FOCUS ON THE ECONOMY

THE PUBLIC POLICY PIECE OF THE ECONOMICS PUZZLE

by Hugh F. Kelly, CRE

There once was a barroom prohibition against discussions of religion or politics—a rule no doubt instituted for the protection of both the inventory and the real estate. The pages of *Real Estate Issues* are a more sober context, though, and I am going to hazard an economic discussion that may cross over the line into politics, at least implicitly. In the Winter edition of *REI*, this column attempted to offer some diagnostics on the U.S. economic cycle. At that time, I suggested that we'd deal with public policy, business management, and world affairs in a series of essays. What follows are some observations on the public policy dimension of the economy.

On March 28, 2002, the U.S. Bureau of Economic Analysis (BEA) released its "final" revision of fourth quarter 2001 GDP statistics. The BEA reported that the national economy had expanded at a 1.7 percent annual rate, posting a net growth of 1.2 percent for all of 2001, despite the third quarter's contraction of 1.3 percent. In the year's final three months, the turnaround was led by a 6.1 percent advance in personal consumption expenditures and a 10.2 percent rise in government expenditures from third quarter levels.

To determine the implications for real estate, let's take a look at that 10.2 percent increase in government spending, first on a policy basis. Next, in some detail, we'll unpack how budgetary choices—fiscal policy—affect the business cycle. Finally, we'll examine the complementary tool available in Washington—monetary policy—exercised through the Federal Reserve Board, also with an eye to cycles and local effects.

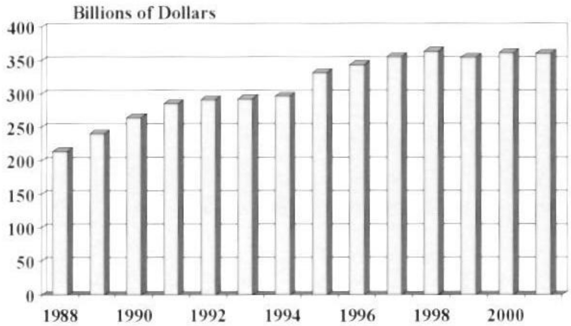
First of all, it is always a good idea to be wary of quarter-to-quarter shifts, (and even more wary of month-to-month changes). The shorter the period, the more volatile the figures are likely to be when they are reported in the economists' standard measure of the "seasonally adjusted annual rate" (SAAR). Nevertheless, when we look at the "real" (*i.e.*, constant dollar) annual percentage change in government spending for the year, we do see an increase in spending of 3.6 percent. The fourth quarter surge followed a change in government expenditure in the third quarter that was just 0.3 percent, betraying a "Johnny-come-lately" response by budgeteers to a recession that the National Bureau of Economic Research says began in March 2001. A classic headline was published in the *New York Times* last month: "Fed Chief Sees Decline Over; House Passes Recovery Bill" (March 8, 2002).

However late, though, an increase in governmental spending at points of national economic weakness is a fully appropriate action at the federal level. This is true even if it means running a federal budget deficit. The right time to run deficits is in recession; the right time to run surpluses is during expansions.

Exhibits 1 - 4

Exhibit 1

Interest Payments on U.S. Federal Debt

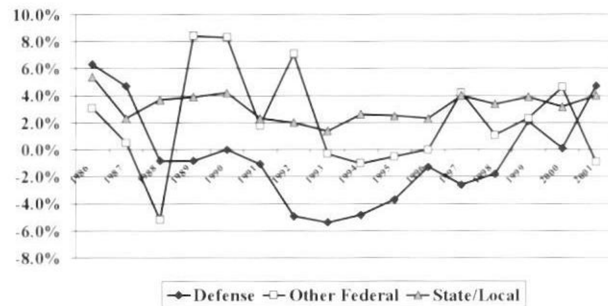


Source: U.S. Treasury Dept.

Exhibit 2

Government Expenditures

Real Annual Percentage Change



Source: U.S. Bureau of Economic Analysis

Exhibit 3

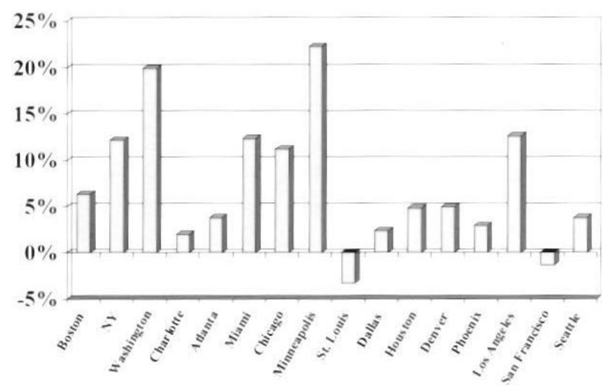
Commercial Mortgage Leverage Advantage Widens in 2001

Source: CCIM/Landauer Investment Trends Quarterly

Exhibit 4

Change in Median Home Prices

4th Q 2000 - 4th Q 2001



Source: National Association of Realtors

This rule of thumb is something that had been neglected for a quarter century, as we ran federal budget deficits in good times and in bad. The national debt is now about $6 trillion, and in fiscal year 2001 the U.S. Treasury had an interest expense on that debt of $360 billion. *(See Exhibit 1).* That is roughly equivalent to the entire Defense budget for consumption and investment for the year. So, in terms of policy, while the counter-cyclical spending surge is the right move, it should not be made permanent. One key to keeping policy options optimal in future downturns is to return to running a prudent surplus once the economy is safely back in growth mode. It would be a major mistake to back future policymakers into a corner by broad-based tax cutting that seeks to starve the government of revenue. That was the philosophy of Arthur Laffer and other "supply-side economists" of the 1980s—intellectually bankrupt and disastrous in application.

