

# Housing Woes Weigh Heavily on the Economy

By Kevin L. Kliesen

U.S. economic and financial conditions appeared to take a turn for the worse in late August and early September. Markets were especially unnerved about the unexpected drop in employment in August.

Although the preliminary estimate showed that real GDP grew at a robust 4 percent annual rate in the second quarter of 2007—significantly stronger than the 0.6 percent growth seen over the first three months of the year—financial market turmoil spurred the Board of Governors to reduce its primary credit rate on discount window loans by 50 basis points on Aug. 17, 2007. The turmoil included sharp declines in stock prices, rising interest rates on higher-risk financial instruments relative to Treasury securities, and an inability of some firms to secure short-term financing or sell new mortgage-backed securities (even highly rated ones). The Federal Open Market Committee (FOMC) refrained from following through with a reduction in its federal funds target rate, but it announced that this turmoil had raised the potential for appreciably weaker economic growth going forward.

### Housing Is the Culprit

The primary catalyst for these developments is the ongoing difficulties in the housing sector. First, data through July indicated that inventories of new and previously sold single-family homes remained exceptionally high, limiting new construction. The number of single-family housing starts in July registered its lowest rate in more than a decade. It seems likely that housing will continue to be a drag on real GDP growth into next year.

Second, default and foreclosure rates for adjustable-rate subprime mortgages that were made after 2004 have risen significantly. Most of these mortgages were bundled into securities and sold to mutual funds, hedge

funds and other financial institutions. Foreign institutions were among the largest buyers of these mortgage-backed securities, and the resulting turmoil also spurred market-calming actions by the European Central Bank. As fears mounted that many of these mortgage-backed securities were worth far less than initially thought, investors sought the safety of short-term U.S. Treasury securities. As a result, many firms in both the mortgage and nonmortgage market had difficulty borrowing money or finding buyers for their newly issued financial instruments.

Although conditions appear to have improved since Aug. 17, a key unknown for forecasters and policymakers is the extent to which—if at all—these financial market disruptions will reduce real GDP growth. The FOMC carefully monitors the flow of reports that measure economic activity on a monthly or quarterly basis. A good example would be the monthly employment report. But since this report is only a monthly snapshot and is often subject to large revisions, policymakers must instead form opinions based on assumptions, anecdotal information, or daily and weekly data that are often highly volatile. In a nutshell, it is difficult to form clear judgments about the near-term path of the economy during times of increased uncertainty.

The consensus of most forecasters is that the growth of real GDP will still hew pretty closely to the projections issued by the FOMC in its July 2007 *Monetary Policy Report to the Congress*. At that time, the FOMC projected that real GDP would increase by between 2.25 percent and 2.5 percent this year and by between 2.5 percent and 2.75 percent next year; the unemployment rate was projected to remain



modestly below 5 percent for both this year and next.

Currently, economic conditions outside of the housing sector remain reasonably good. However, the August employment report was much weaker than expected. Also, if financial markets fail to stabilize and the difficulties in the housing sector cause consumers to reduce their purchases, a pullback in business investment would most likely occur as well, probably resulting in a less vibrant outcome.

### What about Inflation?

In its Aug. 7 announcement, the FOMC said that its “predominant policy concern remains the risk that inflation will fail to moderate as expected.” There was no mention of the inflation outlook in the FOMC’s Aug. 17 statement. This does not necessarily imply that the committee’s views on the inflation outlook changed overnight. Instead, one interpretation could be that the risk of slower growth now outweighs the risks to the inflation outlook.

Diminished inflation expectations over the next five years that are embedded in nominal and inflation-adjusted Treasury securities suggest that financial markets share this view. At the same time, inflation expectations over the next five to 10 years have been fairly steady, which suggests that financial markets view the near-term drop in price pressures as a temporary respite. This suggests that once the current turmoil has passed, the FOMC may have to shift its focus back to inflation.

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