The Economic Outlook for 2008

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Thank you. It is a pleasure to once again join you at the Central Exchange and share my perspectives on the current state of the U.S. economy and my outlook for 2008. As you know, over the past year the economy has experienced considerable stress. A slumping housing market has caused weaker growth, and higher food and energy prices have boosted inflation. In addition, rising mortgage delinquencies have caused considerable turmoil in financial markets around the world, leading the Federal Reserve and other central banks to take actions to stabilize financial markets and limit the effects of these disruptions on the broader economy. These developments have led to considerable pessimism in the media about the prospects for the U.S. economy in the period ahead and increased speculation about the possibility of a recession.

Although I, like others, see a significant slowing of economic activity through the first quarter of 2008, there also is a case to be made that growth will strengthen over the balance of the year. And, in my view, the likelihood of a recession is smaller than others are suggesting. I also judge that in the current economic environment, the challenge for monetary policy in the coming year is especially difficult and will be influenced not only by the risk to growth but the risk of inflation.

Let me now turn to a more detailed discussion of the economy’s performance over the past year and my thoughts on the economic outlook and monetary policy in the new year. My comments today represent my own views. I am not speaking on behalf of the Federal Open Market Committee or the Federal Reserve.

The Economy’s Performance in 2007

Last year was challenging for the U.S. economy as the housing slowdown intensified and led to significant losses for major financial institutions and disruptions in
financial markets. In addition, higher food and energy prices boosted overall measures of inflation. Despite these challenges, however, overall economic performance remained solid as consumer, business and government spending remained sound and as a lower dollar boosted exports to our major trading partners. Moreover, there were important regional differences in economic performance, with the Midwest doing significantly better than some other parts of the country.

Housing and inflation

The big story of the past year, of course, was the continuing decline in housing activity. Since the beginning of 2006, new housing construction has declined by more than 50 percent, sales of new and existing homes have plummeted, inventories of new and existing homes have ballooned, and house prices have fallen significantly in many parts of the country. And, unfortunately, the bottom has not yet been reached as housing starts, permits, and sales fell significantly in the most recent November data.

To a large extent, the housing slump represents the unwinding of a surge in housing construction and house prices earlier in this decade that was fueled by low interest rates and ample credit. Both subprime lending and speculative activity played a key role in these developments. With higher interest rates and slower house price appreciation in 2005 and 2006, however, the housing market changed abruptly. Many borrowers were simply not qualified to borrow in the first place, and others could not meet higher mortgage payments when their adjustable-rate mortgages reset. As mortgage delinquencies and foreclosures rose, higher inventories of unsold homes placed additional downward pressure on house prices.
In the past, traditional mortgage lenders, such as banks and savings and loans, bore the brunt of a decline in housing activity. However, over the past 25 years, housing finance has changed considerably. Many mortgage loans, particularly subprime loans, have been originated by nonbank mortgage lenders and have been “securitized” and used as collateral for bonds that are sold to investors in the United States and abroad. These investors are now exposed to this decline in housing activity as mortgage defaults reduce the value of the underlying collateral.

Indeed, last August, the housing slump took a new and unexpected twist as rising delinquency and foreclosure rates on “securitized” subprime mortgages caused investors to flee from mortgage-backed securities. The resulting financial panic affected financial markets in the United States and a number of other countries and caused severe strains on the banking system in the United States and abroad.

As these financial pressures worsened, the Federal Reserve and other central banks began a series of actions to restore liquidity to financial markets. For example, the Federal Reserve attempted to make funds available to banks through its Discount Window. Its actions included reducing the interest rate and extending the term on its loans to banks. Last month, the Federal Reserve took additional steps to provide funding to banks by introducing a new Term Auction Facility, which allowed banks to obtain needed longer-term funding through a competitive auction.

In addition to the direct effects of the housing crisis on financial markets, the Federal Reserve recognized that these financial disruptions could have potential effects on the broader economy by reducing credit availability to households and businesses and by damaging consumer and business confidence. To limit the potential spillover of
financial distress to the broader economy, the FOMC lowered its target federal funds rate from 5 ¼ percent to 4 ¼ percent over the past four months.

*Underlying economic strength*

Despite these considerable challenges and the attention they have received, you may be surprised to know just how well the overall economy performed last year. While housing accounts for between 6 percent and 8 percent of total GDP and its decline was substantial, it was not the only economic event in 2007. Strength in other sectors resulted in good overall economic performance. Indeed, even with a significant slowdown in growth in the fourth quarter expected by most forecasters, GDP growth for 2007 is likely to come in at 2.5 percent or slightly higher when we get full-year data later this month. Moreover, despite a decline in construction and manufacturing jobs, overall employment growth remained solid.

Behind this solid economic growth were some pretty substantial factors. For example, consumers, despite the housing slump and higher food and energy prices, continued to spend. And, businesses and government continued to invest and spend at very good levels. A particularly important factor was a rise in U.S. exports. Sales of U.S. products abroad have surged over the past year, supported by strong growth in the economies of our major trading partners and by the decline in the dollar, which has reduced the price of U.S. exports.

*Regional Differences*

Finally, let me focus on some significant regional differences in economic performance. Having spent considerable time traveling this region over the past year, I suspect that some of you have experienced a “disconnect” between media reports of
economic weakness and your own personal experience. Indeed, there have been important regional differences in economic performance across this country. The Midwest and the Tenth District, in particular, have generally performed better than the nation as a whole. Part of the regional variation is due to differences in housing markets. While housing is weaker than normal almost everywhere, it has been especially weak in those parts of the country, such as Florida and the West Coast, that experienced the largest boom in housing construction and housing prices in recent years. For the most part, this part of the country did not experience the boom and has not experienced as much fallout from the housing collapse.

