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## The Fed: Pulling on a Rubber Band

By John H. Makin

On December 13 the Federal Reserve's Open Market Committee (FOMC) raised the federal funds rate, the principal tool for setting monetary policy, by 25 basis points to 4.25 percent. At the same time, the Federal Reserve Board of Governors greatly simplified what had been a tortured statement explaining the basis for their actions and the factors that will govern future actions. The statement was remarkably brief:

Despite elevated energy prices and hurricane-related disruptions, the expansion in economic activity appears solid. Core inflation has stayed relatively low in recent months and longer-term inflation expectations remain contained. Nevertheless, *possible increases in resource utilization as well as elevated energy prices have the potential to add to inflation pressures.*

The Committee judges that *some further measured policy firming* is likely to be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. In any event, the Committee will respond to changes in economic prospects as needed to foster these objectives. (emphasis added)

Markets broadly interpreted the statement as implying 25 to 50 basis points of additional tightening to come. Most analysts leaned toward two additional increases—one on January 31, 2006 (Chairman Alan Greenspan's last meeting), and another 25 basis points on March 28, 2006, the first meeting to be led by incoming Federal Reserve chairman Ben Bernanke.

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### Markets May Underestimate Need to Tighten

As is often the case, the market's current view of the future path of Fed actions may be misguided. The American economy, and especially the American consumer, is not behaving as if monetary policy is restrictive. And in fact, with real interest rates (market rates minus inflation) at about 2.25 percent and growth at 4.25 percent, monetary policy is not restrictive.

The Fed is fully aware of the possibility that monetary policy may need to tighten more than markets expect. One of the four sentences in that December 13 press release, "Nevertheless, possible increases in resource utilization as well as elevated energy prices have the potential to add to inflation pressures," says as much.

The U.S. consumer, truly a robust species, holds the key to the outlook for Fed policy and the U.S. economy in 2006. The most important determinant of consumption spending that has emerged this year is not the path of income, or even the path of wealth, but rather the immense elasticity of the credit available to consumers. Financial innovation by U.S. banks and credit unions has engineered an extraordinary liquefaction of housing wealth. Home equity lines of credit enable Americans to use accumulated wealth in their owner-occupied real estate to write checks or use credit cards to pay for whatever they want—from restaurant meals to automobiles.

The consumption-enhancing upshot to the boost to real estate has been further aided by changes in tax policy. Since 1997, homeownership couples have been entitled to realize up to half a million dollars of tax-free capital gains on their

primary residence if they have lived in it for two of the five years prior to sale. A new class of fix-up vagabonds has emerged to move into houses, fix them up, sell them for a substantial tax-free capital gain, and move on to a more expensive house to repeat the process.

In fact, it is not even necessary to sell one's house to realize capital gains. Banks continue to aggressively market cash-out refinancing, wherein homeowners are invited to lower the rates on their mortgages and, while they are at it, increase the size of the mortgage in order to withdraw cash. Judging by most spending data, such cash-outs are promptly spent on a wide range of consumption goods and services. The strong possibility that many such cash-out refinancings are executed without the benefit of adequate equity in the house used as collateral is a detail that is often overlooked.

The banks that are granting such new loans do not keep them on their balance sheets. Rather, they package them and sell them to other intermediaries that in turn securitize the collection of mortgage loans and resell them, often to investors in Asia and Europe. Many have remarked on the irony of the fact that it is the foreign investors from countries that are most disapproving of America's rising current-account deficit who are sustaining that very deficit by eagerly lending to Americans who wish to liquefy the large increase in housing wealth.

### **Real Estate Wealth Gains Being Consumed**

The tax-break-enhanced buildup in U.S. real estate wealth since 2000, when Americans returned from stock market mania to their traditional favorite investment—housing—has been about \$5 trillion. The typical disposition such an increased “nest egg” used to be to employ it as a form of savings, so that one's house served as the primary investment of most middle-class American families. But financial innovation has turned the nest egg into a vehicle to support consumption, with the result that the Federal Reserve faces a difficult challenge as it tries to moderate U.S. growth before inflation rises to unacceptable levels, specifically core inflation that persists above 2 percent per year.

So far, the Fed's efforts to slow the U.S. economy have been something akin to pulling on a rubber band. While short-term rates have been boosted from 1 percent in June 2004 to 4.25 percent at the end of 2005, consumption growth has actually accelerated, having reached a 4.3 percent annual growth rate in the third quarter, identical to the average growth rate in the second-half of 2004 and

well above the 3.5 percent growth rate during the first-half of 2005. Part of the reason lies with the fact that long-term interest rates have not risen since the Fed began its rate-boosting exercise nineteen months ago. Ten-year yields, at about 4.5 percent, are exactly where they were in June 2004. Higher short- and medium-term interest rates, still at about 4.25 percent, have not proved an impediment to continued increases in U.S. household borrowing and spending.

