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Did the Fed Cause the Housing Bubble?



The Fed Provided the Fuel

By David Malpass

The blame for the current crisis extends well beyond the Fed -- to banks, regulators, bond raters, mortgage fraud, the Bush administration's weak-dollar policy and Lehman bankruptcy decisions, and Congress's reckless housing policies through Fannie Mae and Freddie Mac and the Community Reinvestment Act.

But the Fed provided the key fuel with its 1% interest rate choice in 2003 and 2004 and "measured" (meaning inadequate) rate hikes in 2004-2006. It ignored inflationary dollar weakness, higher interest rate choices abroad, the Taylor Rule, and the booming performance of the U.S. and global economies.

Even by the Fed's own backward-looking inflation metrics, the core consumption deflator exceeded the Fed's 2% limit for 18 quarters in a row beginning with the second quarter of 2004, while 12-month Consumer Price Index (CPI) inflation hit 4.7% in September 2005 and 5.4% in July 2008. This despite the Fed's constant assurances that inflation would moderate (unlikely given the crashing dollar.)

Background [The Fed's Moment of Weakness \(09/25/02\)](#) By David Malpass

Despite its role as regulator and rate-setter, the Fed claimed that it could not identify asset bubbles until they popped (see my rebuttal on this page "The Fed's Moment of Weakness," Sept. 25, 2002). It is clear that the Fed's interest rate policies cause wide swings in the value of the dollar and huge momentum-based capital flows. These bring predictable -- and avoidable -- deflations, inflations and asset bubbles.

Beginning in 2003, the Fed filled the liquidity punch bowl. Low rates and the weakening dollar created a monumental carry trade (borrow dollars, buy anything). This transmitted the Fed's monetary excess abroad and into commodities. As the punch bowl overflowed, even global bonds bubbled (prices rose, yields fell), contributing to the global housing boom. Alan Greenspan singled out this correlation in his March 11 op-ed on this page, "The Fed Didn't Cause the Housing Bubble."

Given this power, the Fed should itself stop the current deflation and the economic freefall. It has to add enough liquidity to offset frozen credit markets, the collapse in the velocity of money, and bank deleveraging (which has reversed the normal money multiplier.)

The Fed was on the right track in late November when it committed to purchasing \$600 billion in longer-term, government-guaranteed securities. Equities rose globally, and some credit markets thawed, including a decline in mortgage rates and corporate bond spreads. However, the Fed reversed course in January, delaying its asset purchases and shrinking its balance sheet. Growth in the money supply stopped. Since then, the Fed increased the amount of assets it intends to purchase, but lengthened the time period rather than accelerating the pace of purchases.

Given the magnitude of the crisis and the stakes, the Fed should be buying safe assets fast, not parceling out a few billion. Confidence and money velocity would also increase if the Fed committed itself to dollar stability, not instability, to avoid causing future inflations and deflations.

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