Four Corners Economic Quarterly

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Fort Lewis College, Durango Colorado

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Exchange Rates

By: Dr. Robert Sonora

> I know the "R" word is still not official – usually we don't know we were in a recession until we are out of it – but it's probably safe to say we are in one.

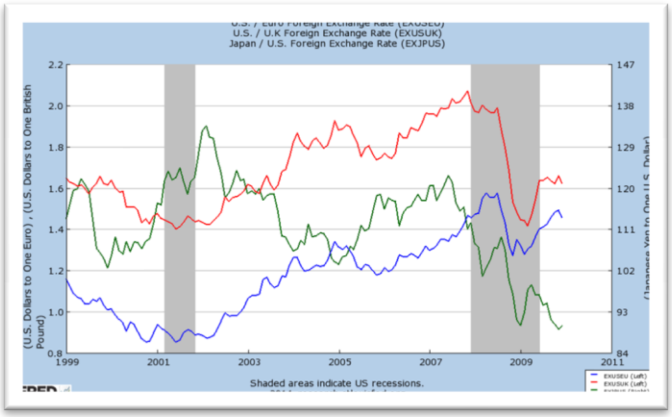
Zagreb, Croatia – As I am currently in Croatia I spend a lot of time thinking about the exchange rate. Over the past seven years, the dollar has depreciated about 60% to the euro, 33% to the pound, and 44% to a basket of our 12 largest trading partners. Of course this has implications for many economic variables. See figure below for euro (blue), yen (green) and UK (red) pound exchange rates, all show a depreciation of the dollar since 2001.

Though seemingly somewhat simple, exchange rates contain a lot of information. A currency's value reflects peoples willingness to hold that currency, hold assets denominated in that currency, or trade with that country. Changes in these preferences impact the value of that currency relative valid substitutes – other currencies.

Loss of faith in a given currency has precipitated many global financial crises: the European currency crisis in the early 1990s, the Mexican peso crisis a couple of years later, and the Asian crisis and Argentinean currency crises soon thereafter.

Let's discuss the trends in causality, both how the exchange rate effects us but also how our behavior impacts the exchange rate. As you might suspect, the combination of these effects becomes a loop – back and forth.

Figure 1. Exchange Rates



Source: Board of Governors of the Federal Reserve System

Recession

I know the "R" word is still not official – usually we don't know we were in a recession until we are out of it – but it's probably safe to say we are in one. Over the past 8 – 10 years the health of the economy has increasingly fallen on the shoulders of the humble household consumer – household consumption now accounts for about 70% of total GDPO rising from about 65% or so in all previous years.

This was, of course, fueled by over spending by households, stoked by rising home prices and historically low interest rates. However, for the past three years, household personal income has fallen behind its trend, and is currently about 2% below trend. Simple analysis shows that a fall in personal income below trend of 10% causes the dollar to depreciate about 1%.

Trade-Deficit

Many economists and policy makers believe that the large trade deficit is also responsible for the falling dollar. With a rising trade deficit the demand for foreign currency (say, the euro or Chinese yuan) relative to the dollar rises pushing the value of the dollar down a10% increase in the deficit yields about an unconditional 3% depreciation of the dollar.

This is not helped by the relatively low interest rates in the US and the slumping stock markets as American producers fail to reach analyst's expectations and rising costs, e.g. the price of oil. This makes US paper assets less attractive to foreign and domestic investors and they ship their money elsewhere, again more downward pressure on the dollar.

To combat inflation the European Central Bank (ECB) has maintained a relatively high interest rate for its member banks while the FED has chosen to lower rates to combat an impending recession.

Next, we have risk. The US being involved in a couple of years in the Middle East makes holders of dollars a little nervous. Couple that with the decline in the housing market, rising household debt, and rising government deficits (increases the probability of default) and you have a rising risk premium.

Inflation

One of the great concerns of any central bank is inflation. Many of the largest central banks have chosen to concentrate much of their efforts on keeping inflation low and predictable − including the US Federal Reserve. Unfortunately, a falling dollar impacts our inflation rates as the prices of imported intermediate and final goods rise if we use dollars to buy them. Clearly this helps to drive inflation, and the Fed should be concerned about this. Unfortunately, the lower interest rates, which helps stimulate the economy driving inflation, a dangerous game.

