Northern Trust

DAILY GLOBAL COMMENTARY

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Did Greenspan Have to Cut the Fed Funds Rate as Much?

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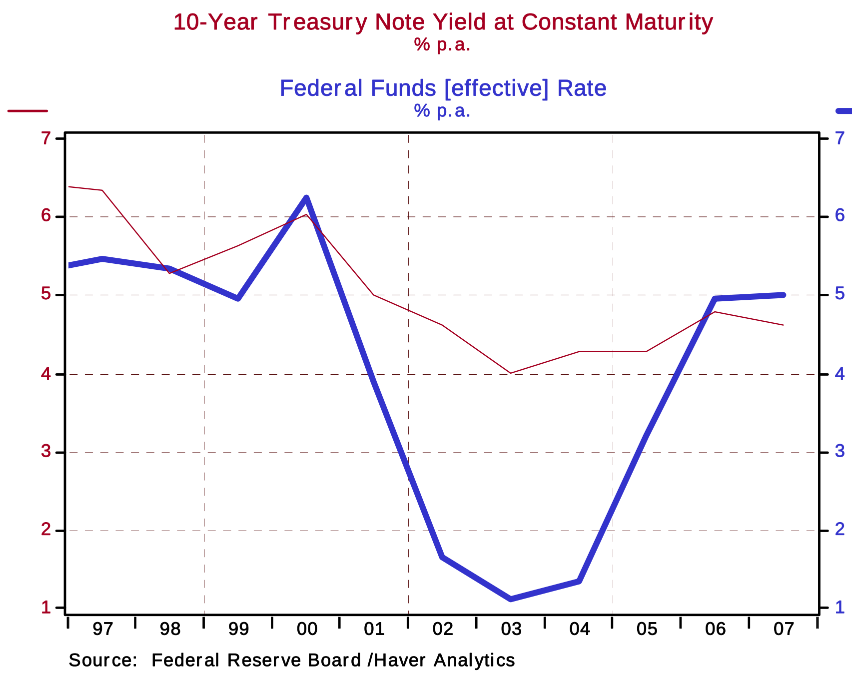
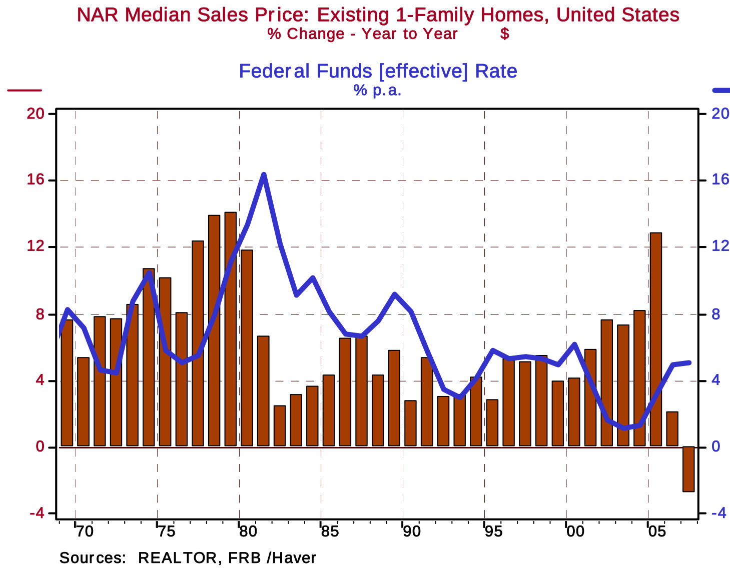
In today's *Financial Times*, Greenspan is generously given yet another chance to defend his legacy. Greenspan's argument that it was not his doing that set off the U.S. housing bubble reminds me of my two *perfect* children. When they appeared to err, it was never *their* fault. Greenspan's main defense lies on the fact that long-term interest rates were falling in the early 2000s due to global factors beyond his control. To start with, let's give him this one. But even if the decline in long rates were beyond his control, did he have to cut the fed funds rate – an interest rate he did control – as much as he did and hold it at the low level as long as he did (see Chart 1)?

