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Can the Fed Achieve a Goldilocks Tightening?

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The persistence of annualized economic growth of about 3.5 percent—despite crude oil prices between $50 and $60 per barrel—has led many analysts to claim that the U.S. economy has already "absorbed" the shock of $2.35-plus-per-gallon prices for self-serve regular gasoline along with a rise in heating oil costs of more than 30 percent over the last year. As if to underscore their insouciance over energy costs, American consumers accelerated the volume of vehicle purchases in June, especially those of light trucks that get only twelve or thirteen miles per gallon.

The oil drag on growth is barely being offset by a boost from housing that has made consumers too comfortable with higher oil prices. For the economy to avoid recession, the Federal Reserve will need to pull off a "Goldilocks tightening" that just cools the housing sector without freezing it. Achieving that outcome is a tall order, even for Alan Greenspan.

The Oil Drag and Its Temporary Antidote

As we move into the second half of 2005, what many analysts ignore is that a doubling of oil prices from $30 per barrel to $60 per barrel in just over a year is reducing U.S. growth by about 1 percentage point and will continue to do so for another year if oil merely remains at current levels. Beyond that, if $60-per-barrel oil prices fail to alter behavior, as the surge into heavy passenger vehicles and bigger houses (more space to heat and cool) suggests, then oil prices will rise even further, perhaps to $80 or $100 per barrel. Significant increases in the supply of oil typically take a few years' time to achieve, so at least for a while steadily rising demand means steadily rising prices. If the price of crude oil spikes to $100 per barrel, however, suppliers may begin to think more earnestly about adding to oil extraction and refining capacity.

The U.S. economy has held up nicely, despite the growing oil drag, because of a rising tailwind from the robust real estate sector. House price increases have accelerated in 2005, enabling homeowners to continue to draw equity out of real estate and therefore to boost discretionary spending despite more costly energy. Banks are aggressively and successfully promoting home equity loans as a lower cost way than credit cards for households to borrow. Beyond that, many American homeowners are generating money from their residences either by repeatedly turning over homes at substantial capital gains or by continuing to refinance mortgages, although refinancing has slowed somewhat as the Fed boosts short-term interest rates. Moreover, America's mortgage industry has become ever more innovative at devising ways for households to turn more valuable housing into ready cash.

In short, the 1-percent drag on growth from higher energy costs has, at least for the first half of 2005, been offset by a 1-percent boost from higher home equity extraction and from the positive wealth impact of higher home values on consumption. During the first quarter of 2005, real estate appreciation (net of mortgage increases) was $300 billion, which by itself added

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about a half a percentage point to growth through a boost to consumption.

The two opposing forces operating on U.S. growth have enabled gains in gross domestic product to be sustained even as energy prices rise further, thereby fostering the notion that U.S. growth is impervious to higher energy prices. Yet, that notion is tenuously based on a U.S. housing bubble in which the ratio of home prices to incomes is two to three standard deviations above the average since 1980 in over twenty major cities including (in order of decreasing intensity) Miami; Minneapolis; Chicago; San Diego; Seattle; Los Angeles; Las Vegas; San Francisco; Washington, D.C.; Baltimore; Tampa; Denver; Orlando; and New York. In these and other "hot" markets, house price indices rose by an average of more than 20 percent during the year ending in the first quarter of 2005. In the hottest market, Las Vegas, prices rose by a third in a single year.

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The U.K. Example

The experience of the United Kingdom since mid-2003 provides a vivid example of an economy driven by a housing boom that was eventually reversed by a central bank acting to tighten monetary policy. With housing prices rising about 25 percent during 2004, the British economy was fueled by a booming construction sector and strong consumption growth, which in turn was propelled by optimism and additional wealth generated in the housing sector. GDP was growing at a 3.75-percent annual rate.

The Bank of England had begun to sense some overheating in mid-2003, and between November 2003 and August 2004 the bank boosted its repo rate—the rate at which it lends to commercial banks—by 125 basis points from 3.5 percent to 4.75 percent. From August 2004 onward, the bank has held its repo rate at 4.75 percent.

At first, there was no response from the housing sector. Housing prices continued to rise and observers suggested that a mere 125-basis-point increase was not sufficient to slow the housing boom. However, in the United Kingdom almost all mortgages have adjustable rates, and so a 125-basis-point increase in short-term rates caused mortgage rates to be revised upward with a lag of about a year. Beyond that, households knew that those adjustable rates were going to lead to higher mortgage costs.

After the Bank of England's tightening steps, first, the market for rental properties, where amateur real estate investors buy "flats," or apartments, on the expectation of higher prices, weakened. The increase in U.K. home prices cooled from the 25-percent annual rate in 2004 to nearly a zero increase in 2005. Almost immediately thereafter, retail sales fell sharply so that, by the first quarter of 2005, household spending was also growing at a rate close to zero. Consequently, overall growth dropped sharply, below 2 percent, and sterling began to weaken as the market expected rate cuts from the Bank of England.

