Testimony of

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On Behalf of the
National Association of Home Builders

Before the
Joint Economic Committee

"The Economic Outlook"

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Thank you Chairman Saxton and members of the Joint Economic Committee, I appreciate the opportunity to testify before you today on behalf of the National Association of Home Builders (NAHB). NAHB represents more than 220,000 members involved in home building, remodeling, multifamily construction, property management, subcontracting, and light commercial construction. NAHB is affiliated with more than 800 state and local home builder associations around the country. Our builder members will construct approximately 80 percent of the more than 1.84 million new housing units projected for construction in 2005.

The home building industry has been one of the strongest contributors to the national economy in recent years. We have had record years of production that have led to the highest homeownership rate in U.S. history -- 69 percent. It is in America's interest to assure that the home building industry maintains its leadership role in the economy, not only because housing and related industries account for 16 percent of the gross national product (GDP), but most importantly because of the benefits of home ownership to our country.

Introduction

The current U.S. economic expansion began almost four years ago, payroll employment has been growing for about two years, and the unemployment rate has come down substantially in the process.

The housing sector has been a pillar of strength throughout this economic expansion. The housing production component of GDP (residential fixed investment) has delivered major contributions to growth, particularly since early last year, and surging home sales and residential construction have pulled related components of GDP ahead as well -- including the furniture and household equipment component of consumer spending. The volume of services produced by the housing stock and consumed by households also has been a large and growing component of GDP. Finally, surging house prices have generated massive amounts of wealth for America's homeowners, and debt-financed "extraction" of housing equity has supported spending on residential remodeling and a variety of consumer goods and services. Everything considered, it's safe to say that the housing sector has contributed at least a full percentage point to overall GDP growth in recent times, conservatively accounting for between one-fourth and one-third of the total.

The extraordinarily strong performance of housing, including the large cumulative increase in house prices, has prompted widespread charges of an unsustainable housing boom as well as projections of a bust that could wreck not only the housing market but also the entire economy. Indeed, analogies have been drawn between the current housing market and the stock market bubble that preceded the recession of 2001.

The housing market inevitably will cool down to some degree before long, but a destructive housing bust is not in the cards; furthermore, rebuilding in the wake of this year's hurricane season will add to housing production for years to come. Everything considered, the housing sector should transition from a strong engine of economic growth to a more neutral factor in the GDP growth equation, but housing will continue to play a vital role in U.S. economic activity going forward.

It should be noted that the housing forecasts presented below (attachment) assume that the current U.S. housing policy structure remains essentially intact, with some temporary enhancements to deal with the extraordinary housing issues created by hurricanes Katrina and Rita and with maintenance of current benefits to housing in the tax code and the housing finance system.

Forecast Highlights

- The U.S. economy was performing quite well prior to hurricanes Katrina and Rita and has enough fundamental strength to easily weather the storms.

- The hurricanes took an immediate toll on growth of economic output and employment and may shift energy costs upward for an extended period of time. But the recovery and reconstruction process will soon provide enough economic stimulus to outweigh the negatives, thanks largely to the federal government response.

- The higher energy costs provoked by the hurricanes are putting upward pressures on headline inflation numbers but that effect will diminish with time. Core inflation (excluding prices of food and energy) promises to accelerate modestly during the next year or so as labor markets tighten further and high energy prices inevitably leak into the core.

- The Federal Reserve tightened monetary policy another notch on September 20, judging that the longer-term inflationary implications of Katrina outweigh the short-term economic negatives. Additional quarter-point hikes are likely at the next three FOMC meetings, taking monetary policy to an approximately "neutral" position as Chairman Greenspan's term runs out at the end of January 2006.

- Long-term interest rates have firmed up from their post-Katrina lows as the bond markets have judged that the economy will weather both storms and generate an inflation issue in line with the Fed's concerns. Long-term rates should move up somewhat further in coming quarters, lessening the risk of yield curve inversion as the central bank raises short-term rates.

