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REAL ESTATE

Fed Felt Hamstrung By 2005 Housing Bubble

By **SUDEEP REDDY**

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WASHINGTON—Federal Reserve officials acknowledged a housing-market bubble more than a year before U.S. house prices peaked, but they showed little inclination to address it, according to transcripts of their 2005 meetings released Friday.

During 2005, the Fed raised interest rates a quarter-percentage point at every meeting, unwinding the ultra-loose policy it pursued earlier in the decade to address deflation worries after the 2001 recession. The economy at the time was growing at a healthy pace with few signs of overheating. But with reports across the U.S. indicating a bubble in the housing market, the Federal Open Market Committee spent time assessing the appreciation in home prices and what, if anything, the Fed could do about it. Fed staff economists had found that housing might be overvalued by as much as 20%, based on the historical relationship between prices and rents.

But Fed officials appeared hamstrung because they believed their most important tool—interest rates—could not address frothy housing markets alone without influencing the broader economy.

"I get very irritated when I see columns suggesting that we are trying to inspire or should be trying to prick a housing bubble," said Fed Governor Edward Gramlich, who died in 2007. "There is no way to do that and still maximize the inflation/unemployment outcome. Monetary policy is broad and has broad effects."

The central bank's decision to push interest rates down to 1% earlier in the decade "probably did add to the housing bubble, if, in fact, there is a housing bubble," Mr. Gramlich said at the June 2005 meeting. "When we take rates down in a soft economy,

we probably will be creating some bubbles, or at least mini bubbles here and there—not because we want to, but because it is inevitable."

William Poole, then president of the St. Louis Fed, knocked down the idea of the Fed tackling asset-price bubbles. "It seems to me that that would change the whole nature of the pricing mechanism in asset markets. And I think it would be a terrible idea in a market economy to have a government agency setting capital asset values."

The Fed releases transcripts of FOMC meetings with a five-year lag—to provide transparency in the long run while allowing officials to speak openly at meetings. The latest transcripts showed many officials acknowledging an unsustainable increase in home prices even if they didn't find acceptable solutions.

The housing bubble's eventual bursting pushed prices down about 30% from their mid-2006 peak and contributed to spurring a global financial crisis. Some officials have acknowledged that they relied on a faulty assumption that home prices would level out but not decline sharply. They also have started to discuss whether other tools, such as consumer regulations or supervision practices, should be employed to control bubbles before they become dangerous.

Some policy makers have questioned whether the Fed can accurately pinpoint bubbles as they are developing. But several officials demonstrated, about a year before the housing peak, an ability to identify factors driving the market and their likelihood to continue.

Janet Yellen, then the San Francisco Fed president and now the Fed vice chairman, said at the June 2005 meeting that newer financing options, such as interest-only mortgages, were widely viewed as "feeding a kind of unsustainable bubble." But she suggested that higher prices themselves were "curtailing effective demand for housing at this point and that house appreciation probably is poised to slow. So the increasing use of creative financing could be a sign of the final gasps of house-price appreciation at the pace we've seen and an indication that a slowing is at hand."

Aside from reviewing complex models for home prices and the economy, one central-bank economist, David Stockton, even presented officials later that year with a piece of anecdotal evidence that "almost surely suggests that the end is near in this sector."

Mr. Stockton had been channel-surfing and came across a new television series "Flip That House," he told central bankers in the Fed's boardroom, drawing laughter.

"As far as I could tell, the gist of the show was that with some spackling, a few strategically placed azaleas, and access to a bank, you too could tap into the great real estate wealth machine," he said. "It was enough to put even the most ardent believer in market efficiency into existential crisis."

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