American Enterprise Institute for Public Policy Research

Economic Outlook

April 2005

Greenspan's Second Bubble

By John H. Makin

I knew Alan Greenspan had his first bubble in late 1999 when cab drivers were too busy talking to their brokers on cell phones to talk with customers. The "cab driver test" flashed its second bubble warning light to me just recently when I arrived in Key West for the annual winter vacation with my family. Without any prompting, our cab driver told us of a Key West real estate market on fire. Condos that were selling a year ago for $600,000 could not be touched for $1 million today, while the units under construction were sold four times over before anyone even thought of occupying them. The old hotels were being torn down to be replaced by condos that were selling like hotcakes before construction had begun. Meanwhile, room rates and rental rates in Key West have hardly budged. The implied return on investment in real estate is tied to an expectation of ever-rising prices, not to income from property.

Although Greenspan and his Federal Open Market Committee colleagues may not have the opportunity to come to Key West and talk to the cab drivers about real estate, they could have heard similar stories over the past several years in the red-hot real estate market around Jackson Hole, Wyoming, where they gather annually for central bankers' summer camp.

Lest I be accused of being unscientific, there is more objective evidence of a housing bubble in the United States than that linked to the opinions of cab drivers. Between 2000 and 2004, house prices, nationwide, rose by more than 40 percent—the fastest rate of increase on record since World War II. Moreover, the pace is accelerating.

John H. Makin (jmakin@aei.org) is a visiting scholar at AEI.

During 2004, the value of real estate on household balance sheets rose by 12.5 percent. That is far short of the 30 to 40 percent increase in prices evident in some markets over the past twelve to eighteen months, but it denotes a substantial and widespread acceleration in the price of owner-occupied real estate. Meanwhile, the ratio of average yearly rents to house prices has been dropping steadily, from about 5 percent nationwide in the 1990s, to 3.5 percent in 2004, reminiscent of the way earnings plunged relative to soaring equity prices before the tech bubble burst in March 2000. Rental yields in the hotter markets are even lower.

What Caused the Housing Bubble?

Bubbles in any market feature expectations for price increases that catch fire, so that more and more people begin to chase the market based only on the expectation of ever-rising prices. This bubble has some clear and proximate causes, none of which by itself would have been sufficient to cause a bubble, but which together create a compelling set of preconditions for a housing bubble.

The key underlying elements contributing to the new-millennium housing bubble are the Fed's responses to a series of unique events over the past seven years: the Long-Term Capital Management crisis in the fall of 1998, the collapse of the NASDAQ Stock Market in March 2000, the September 11 attacks, and the corporate scandals beginning with the 2001 Enron debacle. In the background, the emergence of China as a new mass supplier of inexpensive traded goods has also forced the Federal Reserve to respond to a 2003 deflation scare.

All of these events combined to create a conviction among market participants that the Fed would not allow a serious drop in broad asset prices. The "systemic risk" warning flag would be unfurled should markets be threatened, resulting in an extended period of very low interest rates. The aim was to avoid an asset market meltdown while, simultaneously, addressing a deflationary problem of global excess capacity in the traded-goods sector.

The housing bubble, together with a pervasive underpricing of risk, is a byproduct of a set of compelling and arguably necessary monetary policy responses to a powerful series of market-unfriendly events, each of which potentially constituted a systemic threat to the global financial system. It may be true that the Fed has played the systemic-risk card so frequently since the fall 1998 Long-Term Capital Management rescue that a macroeconomic moral-hazard syndrome has emerged. Specifically, it would be understandable if an asset market participant observing the operation of the Federal Reserve over the past seven or eight years concluded that risk should be sought aggressively as a means to enhance returns because any financial accidents lead to a declaration of systemic risk and accommodation by the Federal Reserve that amounts to free insurance for aggressive risk taking.

The Fed followed its accommodative response to the Long-Term Capital Management crisis in the fall of 1998 with a brief period of tightening in 1999. After the collapse of the NASDAQ in March 2000, the Fed began rapid easing that accelerated in the aftermath of the September 11 tragedy. That was followed by the 2003 deflation scare, which was due partly to the massive excess capacity in the traded-goods sector driven largely by China's emergence as a major producer in the area. This resulted in the Fed's decision to consider buying long-term bonds to avoid deflation and then later to predetermine that its tightening pace should be slow.

The Fed's need to target its ultra-accommodative monetary stance—the real Fed funds rate was negative during the two and a half years prior to its cautious initiation of tightening in June 2004—to combat a disinflationary trend in the traded-goods markets ballooned the U.S. real estate market. Tax law changes that allowed households repeated exemptions of up to $500,000 on housing capital gains coupled with an innovative mortgage market that simplified withdrawal of accumulated gains, even from unsold housing, added to the fire under the housing market. As a result, housing replaced tech stocks as the "hot" way to accumulate wealth for most American households.

