Economics forecast paper

Interest rates & housing Interest Rates & Housing Industry Housing industry is the broader term that encompasses both residential and commercial building activity, which has been in the news recently, threatening the health of our national economy. The Federal Reserve Board (FED) is seized of the situation and the market expectation of softening interest rates is high. This paper aims to analyze and forecast the relationship between interest rates and housing industry across the United States in general and in the state of California in particular.

Relation between interest rates and housing industry

Interest rates and housing starts have an inverse relationship – declining interest rates and therefore cheaper loans, lead to jump in housing starts and vice versa. Adjustable home loan rates have attracted more consumers. The risk involved in the possibility of increases in interest / repayment obligations which was not realized by the consumers, is now being driven home literally. The crisis got deepened due to the unregulated growth of derivative markets for mortgage loans, which has now impacted everyone – the consumers, the financial institutions, the industry and the national economy as a whole.

Interest rate scenario and forecast

In the last 12 years since 1995, the US bank prime rate has changed as follows (FED Statistics):

1995 96 97 98 99 2000 01 02 03 04 05 06 07

8. 83 8. 27 8. 44 8. 35 8. 00 9. 23 6. 91 4. 67 4. 12 4. 34 6. 19 7. 96 7. 7*

(*estimated)

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As can be seen, the rates remained high during 1995 – 2000 and started declining from 2001 to 2004 but again started firming up from 2005 onwards. Increase/decrease in the bank prime rate has corresponding impact on commercial lending in the economy. This period coincided with the decline in the number of housing starts both nationally and in California, which in the later area reduced from 1 million plus to just about 200, 000 during the above period.

In view of the serious crisis in the mortgage and financial industries, and in order to avoid the lurking fears of recession, one can forecast that the bank rates across the sectors will soften in the short to medium term period, as already confirmed by the 25 basis points cut announced by the FED this week. This policy approach will help to stabilize the home loan industry and at the same time impact the national economy positively.

Impact of budget deficits/surpluses on economy and home building industry

Budget deficit is the gap between the planned spending and revenues of the government for a given financial year (It becomes a surplus if the revenue exceeds the spending). The higher the government spending, the higher is the economic activity and vice versa. However, pumping too much money into the system, without creating corresponding products or services, will stoke inflationary trends and can lead to a decline in consumer spending and hence, a decline in the demand. A delicate balance is maintained to help economic growth without raising inflation beyond reasonable limits. To this extent, housing industry which forms about 10% of the GDP is directly related to the budget deficits/surpluses and monetary policy decisions.

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References

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