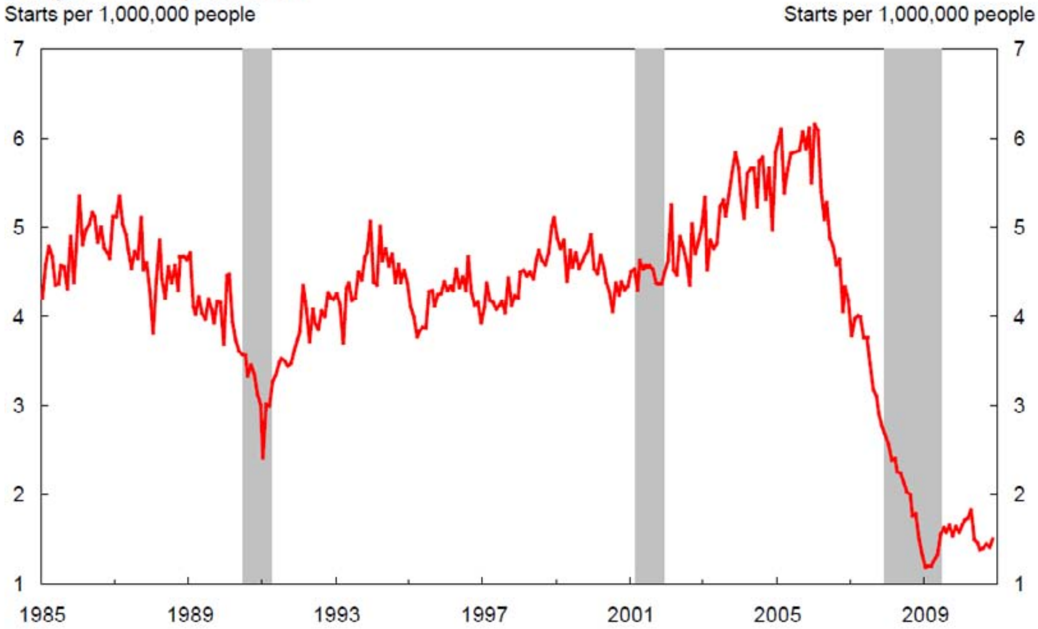
Unemployment Insurance



Source: Department of Labor

Ratio of Housing Starts to Population

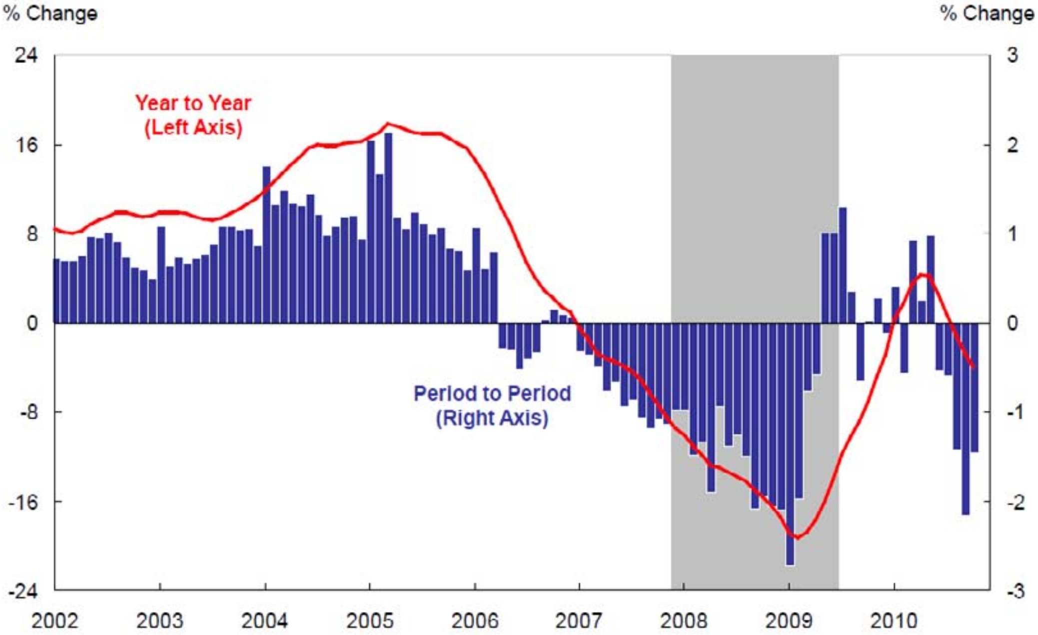
Single-Family Homes



Source: Census Bureau

CoreLogic National Home Price Index

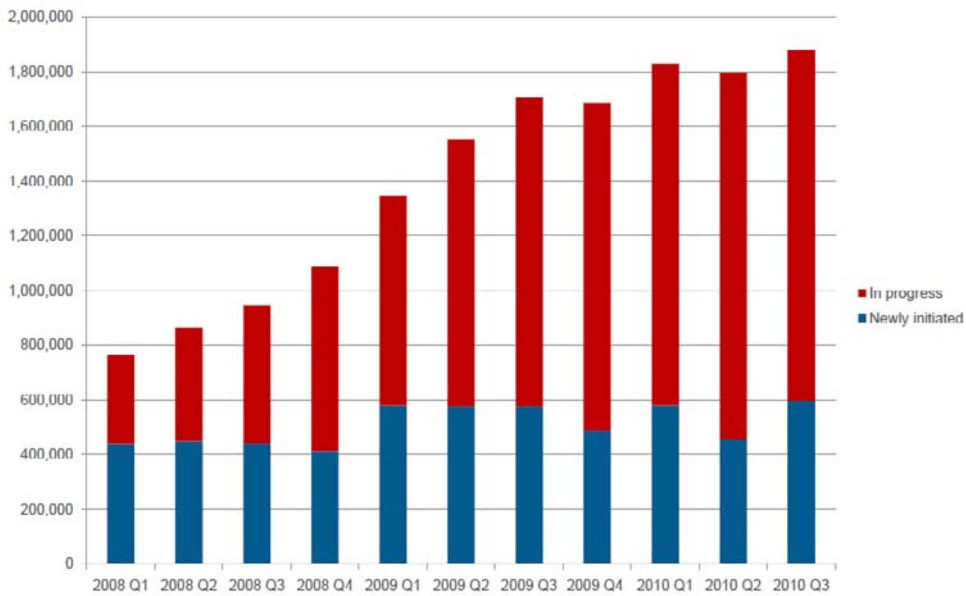