Budgets are planning documents and government money is actually spent by appropriations bills. Funds for the military, for highways, for unemployment insurance, and for Medicaid, all grew at double-digit rates by the end of 2001, despite the inability to negotiate a stimulus package in Washington until early March 2002. That bill extends unemployment benefits for a longer period, and offers investment incentives for business plant and equipment spending. As it happens, such a modest approach may be exactly right for this cycle.

That money will be spent according to national priorities, and the tenor of discussions now suggests that military spending will be at the front of the line for the next several years. The "peace dividend" of the early '90s shrank away long ago *(see Exhibit 2),* but the domestic economic expansion allowed non-defense government spending to increase roughly in line with GDP growth from 1997 to 2000. In 2001, however, it turned negative, even as defense expenditures jumped more than 4 percent in real terms. That relationship—faster growth for the military than for domestic governmental programs—is likely to be a hallmark of the Bush Administration.

Localities with major bases and/or significant defense contracting in their economic base will be seeing the positive effect of federal spending stimulus well into the recovery period for the U.S. economy as a whole. Also, given the high-technology predilections of military procurement, tech-based areas should also see sharp rebounds in 2002 and 2003, far better than most analysts are forecasting right now. Cities now suffering, including Phoenix, San Jose, Seattle, and Austin, could find themselves in an encouraging rebound before this year is through, with thanks to federal fiscal policy. Other areas that have held up rather well—such as Southern California markets like San Diego and Orange Counties, San Antonio in Texas, and Raleigh-Durham's Research Triangle—might find themselves poised to accelerate their growth. These are areas where real estate professionals should be looking closely at economic trends to discover opportunities stemming from improved demand.

If the players on the fiscal side of government policy—namely, Congress and the executive branch—were laggards in addressing last year's economic threat, the Federal Reserve can at least be credited with instituting its regime of interest rate reduction at the beginning of 2001 when, officially at least, the recession had not yet arrived. A year ago in this column I predicted that the nation would avoid a recession if the Fed continued its rate-cut program. Absent the September 11 attacks, it now seems evident that we could have had a "soft landing" in 2001 and that we might have avoided even a single quarter of negative GDP. But that is unknowable now, and it is fruitless to speculate on what might have been.

It is worth at least a short look at the impact of the sustained reduction in interest rates on economic activity, especially as it has affected real estate markets. The Fed is charged with being an independent (that is, non-political) agent, assuring the safety and soundness of the banking system and, by management of inflationary forces, of the currency itself. In practice, the Fed has become more and more a "nuanced" force in shaping the domestic and indeed the international economy by its decisions about interest rates and its moves to provide or withdraw liquidity from the capital markets at critical moments (*"kairos,"* as I described the situation in the Spring 2001 column).

Generally speaking, the reason why commercial property values have remained "sticky" in the present cycle (that is, they have not deteriorated to the degree that rising vacancies and falling rents suggest they might) is that the markets have stayed quite liquid throughout the nation. Ample and very cheap debt capital is very much part of this reason. When commercial property can be purchased at cap rates of 9 percent - 10 percent, but mortgage debt is available at 7 percent, transaction markets can remain healthy. *(See Exhibit 3).* And the reason lenders can put out mortgage money at 7 percent is that their own cost of funds is even less. Equity spreads, in fact, widened sharply over the course of 2001 and this is an under-appreciated consequence of monetary policy and a reason why real estate is not being blamed for contributing to the 2001 recession.

Home values also were buoyed by low mortgage rates. Freddie Mac reports that the average 30-year fixed rate mortgage for all of 2001 was 6.97 percent, which helped push existing home sales up to a record 5.25 million units. And, while new mortgage originations for 2001 were a strong $882 billion, refinancing accounted for 55 percent of all mortgage lending on one-to-four family residential properties, a total of $1,149 billion in such loans, according to the Mortgage Bankers Association of America. That represented a huge cash infusion for the economy, and makes the extraordinary performance of the consumer sector much more understandable than the year's weak employment statistics do.

As in the case of fiscal policy, the impact of monetary easing did not land equally on all parts of the country. Data from the National Association of Realtors on median home prices demonstrate the uneven impacts *(see Exhibit 4).* Low interest rates were not enough to salvage the year for St. Louis and San Francisco. And a variety of Sunbelt cities (such as Atlanta and Charlotte in the Southeast, and boom/bust energy and technology cities like Dallas, Houston, Denver, Seattle, and Phoenix) had fairly tepid home price increases. But at least a half-dozen of the nation's largest market areas had housing prices posting gains of 10 percent or more: New York, Washington, D.C., Miami, Chicago, Minneapolis, and Los Angeles.

Short-term interest rates should be rising as 2002 progresses and the economy gets back on its feet. It is unlikely that the Fed will drive rates up with the enthusiasm that it propelled them downward, though. More likely, we'll see a flattening yield curve, fewer adjustable rate home mortgages, and some slowing in housing transaction and refinancing velocity. That's okay, as long as fundamentals in other segments of the economy come back. Those segments are industrial production, economic productivity, corporate profits, and employment. We'll turn our attention to those in the next column. REI

ABOUT OUR FEATURED COLUMNIST

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