

above any sustainable rate this side of nirvana. On top of this many forecasts are calling for an even higher growth in earnings, 16% for the next year. In the shorter run forecasts are calling for 3rd and 4th quarter results to top 1998 figures by 24% and 21% respectively. Corporations have generated profits at an extraordinary rate and the market is currently expecting and pricing an even better performance.

The other part of the evaluation puzzle is the expectation for interest rates. An analysis of the yield curve and futures markets is indicating that rates are expected to rise to around 7% for long-term instruments and to about 5.65% for the short end. This represents about a 90 basis point rise on the long end and 40 points on the short end.

It is important that we realize that the Federal Reserve had to operate as a World central bank after the Asian crisis. With the flight from local currencies to the dollar the Fed was very expansive and is now returning to a more normal policy. This should not be mistaken as tightening. Their performance over the past 6 years has been masterful. Can we count on such performance in the future? The market is betting heavily that this mastery will continue.

Are the markets right? I believe that long rates will not go as high as 7% but that short rates will edge up about 50 basis points. Inflation is a monetary phenomenon. It results from mistakes in policy, usually because of bad information or a misinterpretation of good data and only rarely as a policy of "the lesser of two evils." The biggest difficulty, as I see it, is still the problem of predicting the strength of the recoveries in Japan and Europe. If the Fed underestimates the pace of these overseas economies then we will face rising inflation and ultimately higher rates.

The market's optimism about earnings is more troubling. I don't think that we will get the growth in operating earnings that it seems to be expecting. By no means am I expecting a contraction in the general economy but any disappointment could cause a significant decline in stock prices since there is no margin for error built in to these high P/Es.

Finally, the next 12 months should see returns on stocks in the single digits with a fair amount of volatility. The total return in the long-term bond market may not even achieve positive returns. Given the market's past performance this is not bad but it may not feel good.

The International Economy

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Economic growth around the world in 1998 fell below long-run trend; 1999 will not be better than 1998. **Table 1**, based on data available in May 1999, indicates that world output is growing below the average growth rate of the last twenty years. The proximate reasons are that, while the United States is booming, the rest of the world is not. Japan has been in a deep recession and is now struggling to make a come back. The South East Asian economies, swept by a currency crisis in 1997, suffered a sharp growth slowdown. The Russian economy imploded after its government defaulted on its debt and could not prevent a massive devaluation of the ruble in 1998. Brazil as well had a currency crisis in 1999, although with modest consequences on the real sector. Finally, a couple of critical countries (Germany and Italy) of the European Union were scoring disappointing performances.

The outlook for 2000 is good for economic growth. **Table 1** reproduces the real GDP forecast for next year by the International Monetary Fund (IMF). The forecast was made in May 1999. Since then news has been positive for economic growth. Activity is picking up in Japan, although hampered by a tight monetary policy by the Bank of Japan. Improved conditions are emerging in Germany and Italy. The South East Asian economies, in particular South Korea, have made an impressive recovery fueled by expansive fiscal policies and devaluation-led export growth. Finally, economic growth in the United States shows no sign of abating.

The *Economist's* poll of forecasts (see **Table 2**) suggests that the world will have at least two growth locomotives in 2000: the United States and the 11 countries that have formed the European Monetary Union (France, Germany, Italy, Spain, Portugal, Belgium, Luxembourg, Netherlands, Austria, Finland, and Ireland). Both areas will be running close to their sustainable pace. For Japan recovery appears still slow, but there is growing optimism that the country is seeing the light at the end of a long tunnel of disappointment and under performance. For almost 10 years the Japanese economy has been a pale resemblance of mighty Japan Inc. The long crisis started with a deflation of a real estate bubble, which led to a

Table 1
Summary of World Output (Annual Percent Change)

Average	1991-2000	1996	1997	1998	1999 (Est.)	2000 (For.)
World	3.1	4.3	4.2	2.5	2.3	3.4
Advanced Economies	2.3	3.2	3.2	2.2	2.0	2.3
Japan	1.0	5.0	1.4	-2.8	-1.4	0.3
European Union	1.9	1.8	2.7	2.8	1.8	2.7
Canada	2.2	1.2	3.8	3.0	2.6	2.5
Developing Countries	5.4	6.5	5.7	3.3	3.1	4.9
Asia	7.3	8.2	6.6	3.8	4.7	5.7

Source: International Monetary Fund, *World Economic Outlook*, May 1999

Table 2
The Economist Poll of Forecasters (October Averages)

	GDP Forecast		Consumer Prices Forecast		Current Account % of GDP, Forecast	
	1999	2000	1999	2000	1999	2000
U.S.	+3.9	+3.0	+2.2	+2.6	-3.6	-3.8
Japan	+1.0	+0.8	-0.3	-0.2	2.9	3.1
Euro 11	+2.0	+2.9	+1.2	+1.5	1.1	1.0
Canada	+3.6	+3.0	+1.7	+2.1	-0.8	-0.4
United Kingdom	+1.7	+3.0	+1.9	+2.4	-1.3	-1.7

Source: *The Economist*, 16 October 1999

deterioration of the quality of bank assets. Politicians were slow and negligent in recognizing the severity of the problem. This festered, revealing cracks in Japan Inc. An appreciating yen put pressure on the economy to reduce its current-account surplus. The restructuring process from an export-oriented to a domestic-oriented economy turned out to be slower than anticipated. The consensus approach underlying much of Japanese society became an impediment for change. Things had to become much worse before turning for the better. There is some evidence that the corner has been turned, although doubts remain about the character of economic policy in the country.

