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Vest, Swanson see dark clouds, and it's not the monsoon

By Phillip S. Moore, Inside Tucson Business

Tucson could be in for a "growth recession" that will start to show signs later this year, thanks to interest rates going up, home construction and sales headed down, and slow consumer spending.

In what he admitted was a gloomy report, University of Arizona's Marshall Vest, director of economic and business research for the Eller College of Management, said the momentum that has been carrying the local economy lately will fade. He said there will still be growth but in 2007 and 2008 it will be "below-trend growth or even a growth recession."

Speaking at the Eller College's Mid-Year Economic Update June 7, Vest said, "Last year brought the largest surge in economic growth in state history. We're still seeing revisions and the numbers are being revised upwards."

Except for an error in the state's job creation numbers, which will give Tucson a falsely low 1.5 percent employment growth rate until the error can be corrected, Vest said the business totals for the city and state are in record territory, leading the nation for gains in the gross state product during 2005.

However, he said, "that doesn't keep us from a major slowdown. We're in the fifth year of an expansion, with fantastic growth over the last three years. This kind of thing is too good to last and it will come to an end."

Noting inflationary pressures which will push up interest rates and squeeze budgets, he said, "housing is backtracking, returning to some sense of normalcy after the mania of the last couple of years."

He said Tucson, Phoenix and Flagstaff have finally joined other cities where homes are over-valued, according to the latest reports. He said median home prices in Tucson have leveled off at about \$225,000, as opposed to the Phoenix market where the median price of a home has fallen from \$350,000 to \$300,000 since the end of 2005.

Along with lower prices, the number of sales has also gone down. In 2005 there were 17,500 homes sold in Tucson. This year, we're looking at 15,500, Vest said. In Phoenix, the number has fallen from 105,000 in 2005 to a projected 75,000 this year. He also noted that home building permits are also down in both metropolitan areas.

"These are some fairly significant, almost scary, declines from really high levels," Vest said. "But they do need to be adjusted for the size of the market, since there are a lot more units out there than there used to be."

Apartments will see changes, he said. Vacancies, which normally run about 8 percent, are down to about 6.5 percent in Tucson, which in the supply-and-demand equation should mean that rents will be on the rise.

When that happens, he said "it will signal developers to build apartments and could mean condo conversions will be converting back into apartments."

A slowdown in the housing market and higher interest rates will hit consumer spending, as homeowners have less equity to borrow against and face higher costs for equity loans. In addition, Vest said, new regulations on minimum credit card payments that as much as double their monthly cost and the resetting of sub-prime mortgage rates, over the next three years, "will translate into less money to spend."

While there's no evidence of a slowdown in consumer spending, yet, with retail up 10 percent and restaurant-bar expenditures up 12 percent, he warned this will change. "People will have less dollars for goodies."

Vest said a "growth recession" would be like the early 1990s, where gross state product and employment continue to grow, but too slowly to keep unemployment from rising.

"The party is over for consumers," he said. "It's time to dust off contingency plans, just in case something really goes bad."

Following Vest's forecast with "even more good news," Gerald Swanson, the UA's Thomas Brown Professor of Economics, said the national economy "has a lot of unforeseeables." He said the dollar is weakening on international markets, while the stock market is uncertain, interest rates are rising, housing starts are going down and oil prices are at an all-time high.

Unemployment numbers are down, declining from 6.3 percent to 4.6 percent in two years, "but that's because people are withdrawing from the labor market," Swanson said.

Calling inflation the "theme de jour," he said, the current rate is 7.2 percent, with the less-volatile core rate at 2.4 percent, which is still about a point higher than what is considered acceptable. "People believe that inflation is here, and this is scary for the (Federal Reserve Bank)," which may respond by continuing to raise interest rates.

Swanson warned that the inflation rate could continue to rise, in part because of the way the number is calculated. Home prices are not part of the consumer price index. So, the increase of the last several years wasn't counted. However, rents are included, and as the home buying market slows, "higher rents will start to make themselves felt in the consumer price index."

He said exports are higher, but so are imports, giving the U.S. a \$726 billion deficit for 2005. "Petroleum imports accounted for a lot of that."

Swanson said the record \$70 per barrel rate for crude oil and \$3 for gasoline at the pump, "are likely to be around awhile," until the public has time to adjust by driving less or trading into smaller cars.

Meanwhile, the public has a 1.4 percent negative savings rate, "the lowest since the Great Depression," he said, "and they can't use their home equity as an ATM, anymore."

For the next several months, he said inflation will be a concern, along with the danger of a mistake in monetary policy, protectionism, disruption in the oil supply and a decline in foreign investment in U.S. debt.

If that doesn't keep everyone awake, "there's always the possibility of a bird flu pandemic to worry about."

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