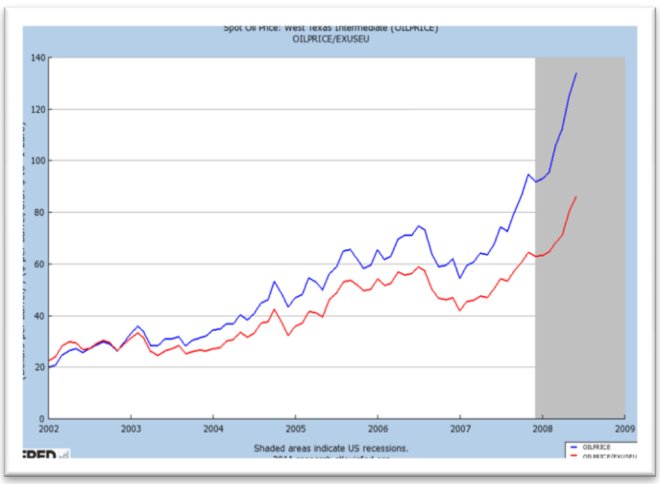
Oil Prices

One of the larges sources of the rise in oil prices is the decline in the dollar. Oil is traded in dollars, and there is a premium associated with a falling dollar − if oil exporters can't buy as many goods per barrel of oil produced, they have to compensate with higher dollar prices.

Of course this happens US demand, but for Europeans, the price of oil has risen but not nearly as dramatically as in the US, red line. Therefore, for them, and all countries which fix their currency to the euro, the rise hasn't dampened demand too much, see the figure below.

It remains to be seen if the depreciation of the dollar is short lived, given that the dollar is the world's "reserve currency" or if other currencies, such as the euro, will maintain their current strength, my guess is that the dollar will probably not regain the same level of prominence it has enjoyed since the end of World War II.

Figure 2. Oil Prices: January 2000 – June 2008



A Look At Some Regional Economic Indicators

By: Dr. Deborah Walker

I thought it might be interesting to look at some regional data in this month's column. A few of what economists call "leading economic indicators" are available from the Colorado Department of Labor and Employment and the Bureau of Economic Analysis at the county level. All of the numbers provided here are the most recent ones available for any given indicator. So let's look at some indicators for Archuleta, Dolores, La Plata, Montezuma and San Juan Countys.

Starting with some labor market data, Archuleta county's unemployment rate was 4.8% in the month of April (preliminary). One year ago during the same month, the rate was 3.5%. The County's businesses employed 6,411 people in the month of April of this year; an increase of 3% over April of 2007. In 2006 Archuleta County's largest employers (by industry) were trade, transportation & utilities, followed by leisure & hospitality. The average weekly wage for all industries in 2006 was $516.00.

Dolores County's unemployment rate was 6.5% in April. One year ago during the same month, the rate was 5.0%. The County's businesses employed 1,049 people in the month of April of this year; an increase of 7.5% over April of 2007. In 2006 Dolores County's largest employers were public administration; followed by trade, transportation & utilities and education & health services. The average weekly wage for all industries in 2006 was $420.00.

La Plata County's unemployment rate was 3.2% in April. One year ago during the same month the rate was 2.5%. The County's businesses employed 30,129 people in the month of April of this year; an increase of 1.5% over April of 2007. In 2006 La Plata County's largest employers were trade, transportation & utilities; followed by education & health services and leisure & hospitality. The average weekly wage for all industries in 2006 was $654.00.

Montezuma County's unemployment rate was 4.8% in April. One year ago during the same month the rate was 3.5%. The County's businesses employed 12,643 people in the month of April of this year; an increase of 0.3% over April of 2007. In 2006 Montezuma County's largest employers were education & health services; followed by trade, transportation & utilities and leisure & hospitality. The average weekly wage for all industries in 2006 was $513.00.

