

The Economy in Perspective

by Mark Sniderman

Closing the books... Another year heads into the barn, bows out, comes full circle, folds its tent, fades into the sunset. Any way you say it, 2006 will soon be history. Everyone's view of the year is colored by their values, expectations, and vantage point. On this page, I'd like to reflect on a couple of the issues that dominated my thoughts about the economy this year.

Housing may be the biggest story of 2006, especially when you consider its potential for influencing next year's economy as well. Housing markets slumped in the second half of the year, dragging activity levels from boom to bust in just a few months. Building permits were issued at a seasonally adjusted annual rate of 2.1 million housing units in the first quarter, declined in each successive quarter, and stood at 1.5 million units in October. Builders themselves have suffered to various degrees, but for the most part seem to be financially viable after several strong years of profitability.

The pace of new home building in itself will not be the most pressing issue for the fortunes of the economy. Yes, the downswing in new home construction will be large enough to show up in the statistics for national employment and output; it has already taken its toll this year. But housing market dynamics can depress consumer spending in a variety of ways.

Considering that housing constitutes the largest form of broad-based wealth in the country, consumers have good reason to feel less wealthy now than they did a year ago. As housing prices appreciated, homeowners pulled out some of their equity and spent it on other goods and services. When appreciation petered out, that extra consumption kicker was gone. Finally, short-term interest rates have risen considerably since the time when many homebuyers took out adjustable-rate mortgages that are only now starting to reset. Rising mortgage payments, other things being equal, seem likely to crowd out consumption.

Housing has played a key role in this year's inflation statistics. One of the largest components in the Consumer Price Index market basket is owners'

equivalent rent (OER) on primary residences—an estimate of the rent that homeowners would pay if they didn't own their homes. OER accounts for about 25% of the CPI market basket, enough for its volatility to show up in the movements of the total CPI.

Utility prices can obscure the true OER picture, so they are actually subtracted from the initial calculation. This means that when utility bills fall, as they have done lately, the OER rises, as indeed it has. Ironically, this combination of events put upward pressure on the CPI's housing component, just when housing and utility prices were weakening. OER increased at a rate of about 2¹/₂% in 2004–05, but is now increasing at a 4% rate. If price movements in the OER component were to decline only by a percentage point, the effect on the CPI's rate of change would be ¹/₄%—a welcome reduction.

At the moment, the price of energy is playing the hero's role in the inflation drama, although it was the villain during summer stock. The spot price of crude oil today is the same as it was at the beginning of the year, roughly \$53 per barrel. Yet by mid-August, the price had escalated to nearly \$70, stoking fears of another wave of inflation, just as the economy began to flag under the weight of declines in home building and automobile production. The more recent energy market developments are providing some breathing room for monetary policy makers, who have been on the alert for any signs that inflationary pressures might intensify.

There is one 2006 development that has had almost no effect on this year's economy but looms larger in the picture for 2007, 2008, and beyond. That development is the reversal in positions of the two major political parties in the U.S. Congress. The ascendant party is espousing a different philosophy on trade, energy, and tax policy (to name just a few issues) than the party heading to the backbenches. And yet no party is in a position to dictate to the other. The parties' relative strengths will certainly shape economic performance, but in ways that have yet to become clear.