While fourth quarter growth may slow to below 2 percent, largely because of a sharp drop in consumption spending, a rebound of consumption and growth during the first-half of 2006 seems likely. The fourth quarter growth slowdown will stay the Fed's tightening hand—perhaps at 4.5 percent. Medium- and long-term interest rates will fall, perhaps below the 4.5 percent on fed funds, and spending and asset markets will rebound.

### **Rising Inflation Risks**

As spending rebounds next year, aided by America's amazing elastic credit machine, inflation risks will intensify. By summer, the Fed may be forced to undertake a second round of tightening, this time pulling even harder on the elastic band until it snaps back hard, preferably curtailing the growth in the U.S. real estate wealth and with it, the above-trend growth in U.S. consumption spending. Already, late in 2005, core inflation is running at about 2 percent, the top of the Fed's preferred range. Rising capacity utilization and possible translation of higher energy costs to core inflation could pressure the Fed to boost rates even sooner than markets expect. As noted above, the Fed specifically cautioned markets about these risks in the December 13 statement that accompanied a boost in the fed funds rate to 4.25 percent.

The Fed's willingness to pull hard enough on the elastic band that transmits accumulated U.S. housing wealth into rapidly growing U.S. consumption spending should not be doubted. There is a great deal at stake. Any risk of substantially higher U.S. inflation carries with it significant risks for the performance of the real economy. A glance at long-term U.S. macroeconomic data during the years since 1950 clearly shows that periods of low and stable inflation not only encourage higher growth, but also a more stable growth path for all macroeconomic variables. Consequently, the asset markets, which price claims on income streams from real economic activity, have performed well at those times. The Fed simply cannot risk a return even to moderately higher and less-stable inflation.

The Fed's concern about its ability to moderate growth has probably been increased by a careful study of third-quarter growth this year and its underpinnings. Even with a 50 percent rise in energy costs over the year prior to the third quarter, rising short-term interest rates, the eroding affordability of housing, and two record hurricanes, the growth rate of the economy and consumption accelerated to 4.3 percent during the third quarter—up smartly from the 3.3 percent rate during the second quarter. Moving into the fourth quarter, despite two months of weak auto sales in September and October, retail sales rose at a 3.6 percent annual rate during the three months ending in November. Excluding volatile auto sales, the three-month annualized growth rate of retail sales through November was 7.1 percent. Adjusted for inflation of about 3.5 percent, that is still a respectable real 3.6 percent growth rate.

All of this consumption growth is even more amazing when you consider the weakness of income growth. Real disposable income has risen at about a 0.9 percent rate over the past year, hindered significantly by energy-led higher inflation. (Without being adjusted for inflation, income has risen at a 4.2 percent nominal rate over the past year.)

The persistent growth of consumption in excess of income growth has typically been explained simply by the large increase in wealth enjoyed by American households. The flow-of-funds data (which track U.S. wealth) released early in December do indeed show an extraordinary \$3.2 trillion increase in real net worth during the year ending in the third quarter of 2005. About half of that increase came from a rise in the net worth of housing—that is, the rise in housing values minus the total increase in mortgages.

The normal rule of thumb is that about 5 percent of an increase in net wealth is spent by households. Five percent of \$3.2 trillion is about \$160 billion, suggesting that about 2 percentage points of consumption growth would be generated by the wealth increase. Another percent or so would come from the 1 percent increase in real disposable income. Yet, real consumption grew by about 4 percent during the year ending in the third quarter, thanks in part to a surge to a 4.3 percent annual growth rate in the third quarter.

Putting it all together, the growth of U.S. consumption spending, even allowing for modestly higher income and powerful wealth growth, remains 1 to 2 percentage points

above its expected path. This comes at a time when external shocks, such as anticipated Fed rate increases, damaging hurricanes, and some slowdown in the housing sector, might have been expected to slow the growth of consumption spending to below its projected level based on wealth and income increases.

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## Mortgage Equity Withdrawal

Much of the explanation for the midyear surge in consumption spending can be attributed to mortgage equity withdrawal. The Fed's flow-of-funds data showed that U.S. households' mortgage equity withdrawal reached about \$800 billion during the third quarter of 2005, with upward revisions to close to \$700 billion in the second quarter. The emerging picture is one in which households, having grown considerably wealthier, thanks to higher

stock prices and persistently rising real estate values, have decided to spend even more than wealth and income increases would normally predict.