- Katrina and Rita destroyed more than 350,000 housing units and significantly damaged another 330,000, creating the potential for a huge repair and rebuilding process with major implications for residential remodeling, manufactured home shipments and conventional housing starts--both inside and outside the impacted areas.

- NAHB's housing forecasts incorporate tentative assumptions regarding the timing and the patterns of repair and rebuilding in the wake of the hurricanes. We're assuming that existing rental vacancies and available subsidized housing units in the Gulf region and elsewhere will meet some of the current need. We've also bolstered our outlook for residential remodeling and manufactured home shipments through 2007 while phasing in increases in conventional housing starts (single-family and multifamily) over an even longer period of time.

- Recent housing market indicators, on balance, suggest that home sales and housing starts were toying with cyclical peaks prior to Katrina, and surveys of builders and lenders conducted since then seem consistent with that judgment. However, the housing market still has a lot of fundamental strength and home prices still are trending upward -- at least according to most measures we have in hand.

- NAHB's housing outlook recognizes declines in housing affordability measures that so far have been caused by sustained rapid increases in house prices and that figure to be further eroded down the line by a persistent upshift in the interest rate structure. We're also anticipating less support to the single-family and condo markets from "exotic" forms of adjustable-rate mortgages and from investors/speculators that have been relying on short-term capital gains – two factors that undoubtedly have contributed to the recent housing boom in some areas.

- NAHB's housing forecast through 2007 shows a definite cooling down of the single-family and condo markets, with relatively strong performances turned in by rental housing, manufactured homes and remodeling -- owing in part to Katrina and Rita. Everything considered, the housing production component of GDP (residential fixed investment) should soon fall out of the economic "growth engine" category and exert a slight drag on GDP growth in both 2006 and 2007.

- The anticipated fade in demand for single-family houses and condo units will result in some deceleration of price gains in 2006-2007, but national average prices will not actually fall in the type of economic and financial market environment portrayed in our forecast. Prices could fall in some local markets that have experienced particularly strong increases in recent times, although persistent supply constraints in such areas should continue to support home prices for some time.

- Homeowner finances currently are quite healthy, despite a huge volume of borrowing against accumulated housing equity in recent years, and the Fed's Financial Obligations Ratio for homeowners still is in a manageable range. Furthermore, the vast majority of homeowners will not be disadvantaged by perspective increases in market interest rates and most have equity positions that could easily absorb declines in house values -- should they occur in some local markets.

Economic Growth

Incoming data suggest that annualized growth of real gross domestic product (GDP) was heading toward a robust pace of about 4.5 percent in the third quarter before Hurricane Katrina hit the Gulf Coast on August 29. We estimate that Katrina took nearly a percentage point out of third-quarter GDP growth (dropping it to an estimated 3.6 percent) and that the one-two punch from Katrina and Rita will hold fourth-quarter growth to 3.2 percent -- still a trend-like performance that displays the resilience of the U.S. economy to serious shocks.

GDP growth should accelerate in the first half of 2006 as rebuilding activities gear up in the wake of this year's unprecedented hurricane damage. A bit further out, GDP growth should settle down to a sustainable trend pace (around 3.25 percent), reflecting minimal remaining slack in labor markets and maintenance of solid growth in labor productivity.

Labor Markets

The employment report for September contained upward revisions to payroll employment for both July and August, bringing the average monthly gain to a robust 244,000. The preliminary estimate of net job losses in September came to only 35,000, much less than the consensus expectations, although data collection problems in the Gulf region definitely created a wide range of uncertainty.

For now, the Labor Department suggests that, in the absence of Katrina, employment growth probably would have followed its recent trend (an average gain of 194,000 for the previous 12 months), meaning that Katrina probably subtracted around 230,000 jobs from the national numbers in September. It's also worth noting that strikes subtracted 22,000 from the September payroll employment numbers, implying that, ex-Katrina and ex-strikes, payroll employment increased by about 225,000 -- in line with the strong July-August performance.