San Juan County's unemployment rate was 8.8% in April. One year ago during the same month the rate was 6.0%. The County's businesses employed 434 people in the month of April of this year; an increase of 1.8% over April of 2007. In 2006 San Juan County's largest employers were leisure & hospitality (by a large margin), followed by trade, transportation & utilities and public administration. The average weekly wage for all industries in 2006 was $406.00.

We can also look at two other indicators – per capita (person) income and deposits in financial institutions. Archuleta County's annual average per capita income in 2006 was $25,145.00, an increase of 5.5% over 2005. Dolores County's per capita income in 2006 was $25,347.00, a decrease of 1.7% from 2005. La Plata County's per capita income increased 8.1% from 2005 to 2006. In 2006, it stood at $36,493.00. Montezuma County's per capita income also increased from 2005 to 2006 (by 5.4%). The County's per capita income in 2006 was $28,547.00. San Juan County's per capita income in 2006 was $30,096.00; up 6.1% from 2005.

Deposits in financial institutions increased from June 2006 to June 2007 in every county except in San Juan, where they remained constant. Archuleta County saw the largest percent increase (10%), followed by Dolores County (7.69%), Montezuma County (7.46%), and La Plata County (1.37%).

How local is Our Real Estate?

By: Dr. Luke Miller

Large metropolitan residential real estate is directly impacted by unemployment, interest rates, home inventories, and relevant macro-economic trends. However, I would argue that real estate in the four corners region of Colorado (and comparable resort- and tourism-based communities) is impacted less by these same macro trends. Keep in mind, the four corners region has lower foreclosure rates, relatively sparse subprime and shady lending practices, and significant interest from the affluent baby-boomer generation searching for their dream retirement community and/or seasonal second home. As such, when evaluating our local market it might be more appropriate to monitor our 'feeder' markets versus standard local real estate metrics.

It's difficult to exactly identify our region's feeder markets. However, casual conversation with any Durango newcomers point to similar clusters: Texas, Southern California, Arizona, Colorado Front Range, and New Mexico. So instead of pulling data for the four corners region, I accessed the U.S. Bureau of Economic Analysis and National Association of Realtors databases to gain insights into our feeder markets. Specifically, I obtained basic real estate metrics for Houston, San Diego, Phoenix, Denver, and Albuquerque. Not coincidentally, I found that "all real estate is local".

Since the real estate "top" in Summer 2005, median home price levels in Houston, Albuquerque, and Denver are actually up 6%, 9%, and 23%, respectively. In contrast, median home price levels in San Diego and Phoenix are down 29% and 32%, respectively. Home inventories appear to be topping in Houston and Phoenix, decreasing in Denver and San Diego, and increasing in Albuquerque. Anecdotally, one could argue the strong oil & gas sector is supporting some of our feeder markets (Houston, Albuquerque, and Denver), whereas, high-flying Phoenix and San Diego markets did not have the fundamentals in place to sustain their real estate valuations.

Isolating the 25th percentile home values (or the entry-level home market) points to another interesting observation. The entry-level homes in Houston, Albuquerque, and Denver have remained relatively constant since Summer 2005, and indicate an equilibrium state between employment, rents, and home ownership. Put another way, those earning stable wages have been able to purchase homes, without the price of homes moving upwards against them. In contrast, entry-level homes in San Diego and Phoenix continue to fall precipitously, indicating significant non-affordability levels. This same observation can be found in a plot of the mortgage-to-income ratios for these markets. Namely, Phoenix and San Diego's ratios are greater than 30% and 50%, respectively. In other words, in San Diego, annual mortgage payments comprise half of an individual's annual income.

In contrast, entry-level homes in San Diego and Phoenix continue to fall precipitously, indicating significant non-affordability levels.

What does all this mean for our local market? About half of our feeder markets have remained relatively strong against national headwinds, with the other half setting new lows every quarter. This observation could be one reason why the four corners market has remained relatively neutral over the last 2 years, with median home prices in Durango near the $400,000 plus or minus $30,000 range. In terms of actionable items, perhaps efforts to 'recruit' newcomers to the area should be focused on comparatively strong feeder markets versus Hollywood and the retiring desert.

