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ECONOMIC NEWS UPDATE

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The “R” word is back. The housing market has moved from cooling, through slide, into collapse. At least, that’s what many property analysts and economists are saying. They are hoping that the Federal Reserve Board’s monetary policy gurus take note when they convene in less than a month, and turn their “pause” in ratcheting up interest rates into a permanent stop. Or better still, change direction completely. Otherwise, the “R” will be deep and nasty.

The dwindling band of optimists suffered four blows last week. First, the National Association of Realtors reported that sales of existing homes in July were at their lowest level since January 2004, and were 11.2% below last July’s level. That brought the inventory of unsold houses to 7.3 months supply, up from 5.1 months at the start of this year. As one would expect, the inventory overhang drove sales prices down in every region of the country except the South.

Then the government reported that contracts for sales of new homes fell by 4.3% in July, to 21.6% below last

July’s pace. Inventories of new houses looking for loving buyers prepared to turn these houses into homes rose to 6.5 months’ supply, the highest level since November 1995. New homes account for only 15% of all home sales, but have a disproportionately large effect on the number of construction jobs, and sales of building materials (currently benefiting from booming commercial construction).

The third blow came when Toll Brothers, a luxury-home builder (average sales price close to \$700,000) reported a 48% drop in orders, cancellations of buy orders, and a market dominated by sellers offering discounts and extras from finished basements to his-and-hers motor scooters.

As if these developments were not enough to cause the optimists to scurry for cover, Michael Moskow, president of the Federal Reserve Bank of Chicago, threw cold water on the notion that a softening housing market has persuaded all central bankers to freeze, or even lower, interest rates. Moskow is not a member of the Fed’s

monetary policy committee, but his views are given considerable weight by his fellow bankers.

He acknowledged that there is “some evidence... that the... [housing] slowdown could be more extensive...” but then added, “The risk of inflation remaining too high is greater than the risk of growth being too low....Thus some additional firming of policy may yet be necessary to bring inflation back into the comfort zone [1%-2%] within a reasonable period of time.” As if to prove that Moskow’s view has support among his colleagues, Jack Guynn, retiring after 42 years as president of the Federal Reserve Bank of Atlanta, and a stint on the Fed’s monetary policy committee, told a business audience, “I’m leaving ... confident in the Fed’s commitment to keep inflation at bay. I’m sure future policymakers will remember ...what happens when you start down the slippery slope of trading inflation for growth.”

So when Fed chairman Ben Bernanke gathers his colleagues next month, here are the facts of which he can be certain. The housing market is slowing. Sales are down, inventories are up, and the rapid escalation of prices has been halted. That will knock at least one percentage point off the rate of economic growth, bringing it to the 2.0%-2.5% range.

Here is what he won’t know with any certainty: the effect of developments in the housing market on consumer behavior. We have come through a period in which consumers used the rising equity in their homes to finance current consumption. We have never seen anything on that scale before, and therefore have no way of knowing what an end of the era of homes-as-ATM machines will look like. Peter Hooper of

Deutsche Bank Securities is predicting a cut in consumer purchases of appliances and other household equipment, whereas Moskow says “history suggests that the impact on consumer spending would be modest and gradual.... Businesses and consumers are likely to continue spending at a reasonably healthy rate.”

He is supported by more than a few economists who expect cash-flush businesses to offset any decline in consumer spending by increasing the pace of investment, especially in high-tech gear. They point out that over half of the spending on such gear is driven by PCs, and Microsoft’s introduction of its new Vista operating system early in 2007 will prompt a wave of PC and software purchases.

Recently published data provide ammunition for the analysts who expect businesses to pick up the slack created by consumer retrenchment. Orders for durable goods (those expected to last more than three years, but excluding the volatile transportation sector), rose 0.5% in July and orders for non-defense capital goods increased 1.5%. Better still, upward revisions of these spending figures for earlier months suggest that the economy grew at an annual rate of 3% in the second quarter, rather than the 2.5% previously reported.

Still, consumers account for about 70% of the economy, making it important to guess whether the consumer-will-retrench crowd proves correct or turns out to have been unduly pessimistic. That will depend largely on two things. One is just how deep the housing slowdown proves to be. Margaret Kelly, CEO of Re/Max International, thinks we are merely “retreating to a normal market.” And Lawrence Yun, the economist at the

National Association of Realtors characterizes current developments as a “healthy cleansing” that will result in “a soft landing” as people waiting on the sidelines for prices to bottom out jump back into the market. That upturn, he predicts, will take hold by the Spring of 2007.

Steve Cochrane, senior managing director of Moody’s Economy.com, looks at rising mortgage delinquency rates, the “lack of affordability” of new houses, “troublesome inventories”, and concludes that we are in for a period of gloom lasting well into 2008.

The second important influence on which way the economy heads will be the Fed. As Bernanke & Co. survey the economic horizon they will see an economy slowing enough to allow them to extend the pause, and contemplate reversing past interest rate increases early in 2007. They will also see prices rising at a rate warranting holding the line, or even ratcheting rates up a notch. Out of the corner of their eyes they will spy oil prices that are weakening but still acting as tax on growth. If they process all this information correctly, continued, although slower, growth. Otherwise, one of two unfortunate developments: “R” or faster inflation.



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