The labor market report for October will have to cope with hurricanes Katrina and Rita, both because more Katrina casualties will drop off payrolls and because Rita destroyed additional jobs of her own. However, the September-October disruption to job markets will be temporary, and national net job growth should regain a solid trend before long. Indeed, we're looking for resumption of strong payroll employment growth in 2006, aided by rebuilding activities, followed by a slowdown in 2007 as GDP growth recedes to around trend. The unemployment rate should sag a bit next year from the current hurricane-related level (5.1 percent) but then edge up a bit in 2007.

Energy Costs and Inflation

The hurricanes have seriously complicated the inflation picture, boosting energy prices and headline inflation in the near term and putting some upward pressure on core inflation down the line as energy prices inevitably seep into the business cost structure.

The disruptions to energy production and transmission in the Gulf region caused energy prices to spike sharply after Katrina, but prices subsided within a few weeks as the supply situation improved. However, the arrival of Rita caused energy prices to surge again, particularly for gasoline and natural gas, and prices for these products are likely to remain elevated for quite a while.

We're currently assuming that the spot price of WTI crude oil averages a record $65/barrel in the fourth quarter and gradually recedes to about $45/barrel by late 2007. We expect the retail price of gasoline to continue to recede gradually from the post-Katrina peak (above $3.00/gallon) but remain historically high across the forecast horizon. We also assume that persistently higher prices for natural gas will make their way into the prices for residential gas and electric service as utilities gain regulatory approval to raise their rates.

We expect core inflation to firm up to some degree, particularly in 2006, reflecting tight labor markets and stronger growth of hourly compensation as well as some pass-through of high energy prices. Core consumer price inflation is likely to rise from year-over-year rates of slightly below two percent in the third quarter of this year to about 2.5 percent by 2007. That pace may be around the upper end of the Federal Reserves "comfort zone."

Interest Rate Structure

The apparent strong forward momentum of the U.S. economy, along with the prospects for higher headline and core inflation, apparently have steeled Federal Reserve resolve to keep the inflation situation under control and have sent long-term rates upward.

The Fed enacted another quarter-point increase in short-term interest rates at the September 20 meeting of the Federal Open Market Committee (FOMC), raising the federal funds rate to 3.75 percent (the bank prime rate went to 6.75 percent in the process). While acknowledging the negative economic effects of Hurricane Katrina, the FOMC characterized these negatives as temporary and focused heavily on the evolving threats to core inflation. And while continuing to say that remaining monetary policy accommodation can be removed at a "measured" pace, the FOMC held open the possibility of a more aggressive approach in the event that inflation concerns become more serious than expected.

In recent weeks, various Fed spokespersons have stressed the evolving inflation threat, and another quarter-point rate hike at the next FOMC meeting on November 1 seems a foregone conclusion. Furthermore, we're assuming additional rate hikes at the December 13 and January 31 meetings, as Chairman Greenspan's term runs out. We're assuming the 4.5 percent funds rate will be considered "neutral" and that monetary policy will hold steady for some time.

The bond markets apparently share the Fed's perspectives on economic growth and inflation, and market expectations for monetary policy are essentially the same as ours. As a result, long-term interest rates have backed up considerably from their post-Katrina lows and the long-term home mortgage rate edged over 6.0 percent in the second week of

October. Our forecast shows some additional increase in long-term rates in coming quarters, with the home mortgage rate reaching 6.6 percent by the fourth quarter of 2006.

Hurricane Housing Damage

According to the October 3 Red Cross "disaster assessment" for hurricanes Katrina and Rita, the two storms destroyed an estimated 356,000 housing units, with 353,000 attributed to Katrina. This was more than 12 times the number destroyed in any previous natural disaster (or series of disasters) in the nation's history.

Furthermore, 146,000 units suffered "major" damage (not currently habitable), 184,000 had "minor" damage (could be occupied), and an additional 206,000 had "extremely minor" or "nuisance" damage such as a few missing shingles or broken windows. Four-fifths of the "destroyed" housing units (uninhabitable and beyond repair) are in Louisiana and nearly one-fifth are in Mississippi, while Alabama and Texas got off quite lightly in this regard. Total damaged housing units (needing major, minor or extremely minor repairs) amounted to 329,000 in Louisiana, 173,000 in Mississippi, 33,000 in Texas, and about 1,000 in Alabama.