Chart 1



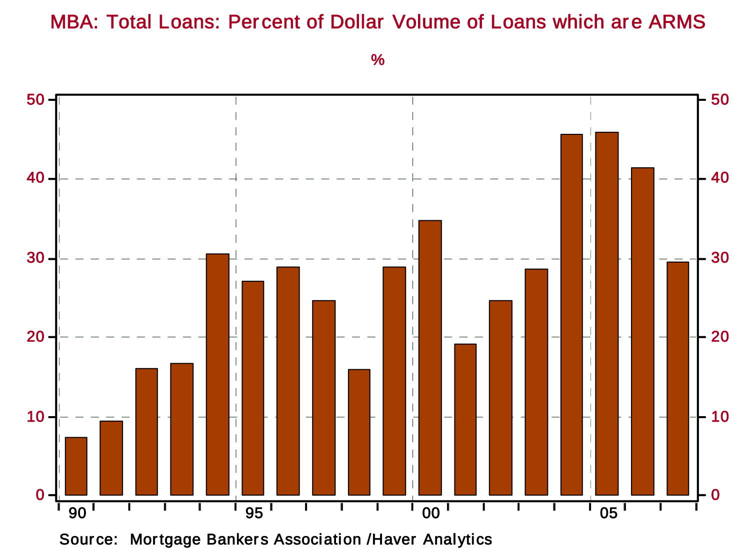
Starting in 2001, Greenspan held the fed funds rate below the year-over-year percent change in the median price of an existing single-family home, holding it below house-price appreciation through 2005 (see Chart 2). That is, the *real* fed funds rate in terms of house-price appreciation was *negative* from 2001 through 2005, establishing a record low real fed funds rate of *minus* 9.6% in 2005. Not since the late 1970s had the Fed allowed the fed funds rate to consistently trade below the rate of house-price appreciation.

Chart 2



Mortgage borrowers are not restricted to 15- or 30-year fixed rate loans. If shorter maturity rates are attractive, they can opt for those adjustable rate loans Greenspan was actually touting back in 2004. Chart 3 shows that mortgage borrowers *did* increasing opt for adjustable rate mortgages in the last housing cycle, in part (see Chart 3), presumably, because Greenspan held down short-term interest rates.

Chart 3



Back to Greenspan's lack of control of long-term interest rates. Although bond yields do march to a different drummer than does the fed funds rate, they still "hear" and are affected by the Fed's drum beat. That is, if the Fed sends a strong signal to the markets that it intends to slash the level of the federal funds rate and hold it at a low level for an extended period of time, these fed funds rate *expectations* will be factored into the level of bond yields – not one hundred percent, but not zero percent, either. So, Greenspan's argument that he had no control over bond yields is not entirely accurate.

So, as a free market economist, I can only lament that one of the byproduct's of Greenspan's artificially-low interest rate policy will be to discredit the functioning of free markets and bring on more regulation. Thanks, Alan. Ayn Rand must be spinning in her grave.

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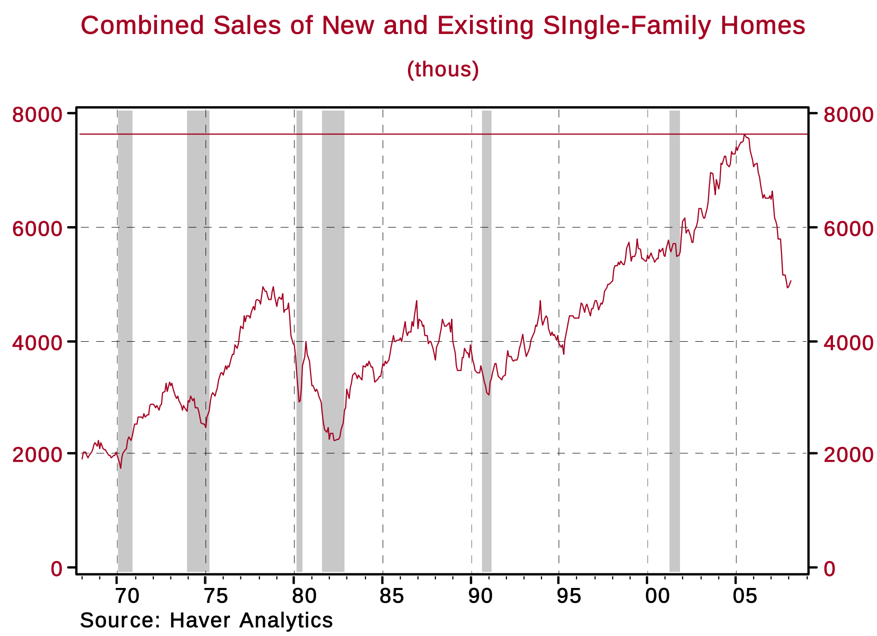
Employment and the Housing Sector – An Update

