

Monetary Policy And Housing

The phrase, “First, do no harm,” while not part of the Hippocratic Oath for physicians as commonly believed, is good advice nonetheless. What, do you want the representative of your local HMO to have a needlepoint up on the wall reading, “Go ahead, what’s the worst that can happen?”

It is good advice for monetary policy, too, and as any honest assessment of the Federal Reserve’s history (see Allan Meltzer’s [“A History Of The Federal Reserve”](#)) would have to conclude, it was honored in the breach more often than not during the central bank’s first half-century. I have argued you could extend Meltzer’s conclusion another thirty years until passage of the Depository Institutions Deregulation And Monetary Control Act of 1980.

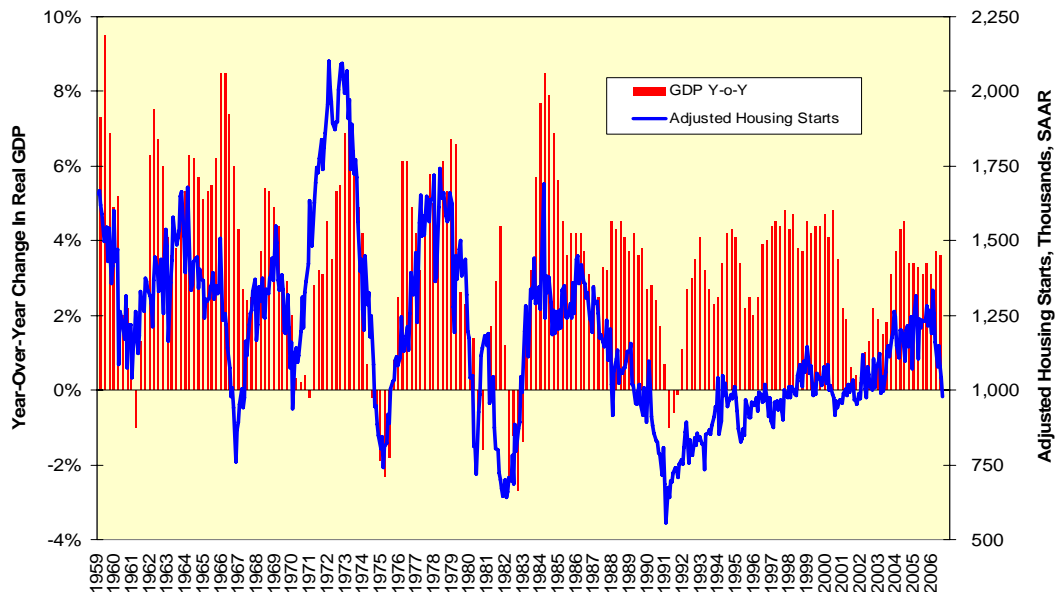
This Carter-era measure phased out the interest rate ceilings of Regulation Q and effectively prevented the Federal Reserve from crushing the interest rate-sensitive housing and automobile sectors at a whim. No longer could the Federal Reserve raise rates over the levels banks and savings & loans were allowed to pay and starve lenders of deposits. Along with financial derivatives, which created mortgage-backed and asset-backed securities, the removal of interest rate ceilings allowed credit to flow to borrowers even when the Federal Reserve raised short-term interest rates.

We have had only two recessions since that time, one associated with the Persian Gulf War in 1990-1991, and one associated with the bursting of the stock market bubble in 2001. It’s amazing what a free economy can do when its government is prevented from declaring war on it.

Different This Time?

That housing is taking it on the chin and elsewhere these days is hardly front-page news. Have housing downturns led economic downturns in the past? Let’s adjust housing starts for population growth – some might argue with reason population growth within prime home-buying age cohorts might be a better measure – and map it against the year-over-year change in real GDP. If housing downturns have led recessions in the past, it is not visible in this chart. If anything, changes in real GDP appear to either lead changes in housing with a small lag or the two measures are coincident.

