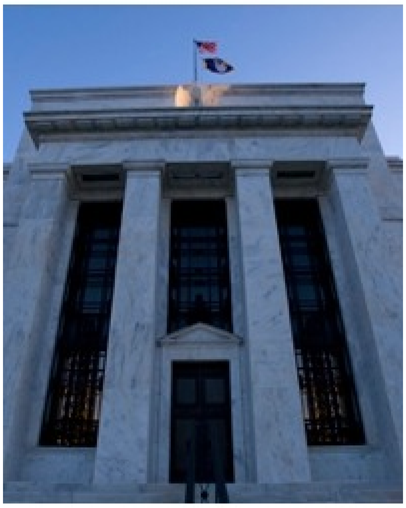
Written by Michael Tennant on January 16, 2012

Fed Didn't Recognize Housing Crisis in 2006, Transcripts Show



As if the last few years haven't provided evidence enough that such notions are pure folly, newly released transcripts of 2006 Federal Reserve meetings offer further proof. The transcripts show that the "experts" — members of the Federal Open Market Committee (FOMC) — were so clueless that even as late as December, when the housing market was displaying serious signs of decline, most showed little concern that the bursting bubble could take down the entire economy.

The committee met for the first time that year on January 31. One of the architects of the housing bubble, Alan Greenspan, was leading his final FOMC confab as Fed Chairman. The Fed's chief economist, David Stockton, was still forecasting a 5.5-percent increase in housing prices that year, though he admitted that "the housing sector is clearly one of the biggest risks that [the economy is] currently confronting."

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Still, overall the mood was one of guarded optimism with regard to the economy as a whole — and one of sheer delight at being in the presence of Greenspan the Great. Then-Fed Vice Chairman Roger Ferguson, for instance, called the outgoing Chairman "a monetary policy Yoda," referring to the guru of the Force in the *Star Wars* movies.

Janet Yellen, then president of the Federal Reserve Bank of San Francisco, said it was "fitting" for Greenspan "to leave office with the economy in such solid shape," telling the Chairman "that the situation you're handing off to your successor is a lot like a tennis racquet with a gigantic sweet spot" — a remark that generated much laughter in the room, though not the same kind it gets today.

The New York Federal Reserve Bank president at the time was not to be outdone in the bootlicking department. "I'd like the record to show that I think you're pretty terrific," one Timothy Geithner said to Greenspan. "And thinking in terms of probabilities, I think the risk that we decide in the future that you're even better than we think is higher than the alternative."

Newly-minted Fed Chairman Ben Bernanke presided over the March meeting. Stockton said housing was "the most salient risk" to the economy at that point and stated that he had no idea how far down the market might go.

Bernanke, however, expressed little concern. "I think we are unlikely to see growth derailed by the housing market," he remarked, later adding that he foresaw "a relatively soft landing in housing."

By May then-Fed Governor Susan Bies was warning of the dangers of "the growing ingenuity in the mortgage market." "Some of the models the banks are using clearly were built in times of falling interest rates and rising housing prices," she continued. "It is not clear what may happen when either of those trends turns around."

The Fed Chairman, on the other hand, said, "We are seeing, at worst, an orderly decline in the housing market." He argued that "some correction in this market is a healthy thing, and our goal should not be to try to prevent that correction but rather to ensure that the correction does not overly influence growth in the rest of the economy."

The next month George Guynn, then-president of the Federal Reserve Bank of Atlanta, pointed to "reports that builders are now making concessions and providing upgrades, such as marble countertops and other extras, and in one case even throwing in a free Mini Cooper to sweeten the deal" — a comment that drew laughter from the other committee members — "rather than reducing prices. So real house prices may be declining more than the data suggest."

Bernanke called housing "an important risk" but still did not seem to see it as a catastrophe about to happen.

In September he would continue to argue that "the economy except for housing and autos is still pretty strong, and we do not yet see any significant spillover from housing." Curious observers may wonder why Bernanke did not consider downturns in two major markets — markets the government would soon seek to salvage at tremendous cost to taxpayers — cause for greater concern. But Bernanke was not alone: According to the *Wall Street Journal*, other "officials played down the housing and mortgage threats" as well.

During the final meeting of the year, in December, "policymakers show[ed] little rising awareness of the storm coming their way," the *Journal* wrote. "Some of the evidence of rising weakness in housing was seen largely as a correction for past excess, rather than the genesis of the worst financial crisis since the Great Depression."

Bies was among the exceptions, referring to "a jump in delinquencies" in subprime Adjustable Rate Mortgages — which subsequently would become one of the biggest contributors to the housing collapse — and "the realization that 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."

The Chairman remained relatively nonplussed, saying, "A soft landing scenario with some slow but, I hope, decided reduction in inflation seems to be a reasonable expectation."

The *New York Times* described well the picture which emerges from the transcripts: "Some of the nation's pre-eminent economic minds did not fully understand the basic mechanics of the economy that they were charged with shepherding. The problem was not a lack of information; it was a lack of comprehension, born in part of their deep confidence in economic forecasting models that turned out to be broken."

The *Times* hastened to point out, quoting University of Pennsylvania economics professor Justin Wolfers, that "any other economist" would likely have been just as unaware of the looming disaster as the Fed was in 2006. That simply is not the case. Economists of the Austrian school had forecast the housing bubble years in advance and knew precisely what was happening as it began to burst. One

Austrian-school disciple, Rep. Ron Paul (R-Texas), told the House Financial Services Committee in 2003 that “the boom in housing prices cannot last forever” and that when it busts, both homeowners and mortgage holders will suffer. “These losses,” he explained, “will be greater than they would have otherwise been had government policy not actively encouraged over-investment in housing.” Paul’s warning went unheeded.

Meanwhile, back at the Fed, one voice remained upbeat throughout the growing housing crisis. In the March 2006 meeting that person argued that “overall financial conditions seem pretty supportive of the expansion.” In September he said, “We just don’t see troubling signs of collateral damage [from the housing market], and we are not expecting much.” And even in December, when Bies was cautioning the rest of the committee on the mortgage market, this member maintained that there was no need for “a substantial reassessment of the risks in the outlook” because “we think the fundamentals of the expansion going forward still look good.”

For his prescience, Timothy Geithner was rewarded with an appointment as Secretary of the Treasury under President Barack Obama.

Photo of Federal Reserve headquarters in Washington: AP Images