Including Distressed-SA



Source: CoreLogic/Haver Analytics

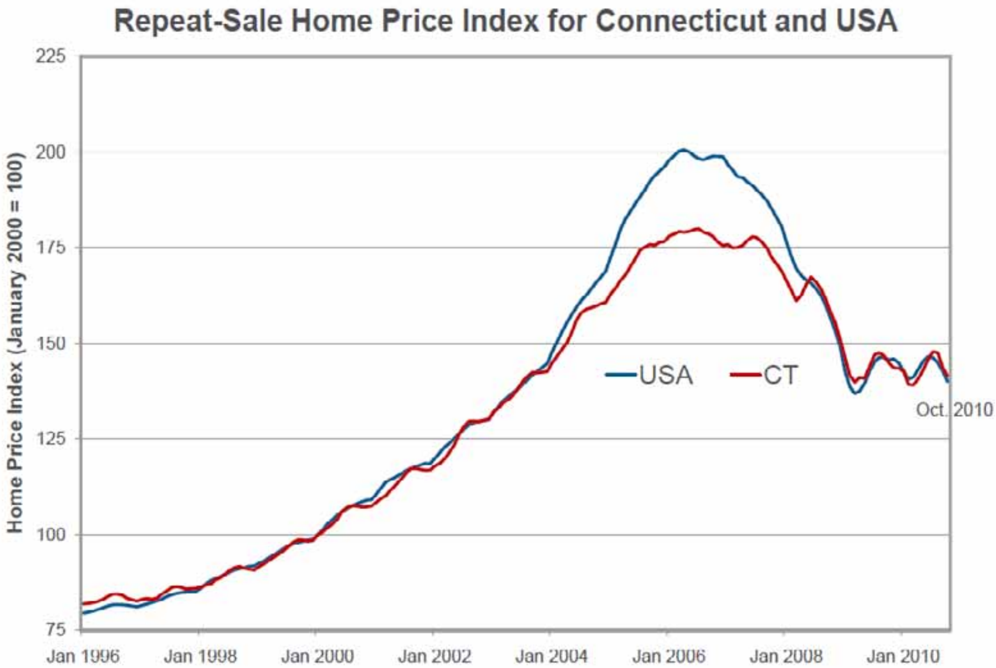
Note: Monthly Data

Growing Foreclosure Pipeline:



Source: OCC & OTS Mortgage Metric Reports

Note: Quarterly Data



Note: Home price index based on repeat sales; includes all transactions.
Source: CoreLogic