Many observers have suggested that the U.S. experience—a slowing housing sector as the Federal Reserve raises rates—will not play out the same way primarily because adjustable-rate mortgages are less common in the United States. While this is true, it is also true that the U.S. share of adjustable-rate mortgages over the past year has risen to about one-third of all mortgages. Beyond that, it is new buyers entering the market to bid more aggressively for real estate that keeps prices rising at double-digit rates. As the Fed boosts short-term interest rates, it is more difficult to engineer short-term teaser loans at artificially low rates to help new entrants purchase real estate or to help existing owners purchase more. Affordability becomes a growing problem at the margin, especially as home prices rise relative to incomes. The average initial payment for upscale home purchases rose by 13.4 percent (a 65-percent annual rate) during the first quarter of 2005.

It is useful to remember that the Fed boosted the federal funds rate by 225 basis points between mid-2004 and mid-2005 and indicates it will add another 75 basis points to that increase over the balance of the year, barring any sudden collapse in the housing sector. The ability of rate increases of that magnitude to slow the rate of increase of housing prices is not in question.

Slower House Inflation Is the Key

It is important to understand that the contribution of the U.S. real estate boom to household consumption and to the construction industry can be sharply curtailed even if price increases just drop from the current 20-percent-plus level to 5 percent or below, much as they did in the United Kingdom. Housing can become a drag on growth even if house prices are not falling. The reason lies with the dynamics of a housing bubble. When prices are rising rapidly, the desired stock of housing increases as households and contractors view housing as a better and better investment. As a result, the demand to buy housing rises and efforts by builders to develop more housing increase. After prices have risen sharply, perhaps at an increasing rate for a time, stresses begin to emerge. The central bank wishes the process to slow, so it signals that it will raise its policy-setting interest rate, and that news erodes affordability as home prices continue to rise. Meanwhile, rental returns fall as the stock of available rental housing that was purchased for investment purposes rises, and the rising supply of rental property on the market depresses rents.

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Once the momentum from ever-rising prices is lost and house prices actually begin to level off, the desired stock of housing falls. It is easy for the desired stock, which takes some time to build and cannot be rapidly destroyed, to fall below the existing stock that was built conditional on the expectation of ever-rising prices. Once the desired stock of housing falls below the existing stock, construction activity ceases and the rush of speculators to purchase more real estate switches to a desire to sell. If the process is orderly, housing price inflation just falls toward zero. If it is disorderly, house prices collapse as panicky speculators, unable to service their mortgages because of falling rents and less ability to obtain loans, start dumping properties.

Obviously, the Fed is shooting for a slowdown in house price increases (perhaps to a zero increase) in order to cool but not crush the housing sector. Yet, a mere leveling of housing prices would be sufficient to remove the boost from housing that is worth about 1 percentage point of growth. With that impetus eliminated and the drag from higher oil prices continuing, the U.S. growth rate could easily drop to 2.5 percent or lower, depending upon the future path of energy prices, the persistence of the negative impact of past energy price increases, and the sharpness of the drop in house prices.

The Tightening Challenge

The Fed faces a difficult operation. Causing the increase in housing prices merely to slow and not drop requires a degree of policy precision that few at the Fed would claim they possess. In fact, the Fed may be required to overshoot in the tightening process. The reasoning is as follows. If the Fed stops tightening before the housing bubble collapses, the bubble may grow even larger. Were the Fed to hint at its next meeting that a 3.5 percent Fed funds rate represented the top, markets would quickly conclude that the next interest rate move would be downward and asset markets, especially the housing market, would experience another leg up. On the surface that may seem like a good thing, but with housing prices already at levels way too high, relative to income, to be sustained, a larger bubble would only increase subsequent instability.

The Fed is forced to signal continued rate increases until it observes a marked slowdown in the housing sector and a leveling of price increases in the numerous "hot" real estate markets. Given the lags involved in collecting data on the housing sector and the lags involved in enacting monetary policy, it may be that by the time a slowdown in the housing sector is clearly obvious, the Fed will already have induced a sufficient housing decline to result in a sharp slowdown of the economy. The slowdown, in such circumstances, is even more likely given the increasing drag built into the economy from ever-rising energy prices. The chance that the Fed will over-tighten and induce an actual drop in housing prices is present, although it is not as likely as an outcome whereby housing prices simply level off. Were housing prices actually to fall sharply, it would be very likely that a U.S. recession would follow.

The Hard Part

The timing in which all this is likely to unfold is very difficult to determine. Based on the U.K. case, which we have acknowledged is not a perfect model, we might expect to see the U.S. housing sector start to level off in the second half of 2005. The clues to a cooling housing sector would

be weaker mortgage financing and refinancing data, longer transaction times for houses on the market, and a weakening of house price increases directly observable from data collected by government agencies. That said, it can be notoriously difficult to detect a slowdown in the housing sector because so many households and businesses have a strong interest in the continued housing boom that survey replies are sometimes unreliable.

For the weakening global economy, such a slowdown would be problematic. U.S. demand growth, in turn driven by robust price appreciation in U.S. real estate, is about the only source of demand growth in the industrial world. If it is dampened by a real estate drag, the negative global growth impact of higher oil prices could quickly become even more obvious. Already, Europe and Japan are suffering from a double negative of higher oil prices and weaker currencies against the dollar, in which oil is priced.

To repeat, the notion that world growth is sustainable with oil at $60 per barrel because the United States can shrug off the implied energy drag depends almost entirely on a continued housing boom. But the Fed is raising interest rates, a central-bank policy move that has already quelled a housing boom in the United Kingdom, not to mention Australia and New Zealand. We need a "Goldilocks Tightening" that sets the temperature in the real estate sector just right: not too hot and not too cold.