Improved economic conditions abroad will give a boost to U.S. exports. Based on the latest figures, real exports of goods were 14 per cent higher than a year ago. But a turnaround in the U.S. current account is distant in the future. And this for two reasons. The first is that the U.S. appetite for imports, fueled by a robust economy, is larger than foreign appetite for U.S. exports. In 1999, U.S. imports are rising much faster than U.S. exports. Given that imported goods and services are approximately 30 percent larger than exports of goods and services, the higher growth of imports over exports adds a dynamic force on top of a static one, exacerbating the trade deficit. The second reason for a large deficit in the current account has to do with our large negative net international investment position. At the end of 1997, U.S. assets abroad were \$5 trillion and foreign assets in the United States \$6.32 trillion, giving a negative imbalance of \$1.32 trillion. This imbalance—by far the largest of any single country in the world—implies that the U.S. will be a net payer of dividends and interest to the rest of the world. The negative investment income flow is recorded in the current account. In turn, today's current account deficit implies a larger net negative international investment position and tomorrow's larger negative investment income flows and larger current account deficit, and so on. The *Economist's* poll of forecasters puts the U.S. current account deficit at 3.8 per cent of U.S. GDP. Given our forecast for GDP, this translates to approximately \$360 billion deficit, which will have to be financed by a net capital inflow and a rise in our net foreign indebtedness.

The interesting question is how long can the U.S. continue to borrow from the rest of the world? We know for sure that we cannot do it forever; we also know that if we did not have the most important currency in the world we would have already been forced to make adjustments. What we do not know is when the world capital markets will pull the plug on us. Suppose, for argument's sake, that in the year 2000 the U.S. could not attract 3.8 per cent of GDP in net capital inflows to finance the projected current ac-

count deficit. The current account would be forced to zero by a combination of more exports and fewer imports. For exports to rise substantially, the dollar would have to depreciate significantly in the exchange markets with the obvious consequences on domestic price inflation. For imports to fall sharply, the U.S. would have to suffer a cut in income. This is what usually happens in countries that have to correct a current account deficit: unpleasant but necessary consequences. The U.S. has had current account deficits for almost 20 years. It may continue to have them for several more, but not forever. Sooner or later the adjustment will have to be made. Capital flows are notoriously fickle; when they move they do it fast, without pre-announcements. In sum, the above adjustment scenario is one of the possible risks of the forecast: perhaps a low probability event, but certainly not zero.

Housing Outlook

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Existing single-family home sales fell along with consensus expectations in September. Record levels of home sales are virtually assured for 1999, with the pace expected to ease only slightly next year, according to the National Association of Realtors. While volume is now 10 percent below June's record, sales remain strong, as they have all year. Mortgage rates pulled back slightly in September from their August high. The dramatic increase in borrowing costs seems to finally be having an effect on the red-hot housing market.

Both average and median prices fell as excess demand for housing fell. Builders have been rapidly catching up with declining demand. Consumer confidence continues to buoy the market, but the impact of higher interest rates and bearish financial markets is taking hold.

Sales are expected to fall again in October as mortgage rates are pushed up by the prospect of Fed tightening and the weakening dollar. Moderation in the volatile residential construction industry could remove one of the most serious inflationary threats. A slowdown in home price appreciation would force consumers to spend within their means, as they can no longer count on rapid gains in real or financial

asset prices.

The combination of rapid price appreciation and increased mortgage rates has been cutting into housing demand. Potential home shoppers can no longer assume double-digit asset price gains and low mortgage rates. This is exactly what the Fed intended when it began tightening policy this summer. As there is little besides consumer confidence maintaining high levels of home sales, further Fed tightening could quickly shrink the housing market.

While sales remain at a high level, price appreciation has stalled, except on the West Coast. The stock market's September struggles are especially impacting demand for high-end homes. With housing supply increasing faster than demand, rapid and broad-based price appreciation is unlikely. Consumers remain confident, but simply can no longer afford as much house as they could a few months ago.

The Fed's efforts are having an impact. The most immediate casualty has been the mortgage refinancing market. Refinancings, which soared to a record \$800 billion last year, are currently running at a \$200 billion annual pace and are sure to weaken further with fixed mortgage rates now near 8%. The refinancing boom was one of the catalysts for the recent consumer spending binge, as homeowners lowered their mortgage payments and many took cash out of their homes by increasing their mortgage balance.

The housing market will also soon begin to feel the impact of higher rates. The market has largely shrugged off the higher rates as fence sitters have recently surged into the market in an effort to buy before mortgage rates move even higher. This activity will wane in coming weeks, however.

Housing starts for 1999 as a whole will probably total 1.66 million units, up about 2 percent from last year's historically high figure. Housing starts were down in three out of four regions of the country, with the largest decline – 25.7 percent – occurring in the Northeast. With mortgage rates back up to the 8 percent range, builders are seeing fewer current home sales and are less optimistic about sales in the near future. Housing starts are expected to slip to 1.56 million in 2000.

Existing-home sales are expected to total 5.20 million this year, which will be a 4.8 percent increase over the record 4.96 million sales in 1998. New-home sales are likely to match last year's record of 890,000, then ease to about 831,000 in the year 2000. The median-price of an existing home for 1999 is projected to be \$132,700, up 3.7 percent from 1998. At the same time, the median new-home price is expected to be \$158,500 for 1999, up 4.3 percent from last year. The median existing-home price is expected to rise only 1.4 percent to \$134,500 in the year 2000.