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Fed follies fallout

By Richard W. Rahn
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MIAMI, Fla. -- The skyline appears to have more cranes than buildings, as if the city were just one vast construction site, and that has been the good news. The bad news here in Miami, as well as most major U.S. cities, is that the real estate boom of the last few years is coming to an end. The villain in this drama is the U.S. Federal Reserve (the Fed), which fueled the boom and now is destroying it.

The Fed, by its own admission, has been failing to keep inflation within its own targets. Yet, the Fed's main responsibility is to provide the U.S. with a sound currency; one that neither loses value (inflation), nor gains value (deflation).

The Fed has a long history of reacting too late, then overreacting, to the inflation or deflation it causes. One reason the Fed keeps failing is its overreliance on lagging indicators of inflation, such as the well-known consumer price index (CPI). A measure of the final price of goods and services, the CPI is like a rearview mirror that shows the Fed produced either too much or too little money a year or two ago. (The Fed controls money supply by setting the rate at which it lends money to banks, and by selling and buying government bonds.) When the Fed produces too much money, it usually shows up first in a big rise in commodity prices (particularly futures) and in asset prices, such as real estate, and lastly in the CPI.

Commodity and real estate prices had increased very rapidly over the last several years, which should have indicated to the Fed it was allowing too much growth in the money supply and thus should have more quickly increased interest rates and slowed money growth.

Look what is happening to real estate. The Fed created very low interest rates. These rates allowed people to borrow very cheaply, and hence buy much more expensive houses than their incomes would normally justify. That gave us the housing boom of recent years. But the chickens are coming home to roost. As interest rates have risen, fewer people can afford the current price of homes.

Initially, sellers are reluctant to cut their prices from those they had expected to receive; yet, when buyers see prices start to fall, they are reluctant to buy; hence, we see the big increase in unsold housing. Eventually, more sellers feel the pressure to sell because they cannot maintain the interest payments (particularly if they have adjustable rate mortgages -- these rate adjustments lag other interest rate changes), or must sell their homes for

other reasons. To do so they must offer bigger and bigger price reductions. Again, as the fall in prices accelerates, potential buyers become even more reluctant to buy into a falling market.

The fall in prices discourages new housing starts, but eventually the reduction in inventories will cause prices to stabilize and then rise.

What often is not understood is the very long lag between changes in Fed behavior and its effects on the real estate and other markets. Excess monetary growth might take two years to show up in the CPI and some interest rates. It takes another couple of years for housing inventories to fully adjust to the fall in prices caused by the Fed's need to reduce monetary growth because of its previous excesses.

As new home production sags, the price of building materials will decline as supply begins to exceed demand. With fewer new homes built, the demand for home furnishings and appliances falls, and workers are laid off. All these falling prices cause the Fed to re-accelerate monetary growth, and the cycle starts all over again.

The price level of basic commodities in the U.S. was little changed from the late 1700s to 1913 (despite temporary spikes and dips), when the Fed was created and took over managing the dollar. In the last 93 years, the Fed has managed to give us the Great Depression, many recessions and made the dollar worth about one-twentieth its 1913 value.

The business cycle is not preordained. In modern times, it has almost always occurred because of failures in judgment by those who can influence the economy. More often than not, the failed judgments have been at the Fed. Nobel Prize winning economists F.A. Hayek and Milton Friedman observed long ago that those serving on the Fed Board, no matter how wise, could not consistently outguess the market, and hence the Fed was doomed to failure.

How many more Fed failures will we have to endure before we abolish it, and start over again?

Richard W. Rahn is director general of the Center for Global Economic Growth, a project of the FreedomWorks Foundation.

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