The current U.S. housing bubble is the result of two aspects of Fed policy. First, as I have already noted, the Fed needed to keep rates very low (negative in real terms) for an extended period that included an underlying disinflationary impulse from the global excess capacity problem. Second, possible systemic risk in the face of exogenous shocks from Long-Term Capital Management to the NASDAQ collapse, September 11, and corporate scandals rightly or wrongly has made the housing bubble intensify further on the notion that the Fed would also act to avoid a housing meltdown that threatened to erase trillions of dollars of household wealth.

The Fed, however, is not supposed to target asset markets for the very reason that too much risk taking would be the result of doing so. Yet who doubts that a sharp drop in the market for housing or in the stock market would cause Fed tightening to stop or even to be reversed? The Greenspan Fed has been willing to spike the punch bowl when the party threatened to end for asset markets. Is it willing to remove it when the party gets too rowdy?

The Greenspan Fed has been willing to spike the punch bowl when the party threatened to end for asset markets. Is it willing to remove it when the party gets too rowdy?

The Fed began to tighten in June 2004 with a commitment to raise rates at a "measured pace" until policy no longer remained accommodative. So far, the measured pace of Fed tightening has left financial conditions remarkably easy as the dollar has dropped and long-term rates have risen a little while, of course, a housing boom has boosted household net worth by $6 trillion since 2000. That said, the Fed faces a difficult task as it tightens in this cycle. Excess capacity in the traded-goods sector continues to exist, somewhat exacerbated by China's refusal to allow its currency to appreciate, while simultaneously the liquidity flowing into China is being recycled back into U.S. financial markets through heavy purchases of U.S. government securities.

In retrospect, there are plenty of reasons to account for the emergence of a housing bubble, and no single one, save perhaps for the Long-Term Capital Management rescue, can be described as an inappropriate or inflationary action by the Federal Reserve. Like so many difficult issues, the housing bubble has emerged from an unusual

combination of events. The Fed's response to each is defensible. However, taken collectively, those responses have encouraged what is arguably a worldwide housing bubble.

The wealth created in the housing sector may be distorting investment decisions and boosting aggregate demand so that even goods prices are starting to rise at a faster pace. The most recent report on the core personal consumption expenditures (PCE) deflator, the Fed's favorite index of inflation, showed a modest rise to a 1.6 percent year-over-year increase. But the annualized inflation rate over the last three months has been 2.1 percent, and it is fairly easy to see the year-over-year rate rising above 2 percent, the top end of the Fed's permissible range, by the end of this year.

What Should Be Done?

The reason to end the housing bubble proactively is straightforward. If it is a real bubble, it will grow bigger and burst of its own accord with even more disruption to financial markets than would be caused by a preemptive strike from the Federal Reserve. It is a simple matter of pay me now or pay me later, but it is less expensive to pay the price now.

The reason to end the housing bubble proactively is straightforward. If it is a real bubble, it will grow bigger and burst of its own accord with even more disruption to financial markets than would be caused by a preemptive strike from the Federal Reserve.

The Fed should proceed in two steps to remove accommodation while minimizing risks to asset markets. First, it must remove the pre-commitment lag, which has been included in the statement following its periodic rate-setting meetings. The phrase "accommodation can be removed at a measured pace" has been interpreted by markets as a signal that Fed rate increases will proceed at 25 basis points per meeting until an unknown, neutral level of the Fed funds rate is achieved. This pre-commitment by the Fed suggests a fear of lower asset values. If the Fed is prepared to temper its tightening pace for the sake of asset markets then, so some believe, it will slow or reverse its tightening process if asset markets fall. As a result of the Fed's implicit guarantee, the return on risky assets has been driven far below normal. The same has happened to the return on low-risk assets, as indicated by the sub-2-percent real yields on ten-year Treasury notes that have yielded long-run average real returns well above 3 percent.

The Fed should eliminate the "measured pace" language from its statement and simply indicate that monetary policy is currently accommodative and that accommodation will be removed at a pace dictated by the future path of growth and inflation. Second, if growth remains at or above a 3.5-percent trend rate and inflation creeps closer to or above 2 percent, the Fed should raise the federal funds rate by 50 basis points, perhaps at its mid-year meeting in June. That would put the federal funds rate at 3.5 percent (assuming another 25-basis-point increase in May) and leave the real rate at roughly 1.5 percent, which would still be accommodative. More important, the Fed would unambiguously have shown markets that the pre-commitment era is over.

The decision to end its pre-commitment strategy to a measured 25-basis-point per meeting pace of tightening brings the Fed up against a basic issue. The Greenspan Fed has always been prepared to consider asset markets in distress with attendant possible systemic risk as a relevant consideration in accelerating the pace of easing. A housing bubble puts the shoe on the other foot. If there is an asset market bubble, is the Fed prepared to alter its pace of tightening in order to address the possible systemic risk associated with the growth and eventual bursting of a bubble in housing prices?

Only by addressing this question and suggesting that the systemic risk consideration works both ways in the asset markets can the Fed remove a long-building moral hazard problem from asset markets in which the price of risk is simply too low. Greenspan's decision is whether to bite the bullet now or leave the hard work to his successor.