The Red Cross has been trying to categorize destroyed or damaged homes by type of unit. Current estimates say 88 percent of destroyed units are single-family homes, 11 percent are apartment units and less than 1 percent are manufactured homes. Census Bureau numbers, on the other hand, show that about 15 percent of the housing stock in Louisiana, Mississippi and Alabama consisted of manufactured homes in 2000. Thus, it's likely that the Red Cross has been categorizing many destroyed or damaged HUD-code housing units as conventionally built single-family homes.

Whatever the exact numbers, it's perfectly clear that the cleanup, repair and rebuilding process in the wake of Katrina and Rita will be immense and that the implications for residential maintenance and repair, spending on improvements (including replacements of major systems), manufactured home shipments and conventional housing starts are profound. The timing and composition of the process will depend heavily on the pattern of government responses.

Repair/Reconstruction Assumptions

It's extremely difficult to estimate the patterns of repair and reconstruction of the housing stock that was destroyed or damaged by hurricanes Katrina and Rita. Experience with previous natural disasters, along with evolving patterns of federal government assistance in the wake of Katrina-Rita, have led us to the following working assumptions for the 9-quarter period extending through the end of 2007:

- $1.8 billion for outlays on residential maintenance and repair.
- $4.7 billion for improvements to residential structures (including replacements of major systems such as roofs and heating systems).
- 38,000 manufactured home shipments (HUD-code units).
- 90,000 conventional housing starts (80 percent single-family units), including units built on existing foundations in the Gulf region.

Recent Housing Performance

Housing market indicators painted a fundamentally positive picture through the pre-Katrina period (essentially through August). Single-family starts and permits for August held in the record range established during other recent months, sales of existing homes (based on closings) displayed a similar pattern, and "pending" sales of existing homes (based on contracts signed) actually moved up to a new record in August. Sales of new homes (contract basis) fell off in August following a record pace in July, but statistical problems definitely contributed to volatility in those months (hardly a new problem with this series).

For the post-Katrina period, NAHB's single-family Housing Market Index fell by two points in September but regained that loss in October, leaving the index slightly below the cyclical peak in June. The weekly index of applications for mortgages to buy homes (Mortgage Bankers Association series) was essentially flat throughout August, September and early October (4-week moving average basis).

Everything considered, it seems fair to say that single-family housing activity has been toying with a cyclical peak and is poised to show some fade before long. Measures of home-buying affordability have been eroding in the face of ongoing rapid increases in house prices in many areas, and the recent upshift in short- and long-term interest rates figures to take some toll as well. Furthermore, there's a good chance that those "exotic" forms of adjustable-rate mortgages are losing some luster under the public scrutiny of federal financial regulators and the rating agencies. Finally, there's some tentative evidence of decline in the investor shares of purchases of single-family homes and condo units, and this component of demand can be quite fragile.

The Housing Forecasts

NAHB's forecast shows a slight decline in total housing starts in the fourth quarter of this year, partly because of hurricane effects in the Gulf region, and we expect total starts to be down moderately in both 2006 and 2007, despite hurricane-related additions.

Our forecast for 2006-2007 shows a cumulative decline of 9 percent in single-family starts from the 2005 record. The multifamily sector is essentially flat in this forecast, thanks primarily to a good performance by the rental sector. We expect manufactured home shipments to pick up significantly in coming quarters, reaching 150,000 units in 2006 before settling back toward a pre-Katrina pace. Residential remodeling should post solid growth (in both nominal and real terms) throughout the forecast period, supported by a massive amount of homeowner equity and swollen repair/improvement needs in the wake of the hurricanes.

Everything included, the residential fixed investment component of GDP should soon move out of the strong "growth engine" category occupied since the 2001 recession, although the real value of RFI should remain within a few percentage points of the record high reached in the third quarter of this year.