(Note: The following graphs were not in original article, due to the loss of the article, the Quarterly presents the home price index and housing starts – a proxy for inventory -- for each of the cities discussed)

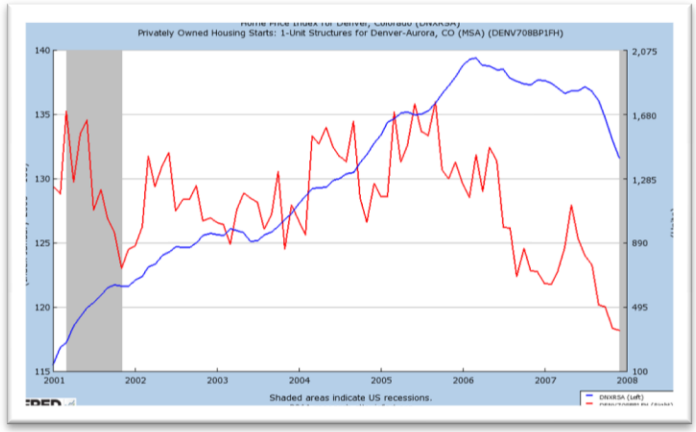


Figure 1. Housing Prices and Starts: Denver

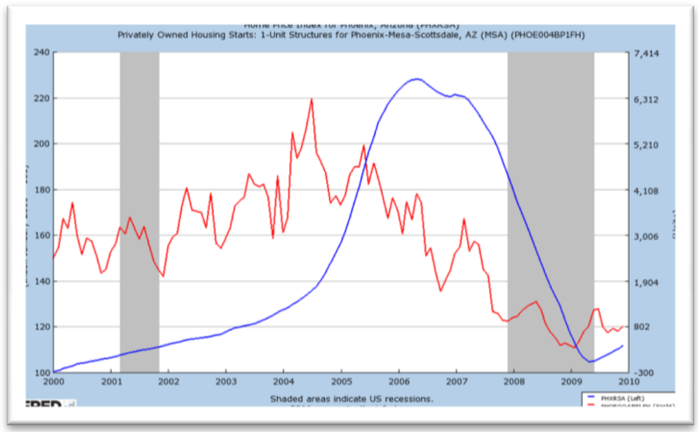


Figure 2. Housing Prices and Starts: Phoenix

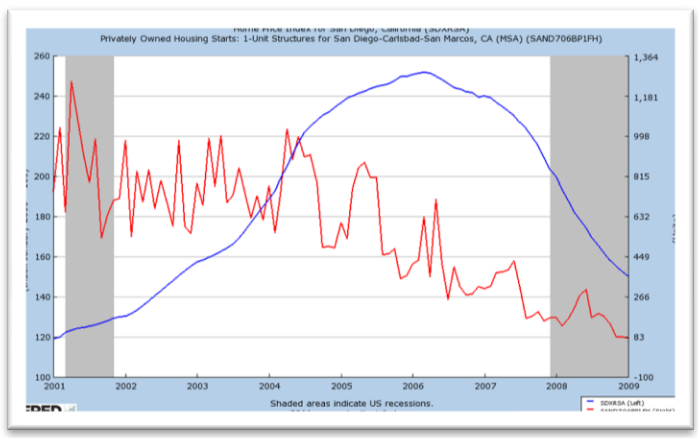


Figure 3. Housing Prices and Starts: San Diego

Households, Prepare to Suffer

By Dr. Robert Sonora

Here's a rather gloomy prediction: In Floyd Norris' New York Times blog of February 16, 2007 he demonstrates that the seasonally adjusted eleventh month housing start declines is predictor of recession (see http://norris.blogs.nytimes.com/2007/02/16/housing-and-recessions/). That was 18 months ago, so where are we?

Revised fourth quarter estimates showed negative real GDP growth, and preliminary GDP statistics are anemic, to put a positive spin on things. Consumer expenditures are slowing, though still positive. The unemployment rate is closing in on 6%, the highest since the last recession. Inflation is almost 5%, the highest in seventeen years, with energy prices 25% higher than they were ago.

