crisis. Many old joint ventures have been changed into wholly owned subsidiaries. Real estate prices have been dropping and affected countries are now welcoming more foreign direct investment (FDI) than ever before. We believe there will be a large change in U.S. exports and FDI in those destinations. Because our lower savings rate appears to have bottomed out, and because we are going to have a budget surplus again in 1999, our current account deficits and capital inflows will become smaller, but only after the first half of 2000. In the meantime, there will be a large increase in risks as well as opportunities in 1999, in both international trade and foreign investments.

Housing Markets

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It has been a good year for housing. The home building industry is enjoying one of its best periods, driven by a strong economy, low mortgage rates, and robust employment growth. Housing starts and home sales reached record levels this year. Privately owned housing starts in August were at a seasonally adjusted annual rate of 1,613,000, which is 17% above the August 1997 rate of 1,383,000 (see **Figure 1**). During the first eight months of this year, 1,074,800 housing units were started, compared to 977,300 for the same period in 1997—about a 10% increase.

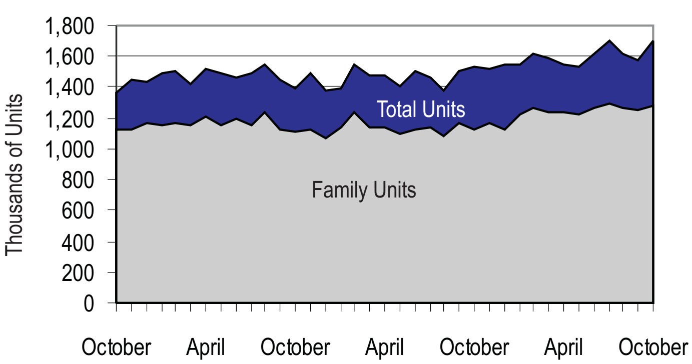
Building permits issued during the first half of 1998 were up 11% from the first half of 1997 and surpassed the first-half record set 21 years ago. The increase in permits in Indianapolis was exactly the same as the national average of 11%. Mortgage Bankers' chief economist David Lereah predicted record highs this year for existing home sales, new home sales, the U.S. home ownership rate, and mortgage originations.

Sales of new one-family houses in August 1998 were at a seasonally adjusted annual rate of 838,000, according to estimates released recently by the U.S. Department of Commerce's Bureau of the Census and the U.S. Department of Housing and Urban Development (see **Figure 2**). This is 5% above the August 1997 rate of 799,000. Through August of this year, 618,000 houses were sold, compared to 564,000 during the same period last year—an increase of about 10%.

Mortgage Interest Rates at Record Lows

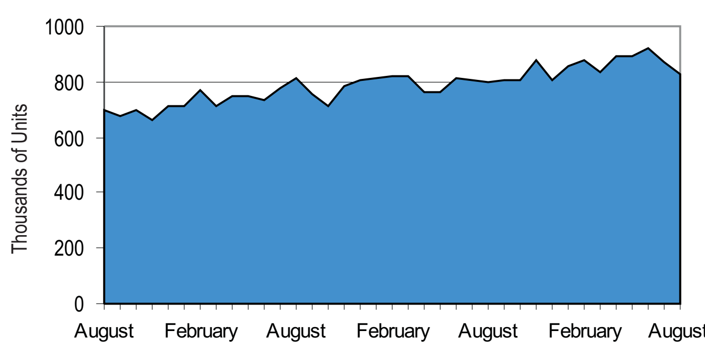
Interest rates for 30-year fixed-rate mortgages dipped to about 6.5% in October, the lowest level in about 30 years. They rose toward the middle of October, but that was before the most recent reduction in interest rates by the Fed (see **Figure 3**). The rate for one-year adjustable-rate mortgages also dropped in October (see **Figure 4**). The spread between the rate on adjustable-rate mortgages and fixed-rate mortgages has

Figure 1
Housing Starts



October 1995 to October 1998
Seasonally Adjusted annual Rate

Figure 2
Single-Family Home Sales



August 1995 to August 1998
Seasonally Adjusted Annual Rate

Figure 3
Interest Rate for 30-Year Fixed-Rate Mortgages

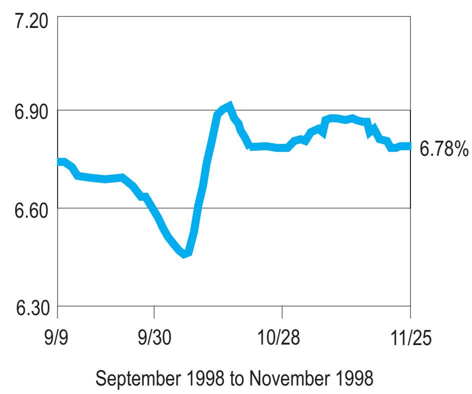
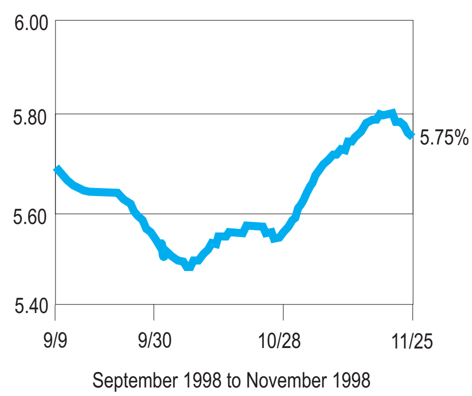


Figure 4
Interest Rate for 1-Year Adjustable-Rate Mortgages



narrowed in recent years as interest rates in general have decreased.

Will the Good Times End?

The two interest rate cuts of late may have helped reduce the likelihood that a slowing economy could cause the housing market to cool, although a dampening of the housing market may already be occurring. Figures recently released by the U.S. Commerce Department show that construction of new homes and apartments fell 2.5% last month after a 5.2% decline in August.

Home sales and mortgage originations are likely to ease off from record levels as the economy cools next year. Yet economists at the Mortgage Bankers Association believe that the actions of the Fed to keep the economy out of serious trouble will again push long-term home loan rates down below 6.5 percent—where they dipped briefly at one point this year—and keep the housing market close to current levels.

Until now, the world economic crisis has been "a blessing in disguise for housing," having pushed U.S. interest rates so low. Because mortgage rates depend on the overall structure of interest rates, that means the general structure of interest rates will decline. Over the next year or so, mortgage rates could come down by another quarter or half point.

But next year a tug of war will emerge between the stimulating effect of lower interest rates and the drag from a weakening economy, which reduces consumers' willingness to commit to purchasing a new home. This is likely to lower housing starts in 1999 to about 1,500,000 units, which is around 6.25% below the 1,600,000 level we are likely to average for 1998. Existing home sales will likely decline to about 4,400,000 units for 1999, about 6% below the average level for 1998. By historical standards, this would still be a very respectable level of housing starts and existing home sales.