Economic theory suggests that higher consumption spending today is the best predictor of future wealth increases, since households are supposed to spend a constant portion of their permanent income, which in turn is proportional to wealth. The jump in consumption relative to wealth and income (as measured in 2005) suggests that U.S. households were expecting a substantial wealth increase in coming years that would also increase their permanent income.

An alternative explanation lies with the financial innovation hypothesis. U.S. financial intermediaries have developed home equity lines of credit, which essentially provide middle-class Americans with prearranged lines of credit that are activated either by checkbooks or the use of credit cards. At the end of September, \$560 billion worth of outstanding lines of home equity credit was available to U.S. households. It appears that households have come to view the home equity credit line as an increase in wealth when, actually, it is simply a new way of liquefying existing wealth. American households feel wealthier than they did in the past when the value of their principle asset—owner-occupied real estate—rises because they already possess a checkbook or a credit card that enables them to spend that increase in value as if it were an extra paycheck.

During periods when real estate values rise rapidly, the actual increase in liquidity and the apparent increase in

available income can seem extraordinary. For a typical American homeowner earning, say, \$60,000 a year and possessing a \$300,000 house, a 10 percent increase in the value of the house produces a \$30,000 increase in funds available to the checking account, thanks to the new prearranged mortgage equity line of credit. For a middle-income household lucky to have annual discretionary income of \$10,000, a \$30,000 boost in available and spendable credit has proved a heady experience.

## Outlook for 2006

The most important question concerning the U.S. economic outlook for 2006 is this: Will consumers continue to use easier access to credit tied to wealth increases so that spending rebounds early in 2006 and poses an inflation threat that forces the Fed to tighten further? Or was the consumption surge during the third quarter a final credit-driven consumption binge that has already been tamed by the Fed's short-term rate boosts to a level above 4 percent?

The consumption-rebound scenario is more likely. Betting on the alternative means betting against the American consumer's willingness to spend, something that for decades now has not been a very good idea. While house prices have leveled off and mortgage equity loans have stopped rising for the time being, interest rates are still low and may move lower, partly as growth slows down during the fourth quarter of 2005. Such therapeutic slowdowns have occurred before, such as during the post-2000 economic expansion, with the result that longer-term interest rates fall and borrowing and spending rebound. Beyond that, banks are eager to continue the real-estate-based credit boom.

As households deplete mortgage equity lines, banks are likely to top them off to previous peak levels, thereby convincing households that their spending can continue to rise. Interest rates on home equity loans have risen from 4 percent to over 7 percent, thereby constituting a profitable line of business for banks and for the investment banks and other intermediaries who package the loans for resale to investors. A package of mortgage-backed securities yielding 7 percent, or slightly higher, constitutes an attractive asset in a world where trillions of dollars are sloshing around looking for an outlet that earns a respectable rate of return.

While some resistance has emerged to purchasing the lowest quality mortgage-backed securities, thereby increasing the spreads between returns on those and

higher quality mortgage-backed securities, the newly innovative real estate lending business is alive and well. Banks are eager to continue to participate in the profitable business of supplying mortgage-backed securities to global financial markets that are, in turn, hungry for high-yielding assets. In short, American households will find it remarkably easy to continue to spend all their income and more.

The only limit to the process comes when the spending produces a persistent increase in prices that forces the Fed to raise interest rates further and faster than markets expect. Then, house prices level off and retail sales suffer as credit conditions become less accommodative. At least this is a scenario that many analysts, myself included, are putting forward based upon the experience after the 2004 rate increases in the United Kingdom. House prices did level off and retail sales did slow. However, in recent months, U.K. property prices have begun to pick up again while retail sales volumes have clearly increased. The evidence from the U.K., Australia, and New Zealand—all countries that have experienced strong consumption based upon rising real estate values—is that consumers are reluctant to end their spending spree. Real estate booms make them feel wealthier, banks convince them that the wealth is part of their income, and spending resumes.

## Soft Landing—or Hard?

This is another way of saying that it is difficult to engineer a soft landing after a real-estate-driven spending boom. The initial wave of tightening can level off real estate prices, but the lending and spending process resumes, albeit at somewhat higher interest rates.

Ben Bernanke and his FOMC colleagues may make the unfortunate discovery that the only way to slow down a credit-driven boom is by creating fear in the minds of consumers who are enjoying the heady experience of overdraft facilities on a scale that few had imagined possible. We probably will not see the end to this expansion until the spending boom produces inflation that, in turn, forces the Fed to raise interest rates to levels that hurt the real economy. That hard-landing pain would come in the form of real interest rates well above the current 2 percent prevailing level. Such rates, in turn, would slow employment growth and might thereby frighten American households enough to make them throw away the letter from the bank congratulating them on another increase in their home equity line of credit.