And household debt payments as a percentage of disposable income are just over 14%, or about 0.4% below its peak in the fourth quarter of 2006.

But, things don't appear too bad on the real estate front in Durango. Recent reports show that local housing rebounded in the second quarter of this year to a median price of $430,000, up from $370,000 in the first quarter.

But, there's a bit more to the story, comparing the second quarter 2008 to the second quarter 2007, which is generally more accurate considering seasonal differences –the first quarter is normally not a strong home sales period, and the second quarter is – we see median prices rose about 10%, but compared to second quarter 2006, in the pre-sub-prime meltdown phase, they fell by about 15%.

The reason I discussed the overall health of the economy was to point to the fact there may very well be shrinking demand for real estate in the Four Corners area – that is, the recent increase might be short lived. As housing prices in California, Arizona, and elsewhere continue to fall, there will be little left over for extra spending on second homes.

Housing prices will rebound, but I suspect growth in the housing market will be somewhat tamer than we have seen recently.

With many banks having little interest or little resources to lend, mortgage markets are growing tighter. Current attempts by the Fed to increase market liquidity have had little impact on lending markets: mortgage rates have hovered around 6% (historically low) since 2001. In the same period, the federal funds rate (the Feds main policy interest rate) has bounced around between 6% and 1% with no effect on mortgage rates.

Currently, the federal funds rate is set at 2% and the average 30 year mortgage is about 6.5%. Jumbo rates, mortgages on homes over $417,000, are one percentage point above that. The median house in Durango may require a jumbo loan, depending how much potential buyers can bring to the table.
Other sources of reduced demand will be the result of declining asset markets (except, perhaps, those that invested in gold and oil), including housing, which further restricts spending, particularly for soon-to-be-retirees.

Nationwide, household consumer sentiment is the lowest it has been since 1981, and with a growing debt burden, there is little cash left over for additional outlays.

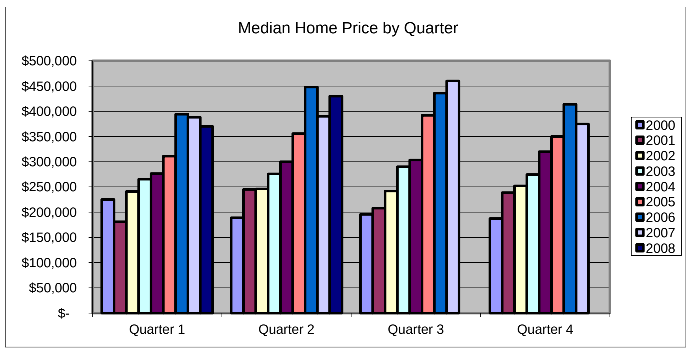
On the other hand, there is a silver lining. The decline in demand will push real estate prices down enabling a greater number of Region 9 residents to buy a home. As reported in the Durango Herald, about 75% of local residents can't afford to buy a home, and that was based on a median home price of $350,000 not $430,000.
Let's put this in perspective. If a buyer puts down 20% and gets a 6.25% mortgage, the monthly payment on the median home, would be about $2,000 per month, not including taxes and insurance. That's about 60% of mean household pre-tax income in La Plata.

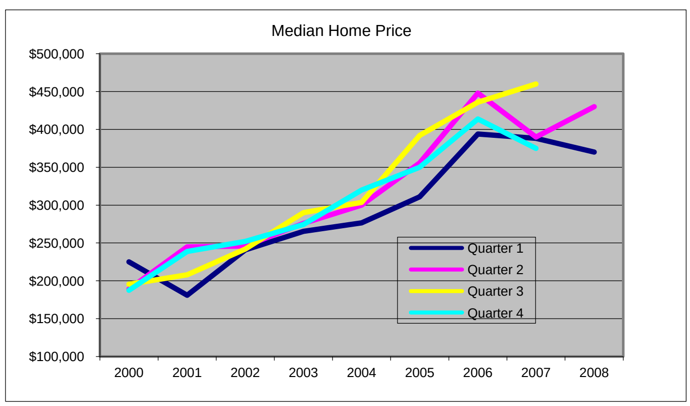
Incomes in Archuleta and Montezuma county have been about 60% of Colorado statewide per capita income for the past 10 years, about $28,000 per year in the two counties compared to a statewide average of $45,300. Over the same period La Plata county income has grown to about 81% of the state average – sitting now at $36,800 per person.

