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St. Louis Federal Reserve Board

Excerpts follow.
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I expect to see a continued moderate recovery in economic activity in 2010, supported by a further healing in financial markets and accommodative monetary policy. The decisive actions taken by policymakers beginning in the fall of 2008 were instrumental in stabilizing financial markets and laying the groundwork for this recovery. However, while the restraint on economic activity from the financial shocks appears to be easing, any realistic assessment of the economic outlook must take into account prospects for conditions in credit markets, which will be a critical element shaping the recovery.

Recent Economic and Financial Developments

The recent news on employment, production, and spending has been encouraging….Nonetheless, while layoffs have started to recede, hiring remains weak, and unemployment is still both high and unusually concentrated among the long-term unemployed.

As demand has improved, firms have increased production levels closer to those of final sales and slowed the pace of inventory liquidation. Our Federal Reserve index of industrial production, which turned up in the middle of last year, has now been rising for five months….Data for October and November showed an encouraging continuation of the positive trend in domestic spending that was reported in the third quarter.

Sales of existing homes showed further strong gains from September through November…improvement in the market for new single-family homes has been disappointing, and construction of new single-family homes, which turned up over the first half of last year, seemed to flatten out in the second half. The housing market is still being weighed down by a number of factors including the high level of foreclosures, the tight credit conditions faced by some builders, and reduced mortgage availability for some households.

In the business sector, spending on equipment and software has also firmed....Meanwhile, construction outlays on nonresidential buildings have continued to fall sharply, as that sector faces extremely unfavorable economic and financial conditions.

Functioning in interbank and other short-term funding markets has improved considerably, interest rate spreads on corporate bonds have narrowed significantly, prices of syndicated loans have increased, and some securitization markets have resumed operation. Equity prices have increased sharply since their low in early 2009, and consensus forecasts of year-ahead corporate earnings have been rising. Reflecting the very accommodative stance of monetary policy, borrowing rates for many households and businesses remain low. Additionally, Federal Reserve purchases of longer-term Treasury and agency securities, including agency mortgage-backed securities, helped to lower rates on mortgages and other instruments.

The Term Asset-Backed Securities Loan Facility (TALF) has helped to facilitate a resumption of activity in securitization markets for consumer auto and credit card loans. In addition, the TALF has supported small business lending…(and TALF loans) also have been used to fund purchases of commercial mortgage-backed securities (CMBS), and recently appear to be providing a catalyst for the new- issue CMBS market.

Still, access to credit for many households and smaller businesses that largely depend on banks for credit remains difficult. Risk spreads on some types of loans at banks have continued to rise, and the decline in bank loans outstanding has been stark.

A number of factors are at work in explaining the reduction in bank loans…for most commercial banks, the quality of existing loan portfolios continues to deteriorate as levels of delinquent and nonperforming loans are still rising…banks with capital positions that have been eroded by losses or those with limited access to capital markets may be reducing risky assets.

The reduction in the availability of credit, however, is not the whole story. There is also less demand for credit….Even small businesses, in a survey by the National Federation of Independent Business, report that while loans remain difficult to get, their most important business problem is lack of customer demand, a factor that has likely restrained their demand for funds.

My conversations with bankers in recent weeks, however, lead me to be somewhat optimistic that we may begin to see an increase in bank loans later this year. Nearly all report that their business plans for 2010 are based on achieving increases in loan volumes. Most are expecting that loan losses will peak later this year. And a few bankers are beginning to report renewed competition for new loans.

The Federal Reserve has been working with banks to foster improved access to credit and prudent underwriting of new loans, and we will continue to do so.

The Outlook

In my view, the outlook for economic activity depends importantly on our ability to build on the progress to date in improving the operation of financial markets and restoring the flow of credit to households and businesses. Although household wealth has received a boost from the gains in the stock market over the last nine months and from the stabilization in house prices, household balance sheets remain weak.

Over the coming year, households should begin to see gains in income associated with an improvement in the labor market, and the drag on spending from past declines in real net worth should ease. As their income and balance sheets improve, consumers should have better access to credit. Favorable trends in income and employment should also bolster consumer confidence, although one risk I see to the outlook for household spending is the possibility of a rise in the personal saving rate as consumers choose to shore up their balance sheets rather than spend. While good in the long run, increased saving means consumers are providing less of a short-run boost to the economy.

The outlook for homebuilding will depend critically on the continuation of the uptrend in the demand for housing that began in early 2009. I anticipate that low mortgage rates and house prices that are still very low compared with the recent past will continue to provide important support for demand. And a shift in expectations from falling house prices to modest appreciation should encourage buyers to invest in houses. That said, the headwinds in housing and mortgage markets remain relatively strong and are likely to restrain the pace at which the residential construction sector recovers.

Prospects for a recovery in business investment are getting better as we move into 2010….That said, the amount of unused capacity in the business sector is substantial, which implies that the recovery in spending on equipment and software will likely be more gradual than typically occurs during a cyclical recovery.

Nonfinancial corporations have built substantial internal funds, and firms with access to capital markets have been finding them generally receptive. Corporate bond issuance for both investment-grade and high-yield issues remained quite solid through November. My expectation is that the interaction of an ongoing recovery in economic activity and improved credit conditions will over time produce a moderate acceleration in equipment and software investment.

Unfortunately, the outlook for commercial real estate is much less favorable. Hit hard by the loss of businesses and employment, a good deal of retail, office, and industrial space is standing vacant. In addition, many businesses have cut expenses by renegotiating existing leases….Commercial mortgage delinquency rates have soared. According to our October survey of senior loan officers, banks continued to tighten standards on CRE loans and, presumably in light of the poor economic outlook for the sector, appear to have been reluctant to refinance maturing construction and land development loans. In addition, the CMBS market has only just recently seen its first activity in a year and a half.

In this environment, a turnaround in CRE is likely to lag the improvement in overall economic activity. However, compared with the situation in the early 1990s, the problems in this sector now appear to be due largely to poor business fundamentals rather than widespread overbuilding, suggesting that the performance of the CRE sector will gradually begin to improve as the economy continues to strengthen.

An important element of a sustained economic recovery will be an improvement in labor market conditions....I expect that businesses will begin to add jobs this year, but I anticipate that they will do so cautiously in order to hang on to their cost savings and efficiency gains. Even as the unemployment rate begins to decline later this year, it likely will remain high by historical standards.

Other measures of resource utilization are likely to show considerable, albeit diminishing, margins of slack for some time. In that environment, product markets will be highly competitive, businesses will have little pricing power, and the incentives to control costs will remain strong…with substantial resource slack likely continuing to restrain cost pressures and with longer-term inflation expectations stable, I anticipate that the subdued trend in inflation that we have seen for the past two years will continue.

Summary and Policy Outlook

I expect that the economic recovery will continue at a moderate pace…however, levels of resource utilization are likely to remain below historical norms for some time. As a result, cost pressures should be contained, inflation expectations should continue to be stable, and inflation is likely to remain subdued.

In the current environment, the FOMC continues to anticipate that economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period….In addition, the Federal Reserve is committed to continue working with banks and bank holding companies to facilitate the flow of credit to consumers and businesses. Of course, if economic conditions and the economic outlook were to change significantly, the outlook for policy would need to be adjusted as well. We have a wide range of tools for removing monetary policy accommodation when that becomes appropriate.