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Economic Corner

Housing & the Economy in the Aftermath of the September 11 Attacks On America by David F. Seiders, Chief Economist, National Association of Home Builders

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It will be great to see 2001 disappear into the record books! But despite all that's happened—including the bizarre conclusion to the 2000 presidential election, the unprecedented events of September 11 and descent of the U.S. and world economies into recession—it's fair to say that our political, military and economic systems have passed some stern tests. While major issues remain with respect to international terrorism and homeland security, surveys show that the national psyche is under repair and the country is poised to move ahead, albeit with more conservative expectations and more caution than during the heady "new economy" era of the late 1990s.

On the economic front, the recession that began in the U.S. back in March has been deepening (the third-quarter contraction in real GDP now stands at -1.3 percent), but it's likely that the trough of this cycle will occur during the first quarter of 2002 and that the recession will go down in the books as quite mild by historical standards (about a year in length, involving a cumulative loss of about 1 percent in national output). When the next expansion hits its stride, sustainable economic growth certainly will be good (around 3 percent), but trend growth is not likely to be up to the standards of the late 1990s since heavier investment in military and security systems, along with some less efficient procedures at business firms (e.g., inventory management), will be restraining productivity growth going ahead.

A quick end to this recession depends heavily on dissipation of the strong negative forces that have been pulling the economy downward, particularly the massive cutbacks of business investment in inventories and capital equipment as well as the sharp declines in U.S. exports. Indeed, even a flattening out of inventory investment will generate an enormous contribution to GDP growth early next year, following the massive contractions of 2001, and NAHB's forecast is heavily dependent on this dynamic. Capital investment is likely to continue downward into the second quarter of 2002, but turnarounds in both capital spending and export growth are likely to be features of the recovery in the second half of the year.

Recovery early next year also depends heavily on maintenance of solid levels of consumer spending. Growth of personal consumption expenditures weakened a good bit in 2001, slipping to an annual rate of only 1 percent in the third quarter, but it's likely that growth at least remained positive in the fourth quarter as well. However, the job market has been weakening since early in the year (the unemployment rate jumped to 5.7 percent in November) and further job losses are inevitable in the months ahead. We're anticipating a mild setback for consumer spending in the first quarter, followed by resumption of positive growth. Readings on consumer sentiment actually perked up in December (University of Michigan survey), suggesting that a major retrenchment of consumer expenditures is not likely in the early part of next year.

The housing sector truly has been a pillar of strength this year. Residential fixed investment made positive contributions to GDP growth during the first three quarters of the year, and the housing market has been remarkably resilient since September despite the shocks from the attacks and the deepening recession. Indeed, strong data on housing starts and building permits for November, along with a large rebound in NAHB's Housing Market Index for December and an upswing in MBA's weekly series on applications for mortgages to buy homes, have prompted an upward revision to our estimate of housing market activity for the fourth quarter of this year (we're now pegging housing starts at 1.55 million units, down only 3 percent from the third quarter pace). While deterioration of the job market (and a return to more normal weather conditions) probably will provoke some slippage early next year, the setback is likely to be minor and the housing sector should swing back to a positive force in GDP growth by the second quarter of 2002.

The performance of the housing sector in 2001 has led many analysts to claim that housing is no longer a key leading indicator and to challenge the classic cyclical role of housing in the economy. While casual observation may seem to support these propositions, a closer examination of events in 2000 and 2001 shows that normal linkages between Federal Reserve policy, housing market activity and the overall economy still exist and that the housing cycle is not dead.

With respect to Fed policy, the central bank behaved as expected at the FOMC meeting on December 11, cutting the federal funds and discount rates by another 25 basis points (to 1.75 and 1.25 percent, respectively). That brought the cumulative rate reduction for 2001 to a whopping 475 basis points, and at the conclusion of the December 11 meeting the FOMC issued a statement saying that the risks to the economy still are tilted toward weakness (rather than toward inflation). In view of the apparent failure of Congress and the Administration to settle on a widely-expected fiscal stimulus package, the probability of more Fed easing has increased. NAHB's forecast now assumes another quarter-point cut at the January 30 FOMC meeting, and we've pushed back the onset of Fed tightening until the second half of next year.

At 4:00 a.m. on December 20, the Republican-controlled House of Representatives passed a revised version of its earlier economic stimulus bill, moving closer to the priorities espoused by the Democratic leadership of the Senate. However, a quick vote count showed that the House bill had no chance of making its way through the Senate, and both sides shifted attention to a furious blame game as Christmas approached. The sizable ideological divide between the parties, the bushels of ruffled feathers on both sides of the aisle, and the prospects for a near-term bottoming of the economy without further fiscal stimulus add up to resounding defeat for an effort that seemed like a sure thing in the immediate aftermath of September 11.

Failure of the economic stimulus package certainly is a black eye for Washington politics, but the implications for housing and the economy in 2002 are not all bad. After all, the House-passed bill was laden with provisions that contained little in the way of short-term stimulus. Furthermore, failure of the fiscal effort has paved the way for more accommodative monetary policy in 2002 and taken some upward pressure off long-term interest rates. Indeed, the 10-year Treasury yield fell by about 20 basis points as it became clear that the stimulus effort was failing, and the 30-year mortgage rate is sure to benefit as a result.

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