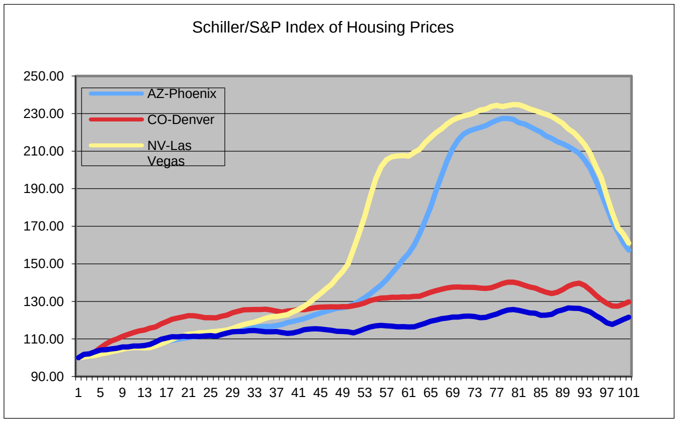
And that's not adjusted for inflation. Nonetheless, incomes in La Plata, Archuleta, and Montezuma counties have grown faster than US and Denver inflation, so local spending power is growing. Unfortunately, overall price levels in Region 9, not including housing, are higher than the US and Colorado average. That is, each dollar spent here buys less goods and services than the same dollar in Denver.

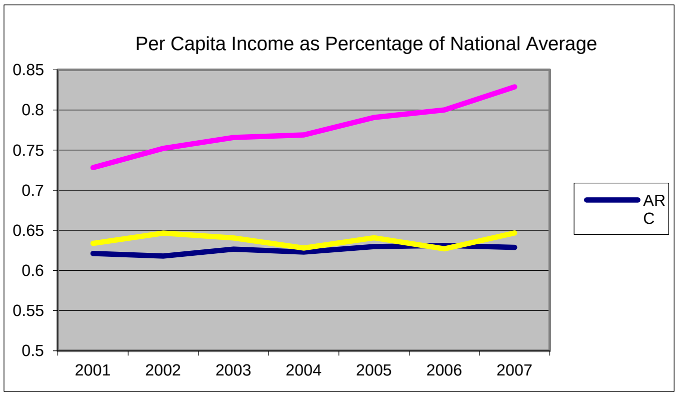
Less discussed in the debate over housing is the increase in the wealth inequality in the region. While homeowners have seen their assets grow at an average rate of 8% over the past 15 years (including declines in 1997 and 2007), non-homeowners have not captured any of those returns.

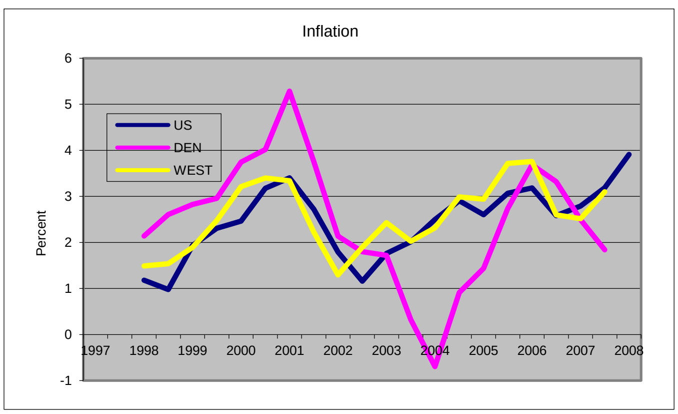
Housing prices will rebound, but I suspect growth in the housing market will be somewhat tamer than we have seen recently. But again, Americans seem to have very short memories (anyone remember the savings and loan bust?), and asset bubbles are increasingly likely to become the norm. Just remember to "buy high and sell low" … wait a minute.











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