In the May 23, 2005 edition of this commentary it was noted the housing and related industries were a major contributor to growth in payrolls during the current business cycle (a copy of this commentary is attached at the end of today's comment). It is only fitting now to examine how employment has fared in housing and related industries in the past two years. Combined sales of new and existing homes peaked in July 2005 (see Chart 4) at 7.629 single-family homes. As of February 2008, combined sales of new and existing single-family homes were down 33.7% from the peak to 5.060 million homes.

Chart 4



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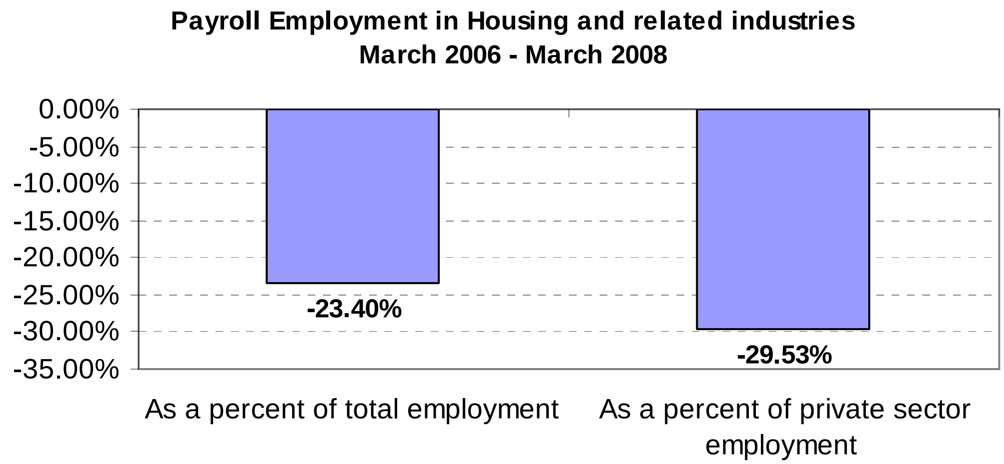
Job losses in housing and related industries were reported as early as March 2006. Moreover, these losses have been consistent and we have seen back-to-back monthly declines of payroll employment in housing and related industries since March 2006 (with two exceptions in April and August 2006). Between March 2006 and March 2008, job losses in housing and related industries have amounted to 23.4% of the change in total payroll employment and 29.5% of private sector payroll employment. In other words, a total of 575,200 jobs have been lost in housing and related industries in this period. Looking at these numbers in a shorter time span between December 2007 to March 2008, housing and related industries accounted for 129.3% of the total job losses and 71.0% of decline in private sector payroll employment. Although the NBER has not officially dated the recession, it is widely held that a recession probably began in December 2007/January 2008.

Chart 5



A word of caution – For the record, this analysis uses the same categories of employment used in the 2005 comment. The broad categories from the monthly employment report used to compute these numbers are – construction of residential buildings, specialty trade contractors (residential), building materials and garden supply stores, furniture and home furnishing stores, real estate, rental and leasing services. The financial sector's involvement is excluded because disaggregated data applicable to mortgage activity is not available in the employment report. Including this component would enrich the analysis. Also of interest is the fact that after revisions of payroll estimates, housing and related industries made up 53.7% of private sector payroll employment in the November 2001 to April 2005 period vs. the May 2005 calculation of 43.15%.

