Why Federal Reserve must raise interest rates

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When housing markets boom, homeowners get rich. And the rich drive fancy cars, have expensive flat-screen televisions and go on nice holidays. At least that is the way people think it is supposed to work. But we all need somewhere to live so, while the above may be true for some, it cannot work for all of us at the same time. Economy-wide consumption should not respond to changes in property values. That the impact has been large is a problem for everyone, especially for monetary policymakers.

As the Federal Reserve’s Open Market Committee (FOMC) meets tomorrow morning, housing should be at the centre of the discussion. Alan Greenspan, the chairman, and his colleagues are in a bind because of the strategy they have followed over the past five years. It now looks as if their overdue reaction to the housing boom will require them to raise interest rates well beyond the 4 per cent or so that most people now expect.

The story starts with the internet boom of the late 1990s. At the time, Fed policymakers concluded that since it was so difficult to identify bubbles as they are inflating, it is best to wait and clean up the mess after the crash. In 2001, that is what they did. The FOMC lowered the short-term interest rate from 6 per cent to 1 per cent.

The predictable result was a housing boom. The value of residential housing in the US is 55 per cent higher today than it was only five years ago. Since household consumption reacts quickly and strongly to increases in property wealth, a recession was nearly averted.

Fed policy replaced the internet bubble with a housing bubble. The problem is that equity and property are very different. When stock prices rise, it signals improved future profitability. Faster growth means higher incomes and more resources to devote to current (and future) consumption.

Housing is different. We all have to live somewhere. When housing prices rise it does not signal any increase in the quantity of economy-wide output. While someone with a bigger house could move into a smaller one, for each person trading down and taking wealth out of their home, someone is trading up and putting wealth in. A rise in property prices means people are consuming more housing, not that they are wealthier.

This logic is clear. Even so, when economists look at individuals they see a large effect – an increase in housing wealth has about twice the impact on consumption of an equivalent increase in stock market wealth. For the US economy, the $6,500bn increase in housing wealth since 2000 amounts to a $200bn rise in consumption – enough to push GDP up 1.5 per cent and drive the household savings rate to zero.

Much of this added consumption has been financed by increased borrowing. This means that as interest rates rise, an increasing portion of household incomes will have to be devoted to repaying the $4,000bn in additional debt incurred...
during the first half of this decade. Low interest rates have encouraged borrowing from the future. And the more we borrow, the larger the debt and the bigger the adjustment.

The most troubling aspect of this is the Fed’s reaction. The minutes tell us that the FOMC spent a portion of their June meeting discussing housing, concluding that since there is no way to know if there is a housing bubble, there is nothing to be done. These conclusions bear an eerie resemblance to comments made at the height of the internet bubble in the late 1990s.

These statements reveal that policymakers are taking the wrong approach. Consumption should not react to increases in housing wealth. Household spending levels are simply unsustainable and something has to be done. The policy prescription is simple: raise interest rates. Higher interest rates both make borrowing more expensive, reducing household demand, and raise returns on alternative assets for yield-chasing financial institutions.

Hopefully, the Fed can emulate its colleagues at the Reserve Bank of Australia. After three years of nearly 20 per cent annual increases, housing prices have been nearly flat for the past 18 months. A series of interest rate increases, coupled with strong public statements, seems to have done the job. While Australian growth has fallen from 4 per cent to less than 2 per cent, it appears the worst is over.

Following this lead, the FOMC should (1) increase interest rates at the coming meeting; (2) signal that they are far from done; and (3) warn people that the best we can hope for is that housing prices stop rising, but that there is a real risk of collapse.

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