In addition, energy and agriculture play a relatively more important role in our part of the country, and the strength in these sectors has more than offset the slower housing sector. This performance is reflected in District labor markets, where businesses continue to report difficulty in finding qualified workers, and in state and local government finances, where revenue growth has supported needed spending for infrastructure and education in many District states.

Inflation Trends and Their Risks

Unfortunately, although the housing slump received most of the headlines, it was not the only challenge the economy faced in 2007. Inflation accelerated at a most inconvenient time. Rising food and energy prices caused the overall inflation rate to surge to its highest level in several years. Through November, overall CPI inflation was 4.3 percent on a 12-month basis, up significantly from the 2.5 percent rate in 2006. Rising food prices were caused by both demand and supply factors. Higher incomes in developing countries and the ethanol boom in the United States have spurred increased
demand for many agricultural products, and world supplies have been affected by
drought in some producing countries

   Energy prices also increased significantly last year. Crude oil prices rose by
nearly 60 percent over the course of the year as demand continued to outpace supply and
geopolitical uncertainty and speculative activity also contributed to higher prices. Core
inflation, while more moderate than overall inflation, is now running at a 2.3 percent
annual rate.

The Economy and Monetary Policy in 2008

   With this review of the economy as background, let me turn now to a discussion
of the economic outlook and the challenges for monetary policy in the upcoming year.
As I indicated earlier, most forecasters believe the economy slowed significantly in the
fourth quarter to about 1 percent from the third quarter’s 4.9 percent pace. While I am
not as pessimistic as some about the outlook, the fact is there most likely will be a
continued slowdown as we move into this year with many growth estimates for the first
quarter at around 1.5 percent.

   Whatever the final figures, a slower pace of growth is likely and is the result of a
combination of factors. Part of it is cyclical and represents some offset to the unusually
strong pace in the second and third quarters of last year. In particular, government
spending is expected to slow somewhat and manufacturers are reducing inventories after
strong gains in preceding quarters. In addition, the continuing weakness in housing and
the impact of higher energy prices on consumer spending for autos and other durable
goods will contribute to lower growth.
However, as we move into the second quarter of the year and beyond, many forecasters see growth picking up, even gaining momentum. This expected pickup comes from several sources including strengthened manufacturing as domestic demand remains stable and export growth remains strong. Also, while hardly a rallying point, GDP growth should be helped to some extent by a slowing in the decline of housing. Also, while energy prices most likely will remain elevated, most expect some slowing in the rise of energy prices, thus giving consumers some added spending power for other goods.

And finally, the policy easing that the Federal Reserve has undertaken in recent months will provide additional stimulus as we move through the year.

From my perspective, the outlook for inflation is less clear and therefore of concern. To the extent the economy’s GDP slows to 2 percent or less, we should see some moderation in what otherwise might be accelerating inflationary pressures. But this outcome is far from certain. There remains, at this point, strong global demand for resources and, in the United States, upward price pressures for both goods and services. Thus, while my views on inflation are not significantly different than that of the consensus forecast, they are, at the moment, on the higher end of views.

Pulling this all together, I expect GDP growth for the year to be in the range of 2 percent to 2.5 percent measured on a Q4-over-Q4 basis. I also expect the rise in overall inflation to moderate as the U.S. economy slows, but I do not expect any quick reversal of inflation trends, and I therefore expect core inflation to remain above 2 percent.

*Risks to the outlook*

While this forecast represents a best estimate, like all forecasts it may not materialize. In particular, the continuing fallout from the housing crisis and financial
market disruptions could lead to weaker growth. This outcome would be more likely if those financial institutions that have experienced losses in recent months reduce credit availability to households and businesses. The resulting credit crunch could reduce growth significantly below consensus estimates and represents an important downside risk to the economy over the next several months.

Another way the consensus forecast might prove wrong is its outlook for inflation. While in 2007 inflation expectations remained contained, this could change if inflation rates continue to rise. In 2008, there are a number of factors that could lead to upward pressure on overall and core inflation and perhaps cause long-term inflation expectations to rise, thus undermining our long-term stable inflation goal. These include the effects of the weaker dollar on import prices and the slower trend productivity growth experienced in recent years. In addition, if food and energy prices do not moderate as forecast, they could further add to these inflation pressures. Thus, another important risk to the forecast is that inflation could move higher.

Implications for Monetary Policy

Let me close then with a brief discussion of the outlook for monetary policy in the coming year. And let me preface these final remarks by emphasizing the view that in the conduct of policy, the central bank must take a long-run approach in its selection among the policy options. Such choices are never simple and sometimes not obvious, but to focus on only short-run disturbances is to assure broader problems as the economy evolves going forward.

The FOMC has eased policy significantly over the past four months to limit the potential spillover of financial market disruptions to the broader economy. And the fact
is that many financial market participants believe that more easing is likely in the coming months. These views are understandable and place significant weight on the downside risks to the outlook and especially the possible development of a credit crunch.

But if the economy continues to expand at a modest but reasonable rate above 2 percent, then the case for further easing would be less convincing, especially in light of the recent moves. And, if the economy strengthens above forecasts, then the risks of higher inflation would increase more significantly. In this instance, the Federal Reserve would need to consider an unwinding of its recent policy easing, especially if inflation expectations also move higher.

Let me close by recognizing that the economy is faced with some obvious difficult challenges as we enter 2008. Growth has slowed as we exit 2007 and there are risks that the economy could falter further this year. But still, on balance the economy in 2007 grew at a solid pace despite the drag from housing. Other sectors have held up well and the prospects for 2008 are reasonably good if these sectors hold up as they have in the recent past. In addition, inflation, while still modest, is on the high side of acceptable levels and we must not lose sight of its harm to the economy if it fails to recede as expected.