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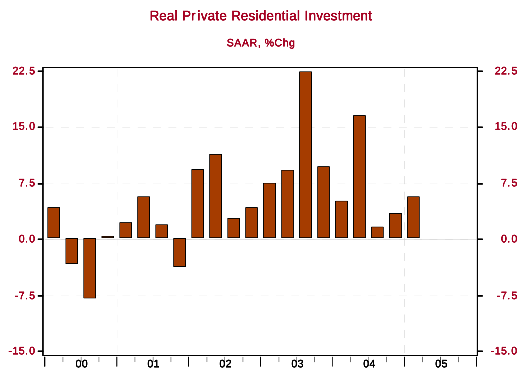
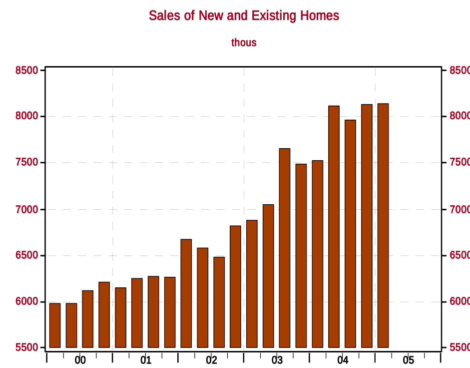
Housing Market – Another Information Tidbit

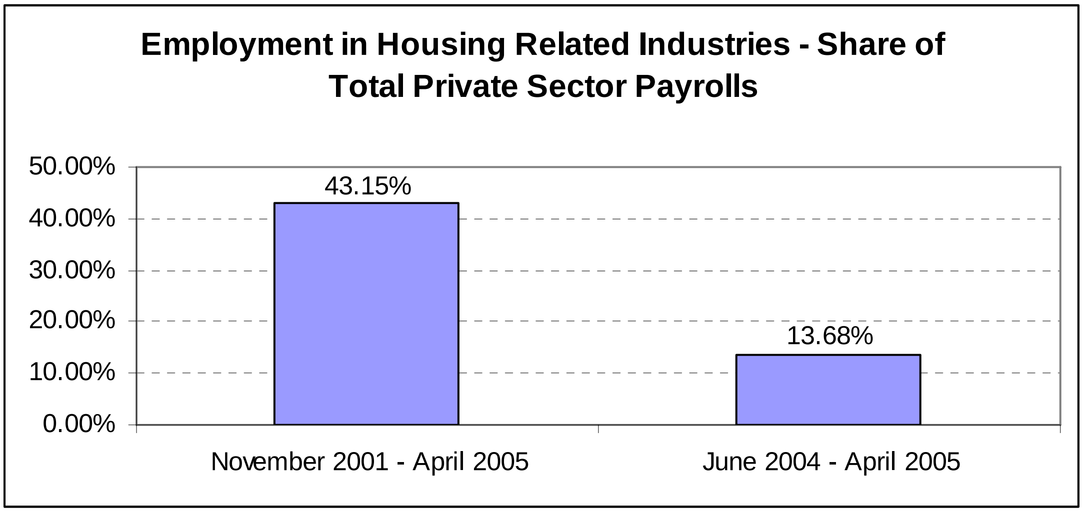
The housing market is featured almost daily in newspapers with catchy titles. The main issue is if a housing bubble exists. There are a range of opinions on this issue from the worrisome contenders pinning the next recession on an unwinding of the housing market bubble to those at the other end who see no major distortion of prices in the housing market and therefore foresee no disruption. Chairman Greenspan noted last week that there is froth in regional housing markets with few worrisome issues at the national level. Historically, the housing sector is the first to succumb to the central bank's monetary policy tightening. The housing sector escaped the 2001 recession unscathed and set a historical precedent.





Source: Bureau of Economic Analysis /Haver Analytics

Residential investment outlays have made a sizable contribution to the growth of real GDP in the current business expansion and sales of new and existing homes have soared to set new records. The future of the housing market is tied to employment conditions in the economy. The sluggish performance of payroll employment is the primary reason for the FOMC to take a measured path toward bringing the federal funds rate to a neutral level. At the same time, the performance of the housing market has played a visible role in payroll growth. Employment in housing and related industries (sum of employment in the establishment survey under various categories related to housing industry) accounted for about 43.0% of the increase in private sector payrolls since the economic recovery began in November 2001. The Fed began raising the federal funds rate in June 2004. During the June 2004 and April 2005 period, housing and related industries have accounted for 13.0% of private sector payrolls. The point I am trying to make is that a cooling off the housing market will have an impact via fewer new jobs in addition to other adverse effects. The number of job losses could be significant given the role the housing sector has played in the current recovery.



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