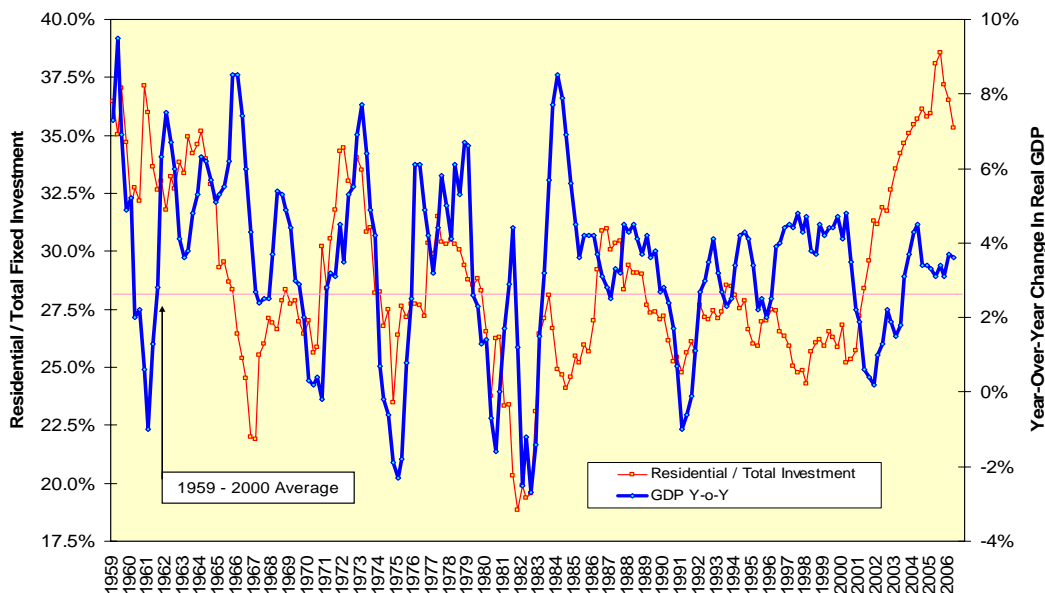
Adjusted Housing Starts And GDP Growth



But this is not the whole story. At no point in the past was national investment so skewed toward residential fixed investment. Between the 1959, the start of the series, and 2000, residential fixed investment averaged 28.1% of total investment. After the Federal Reserve began its grand experiment in lower interest rates in 2001, this measure climbed as high as 38.5% in the third quarter of 2005. This percentage already is in retreat and appears likely to collapse to at least the long-term average if not lower.

Previous downturns in the share of investment accounted for by housing either led or coincided with downturns in GDP growth between 1965-1967, 1972-1975, 1979-1981 and 1988-1990. The obvious question now becomes whether this present decline in residential fixed investment will do the same.

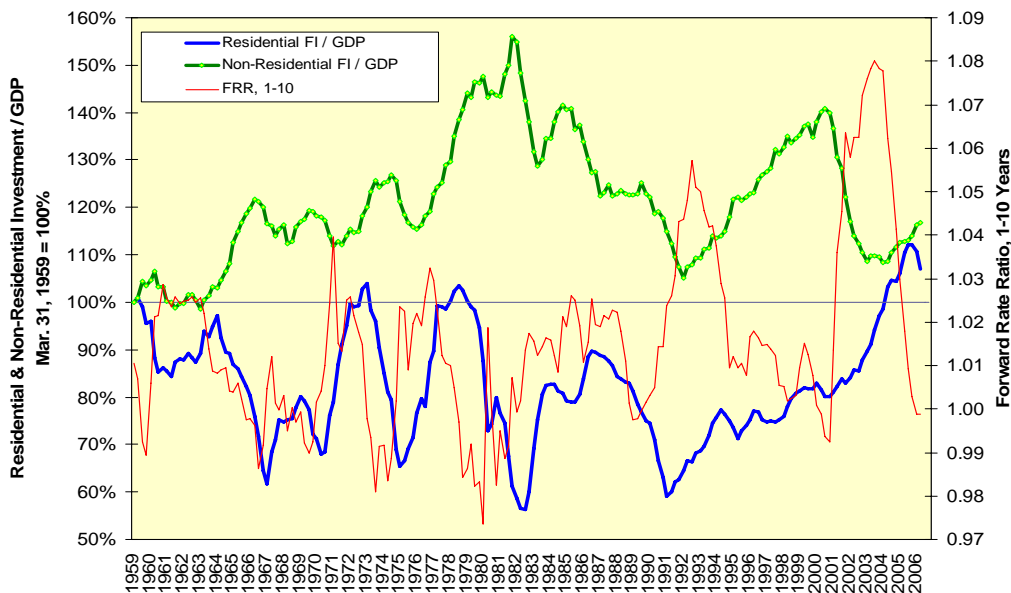
Housing Investment And GDP Growth



Yield Curve And Investment Patterns

Let's compare how residential and non-residential fixed investment patterns have changed over the years as a function of the yield curve. Investment as a percentage of GDP is indexed to the first quarter of 1959, and the yield curve is measured by the forward rate ratio between one and ten years. This is the rate at which you can lock in borrowing for nine years beginning one year from now divided by the ten-year rate itself. The more this number exceeds 1.00, the steeper the yield curve.