Homeowner Finances

Various media reports have been insisting that heavy borrowing against housing equity has been pushing homeowner finances to the brink of disaster. Indeed, Federal Reserve Chairman Alan Greenspan recently unveiled Fed research showing net home equity "extraction" of $600 billion in 2004 (6.92 percent of disposable income), and borrowing against equity could be even bigger this year.

These are staggering numbers, of course, but they don't actually mean that something has gone wrong. Indeed, the Fed's own national balance sheets show that homeowner equity grew to $10.5 trillion by mid-2005, up by 18 percent from a year earlier. Furthermore, the aggregate housing debt-to-value ratio stood at 43 percent at mid-year, lower than at any time in recent years.

It's also clear that mortgage debt repayment is not placing an undue burden on the income of America's homeowners -- partly because mortgage debt has been substituting for a lot of shorter-term, higher-cost, consumer debt. Indeed, the Fed's Financial Obligations Ratio for homeowners was only 16.37 percent in the second quarter, compared with 28.87 percent for renter households.

While it's possible to find debt-strapped homeowners, the overall picture shows remarkably healthy homeowner finances and a housing equity nest egg that could withstand sizeable shocks. Indeed Chairman Greenspan recently pointed out that "only a small fraction of households across the country have loan-to-value ratios greater than 90 percent" and that "the vast majority of homeowners have a sizeable equity cushion with which to absorb a potential decline in house prices."*

Mr. Chairman, that concludes my remarks. Again, thank you for the opportunity to appear before you today. I look forward to answering any questions you or the members of the Committee may have for me.

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*Alan Greenspan, remarks on "Mortgage Banking" to the American Bankers Association Annual Convention, September 26, 2005.

