

Applying the Concept: Housing Bubbles and Monetary Policy

The housing market is hot, and people are getting worried. For the year ending April 2005, prices of existing homes in the U.S. rose more than 15 percent. That's more than four times the increase in the consumer price index during the same period. And the national average masks substantial regional differences. In South Florida, Las Vegas, and parts of Southern California, home prices rose by between 25 and 50 percent.

While it is possible that demand to live in these places has suddenly gone up dramatically, there is also the possibility of that there is a bubble – in other words, that housing prices no longer reflect reasonable valuations, and that people are paying high prices solely because they believe they can sell to someone else at a higher price later. Outsized price increases are not the only sign that something is amiss. The rate at which people are selling their homes – what's called the turnover rate – has risen as well. By spring 2005 people were buying and selling homes at a record rate of more than 7 million per year. And there were stories that some people were flipping houses – buying them and selling them within a few days or weeks in an effort to turn a quick profit.¹

Quickly rising prices coupled with high turnover rates are clear signs that something has to give. And Federal Reserve officials have started to take notice. In their public comments, Federal Reserve Board Chairman Alan Greenspan, Vice Chairman Roger Ferguson, and Governor Donald Kohn have all mentioned the risks posed by a booming housing market, and the risk that the housing market will crash. The rule-of-thumb is that a \$1 change in housing wealth leads to a 5½ cent change in consumption. Households own about \$17 trillion worth of real estate, so a 10 percent decline in value would mean a consumption decline of nearly \$100 billion – that's one percent of GDP!

As we have emphasized throughout our discussion of central banks and monetary economics, monetary policymakers' goal is low, stable inflation and high, stable growth. A sudden collapse

¹ Yet another sign of a bubble include the increased use of adjustable-rate and interest-only mortgages (see Chapter 6, page 133) in an environment where short-term interest rates are rising. People are buying homes that are so expensive they can barely afford the initial mortgage payments on an interest-only mortgage even though they realize that the payments will likely rise. They must expect that they will be able to sell quickly and at a profit.

in consumption is surely something that they would work hard to avoid. This means working to ensure that the housing market doesn't boom and then crash; that a bubble doesn't grow and then burst. To do it, they should consider raising interest rates. And that's what the FOMC is doing.