Investment Patterns And The Yield Curve



The two measures of fixed investment paralleled each other between the early 1980s removal of Regulation Q ceilings and the start of the Federal Reserve's manic interest rate cuts in 2001. After 2001, residential fixed investment surged while non-residential fixed investment fell. The Federal Reserve stimulated the American homebuyer and consumer, but as noted in [January 2005](#), much of this demand was satisfied not by American producers but rather by Chinese producers; this accounted for the "missing" non-residential fixed investment. By

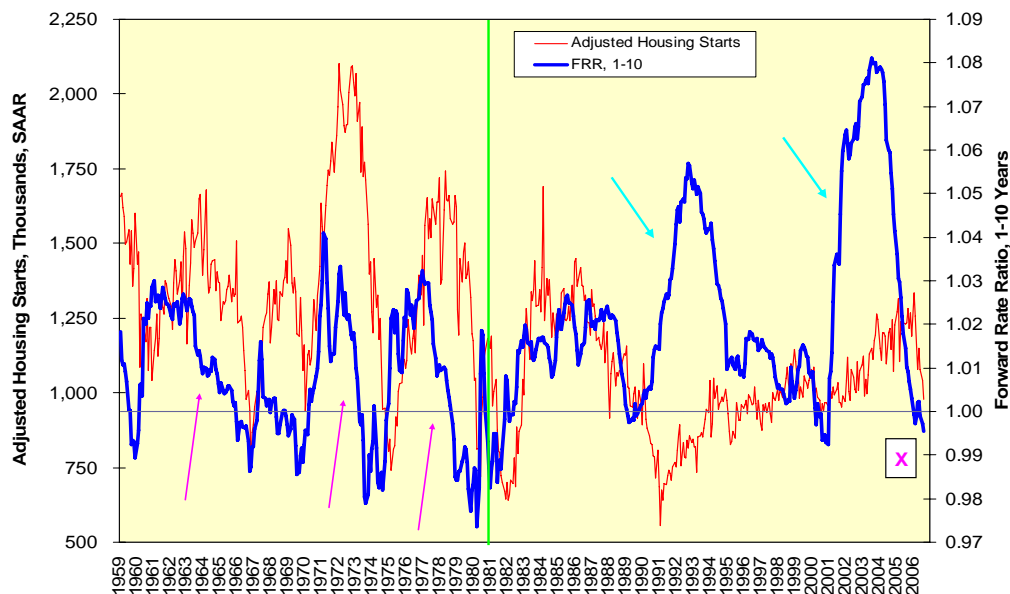
way of confirmation, the two investment measures moved in parallel during the previous yield curve steepening cycle in 1990-1993 and in the subsequent flattening cycle in 1993-1995.

If the U.S. is to avoid a housing-led downturn during the present flattening of the yield curve, it is absolutely critical for non-residential fixed investment to increase as a percentage of GDP.

The Federal Reserve: It's Baaack!

We now have to circle the square by returning to the mischief monetary policy can create. Prior to the removal of Regulation Q, three separate flattenings of the yield curve, noted in upward-pointing arrows, led to sharp declines in adjusted housing starts. After 1981, the two huge steepenings of the yield curve led to increases in adjusted housing starts. The present coincidence of a flattening of the yield curve and a collapse in adjusted housing starts, marked with an 'X' on the chart, is a first in the post-Regulation Q era.

Yield Curve Response To Housing



Can we lay the blame on this state of affairs at the Federal Reserve's doorstep? Yes: By creating the housing bubble with monetary ease, they created the housing downturn.

Can we achieve the growth in non-residential fixed investment required to offset the downturn in housing?

Evidence so far, chiefly strong equity prices, transportation indicators and tight credit spreads, indicate growth is continuing apace. Both markets and economies adapt wonderfully when given the opportunity to do so, and that invariably means an absence of our politicians' best intentions. That admonition to "first, do no harm" should be posted over every doorway in Washington, D.C.