NAHB ECONOMIC AND HOUSING FORECAST

14-Oct-05

	Economic Activity			Interest Rates				New Housing Units					Home Sales		
						Mortgages*		Starts							
	Real GDP	Consumer Price Index	Unemp. Rate	Federal Funds	Prime	Fixed Rate	Adjustable Rate	Total	Single-Family	Multi-family	Mfg. Home Shipments	Total New Housing	New	Single-Family Existing	Residential Fixed Investment**
	Percent Change		Percent					Thousands of Units							Percent Chg.
Annual Data * **															
1992	3.3%	3.0%	7.5%	3.5%	6.3%	8.4%	5.6%	1,201	1,032	170	210	1,412	614	3,143	13.8%
1993	2.7%	3.0%	6.9%	3.0%	6.0%	7.3%	4.6%	1,292	1,131	161	255	1,546	674	3,421	8.2%
1994	4.0%	2.6%	6.1%	4.2%	7.1%	8.4%	5.3%	1,446	1,191	255	305	1,751	667	3,554	9.6%
1995	2.5%	2.8%	5.6%	5.8%	8.8%	8.0%	6.1%	1,361	1,082	279	341	1,702	670	3,514	-3.2%
1996	3.7%	2.9%	5.4%	5.3%	8.3%	7.8%	5.7%	1,469	1,154	314	362	1,830	756	3,783	8.0%
1997	4.5%	2.3%	4.9%	5.5%	8.4%	7.6%	5.6%	1,475	1,136	338	354	1,828	806	3,973	1.9%
1998	4.2%	1.5%	4.5%	5.4%	8.4%	6.9%	5.6%	1,621	1,278	344	374	1,995	889	4,492	7.6%
1999	4.4%	2.2%	4.2%	5.0%	8.0%	7.4%	6.0%	1,647	1,306	341	348	1,996	879	4,626	6.0%
2000	3.7%	3.4%	4.0%	6.2%	9.2%	8.1%	7.0%	1,573	1,232	341	250	1,823	880	4,607	0.8%
2001	0.8%	2.8%	4.8%	3.9%	6.9%	7.0%	5.8%	1,601	1,272	330	192	1,793	907	4,723	0.4%
2002	1.6%	1.6%	5.8%	1.7%	4.7%	6.5%	4.6%	1,710	1,363	347	168	1,878	976	4,995	4.8%
2003	2.7%	2.3%	6.0%	1.1%	4.1%	5.8%	3.8%	1,854	1,505	349	131	1,985	1,091	5,441	8.4%
2004	4.2%	2.7%	5.5%	1.3%	4.3%	5.8%	3.9%	1,950	1,604	345	130	2,080	1,200	5,913	10.3%
2005	3.6%	3.4%	5.1%	3.2%	6.2%	5.8%	4.5%	2,032	1,683	349	134	2,166	1,275	6,167	6.4%
2006	3.5%	2.8%	5.0%	4.5%	7.5%	6.5%	5.4%	1,940	1,590	350	150	2,090	1,215	5,894	0.6%
2007	3.3%	2.2%	5.0%	4.5%	7.5%	6.6%	5.5%	1,883	1,533	350	143	2,025	1,171	5,707	-0.9%
Quarterly Data ****															
2004															
Q1	4.3%	3.9%	5.7%	1.0%	4.0%	5.6%	3.5%	1,929	1,562	367	126	2,055	1,189	5,563	5.1%
Q2	3.5%	4.4%	5.6%	1.0%	4.0%	6.1%	3.9%	1,923	1,600	323	127	2,050	1,203	6,070	17.8%
Q3	4.0%	1.6%	5.4%	1.4%	4.4%	5.9%	4.1%	1,974	1,635	339	129	2,103	1,164	5,970	2.6%
Q4	3.3%	3.6%	5.4%	1.9%	4.9%	5.7%	4.1%	1,973	1,621	352	138	2,111	1,243	6,047	1.6%
2005															
Q1	3.8%	2.4%	5.3%	2.5%	5.4%	5.8%	4.2%	2,083	1,709	374	137	2,220	1,249	5,980	9.5%
Q2	3.3%	4.2%	5.1%	2.9%	5.9%	5.7%	4.2%	2,044	1,693	351	129	2,174	1,289	6,297	10.8%
Q3	3.6%	4.8%	5.0%	3.5%	6.4%	5.8%	4.5%	2,020	1,690	330	125	2,145	1,300	6,290	3.3%
Q4	3.2%	4.2%	5.1%	4.0%	7.0%	6.1%	5.0%	1,980	1,640	340	145	2,125	1,261	6,101	-0.8%
2006															
Q1	3.8%	1.8%	5.0%	4.4%	7.4%	6.3%	5.2%	1,959	1,609	350	150	2,109	1,237	5,993	-0.6%
Q2	3.5%	1.4%	5.0%	4.5%	7.5%	6.4%	5.3%	1,944	1,594	350	150	2,094	1,218	5,902	-0.2%
Q3	3.3%	2.2%	4.9%	4.5%	7.5%	6.5%	5.4%	1,934	1,584	350	150	2,084	1,208	5,864	-0.7%
Q4	3.2%	2.2%	4.9%	4.5%	7.5%	6.6%	5.5%	1,924	1,574	350	150	2,074	1,199	5,817	-0.7%
2007															
Q1	3.3%	2.2%	4.9%	4.5%	7.5%	6.6%	5.5%	1,910	1,560	350	145	2,055	1,189	5,773	-1.2%
Q2	3.2%	2.2%	5.0%	4.5%	7.5%	6.6%	5.5%	1,880	1,530	350	145	2,025	1,180	5,724	-1.3%
Q3	3.3%	2.2%	5.0%	4.5%	7.5%	6.6%	5.5%	1,870	1,520	350	140	2,010	1,159	5,673	-1.2%
Q4	3.2%	2.2%	5.0%	4.5%	7.5%	6.6%	5.5%	1,870	1,520	350	140	2,010	1,156	5,659	1.1%

***** Freddie Mac Commitment Rates: 30-Yr. Average conventional mortgage rate and 1-Yr. Adjustable Rate; forecast of these rates are produced by NAHB.

****** Includes the dollar volume of construction put-in-place for new single-family and multifamily structures, manufactured home shipments, brokerage commissions on home sales, and improvements to existing structures (additions, alterations, and major replacements).

******* Annual totals are averages of seasonally adjusted quarterly data and may not match reported annuals from other sources.

******** All quarterly data are at annual rates, and all data except interest rates are seasonally adjusted.