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Fed Saw Housing Weakness in August '06, Pausing Rate Rise

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(Updates with former Fed official's comment in fourth paragraph.)

Jan. 12 (Bloomberg) -- Federal Reserve officials detected growing weakness in the U.S. housing market in August 2006, deciding to pause after a two-year campaign raising the benchmark interest rate.

"After 17 consecutive moves, we would be tightening into a housing decline," Fed Chairman Ben S. Bernanke warned the Federal Open Market Committee on Aug. 8, 2006, according to transcripts of that year's meeting released in Washington today. "I remind you that the Fed has not been terribly successful with soft landings. We have a chance to get one."

The transcripts detail conversations among Fed officials through the year about housing and credit risk building in the financial system. Fed officials at the time were worried about their credibility to meet both aspects of their congressional mandate to achieve stable prices and full employment.

"I don't think they ever adequately, realistically dealt with the housing situation," said Gerald O'Driscoll, a former vice president for the Federal Reserve Bank of Dallas who is now a senior fellow at the Cato Institute in Washington. "They kept denying it was a bubble and were not prepared for what happened."

In just two years, the FOMC pushed the federal funds rate from 1 percent to 5.25 percent in a series of quarter-point moves as the economy barreled into its fifth year of expansion, driving down unemployment to an average rate of 4.6 percent that year.

'Inflation Nutter'

“I am concerned about the effect on the markets of perceiving the Fed as too aggressive,” Bernanke said at the June meeting. “There is a new chairman. They don’t know me. As far as they know, I am an inflation nutter, and I want to make sure that they understand that output is one of our concerns.”

Amid the boom, the U.S. grappled with near-record gasoline prices, and policy makers regarded the threat of persistent high inflation as their “predominant risk,” according to Timothy F. Geithner, who was then president of the New York Fed and is Treasury Secretary.

Richmond Fed President Jeffrey Lacker cast the first dissenting monetary policy vote of Bernanke’s chairmanship during the August meeting in favor of higher interest rates, and he continued to dissent at subsequent 2006 meetings.

“The first-order policy problem for us today is to influence the evolution of the public’s beliefs in a way that helps bring inflation down more rapidly,” said Lacker who is a voting member of the FOMC this year. “The risk that the housing contraction will have broader multiplier effects on personal consumption and other sectors is still relatively small.”

Price Decline

In 2006, U.S. house prices began to decline after four years of double-digit gains from 2002 to 2005. Home prices fell 0.28 percent in 2006, according to the S&P/Case-Shiller index of property values, a portent of the 8.4 percent slide in 2007 and the 18.4 drop in 2008 that would lead the U.S. economy into the worst recession since the Great Depression.

By October, policy makers had concluded “spillovers from housing to the rest of the economy had not yet occurred” and that “the upside risks to inflation exceed the downside risks to growth,” according to Bernanke’s summary of the meeting.

U.S. central bankers left the benchmark interest rate unchanged at 5.25 percent for the remainder of 2006 following their August pause.

‘Soft Landing’

At the Dec. 12 meeting, Bernanke said he thought “a soft landing with growth a bit below potential in the short run looks like the most likely scenario.” The National Bureau of Economic Research says the 18-month recession began in December 2007.

During the same meeting, former Fed Governor Susan Bies sounded alarms about risks in the so-called shadow banking system, where non-bank financial institutions provide credit outside the scope of bank supervision.

“A lot of the private mortgages that have been securitized during the past few years really do have much more risk than the investors have been focusing on,” Bies said.

“As more products are generated outside the banking sector, they get funneled to pools through broker-dealers as opposed to the banks,” she said. “I think that we’re missing a level of due diligence regarding brokers.”

The central bank releases the records after a five-year lag.

--Editors: James Tyson, Gail DeGeorge