

What Lurks in the Distance?

THE ECONOMY IS PROJECTED TO HAVE A budget deficit of roughly 13% of GDP. Not since World War II has a deficit been twice the size of the next largest deficit.¹

About a year ago, the Fed increased the monetary base—currency in circulation, member banks' reserves held at the Fed and vault cash—by close to one trillion dollars.¹ Normal circumstances most likely would not warrant such an action.

This percentage increase in the monetary base has effectively doubled the amount of money in the monetary base—the largest increase in the last 50 years by a factor of ten.¹ With so much additional cash in the monetary base, one could argue that because of this, inflation lurks on the horizon unless a system is designed to systematically remove some of the additional reserves in the system.

Historically, as mentioned in a recent Wall Street Journal article by Arthur B. Laffer, the currency in circulation portion of the monetary base has comprised close to 95% of the total. This number has risen by around 10% with the latest infusion into the system. Bank reserves have increased by 20-fold, leaving the currency-in-circulation portion of the monetary base at around 50%.¹ The monetary base has significantly increased while the currency in circulation, as a percentage of this base, has significantly decreased. Banks now have a large portion in reserves which, in theory, enables them to make substantial loans.

This brings us to the issue of commercial real estate. In late July, I attended a U.S. Congressional Joint Economic Hearing on the systemic risk associated with commercial real estate.

Since late 2007, a conservative estimate on the value of commercial real estate has values falling by 25%-30%. In the opinions of the JEC members and those who spoke as expert witnesses, there was speculation that this is a potential sinkhole in the economic recovery. Shopping centers, hotels, and office buildings are all being affected—a livelihood of this industry.


By Bill Johnson, *Executive Vice President*
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We are facing declining property values, hundreds of billions of dollars in loans coming due in 2009 and a trillion more dollars in loans coming due by 2012. Demand for space has dropped with 607 major properties changing hands in 2009. This represents a 51% drop since the fourth quarter of 2008. Financing is difficult to obtain even for those who have positive cash flow and equity in the property. Tax revenues that fund school construction and city governments are going to be severely affected—areas that are important to this industry's success.

Which brings us back to the banks with money in reserves. Banks are told to lend and at the same time they are told by regulators to watch who they are lending to. Although much attention is given to large commercial real estate transactions, transactions in the 300K to 1M dollar range are prime candidates for lending—and these types of projects tend to do a lot to fund local tax revenue. But part of the problem remains—it is hard to determine clearly what the value of the asset is.

So, we have to absorb a substantial increase in the monetary base, albeit a large portion held in reserve by banks, and a challenging environment in the commercial real estate sector.

As a result of our attendance at the Joint Economic Committee hearing, we have submitted a letter to Rep. Maloney, chair of the JEC, and to the ranking member Senator Brownback about ideas that could have a positive impact for commercial real estate. These letters are being followed up with our visits to their respective congressional offices.

Both your Foundation and DHI remain vigilant. We will continue to be proactive in gathering information, taking action in areas that are instrumental to our mission, and providing all of you with the timely information that will enable you to make smart decisions for your business. 

Footnote

1. Laffer, Arthur B. 2009. "Get Ready for Inflation and Higher Interest Rates." Wall Street Journal. June 10, 2009.