US Housing and US Interest Rates

It was in 2001 that Alan Greenspan, head of the US Federal Reserve started to reduce interest rates. The change was notable because it happened outside of the normal schedule of meetings and it was a half percentage cut. Financial markets celebrated and then popped, the dotcom bubble was over and the US economy went into recession.

During the next two and half years the Fed cut rates a dozen times. This was designed to fight off the effects of terrorist attacks on the economy and guard against deflation. Eventually, the interest rate hit 1%, the lowest for a generation. Before long the Fed began to raise rates and by 2007 the Fed rate was back to 5.25%. Throughout this period house prices boomed, then borrowers faulted on their repayments; and then the housing market collapsed. Was this necessary?

Central banks alter interest rates in order to manage gross domestic product, GDP and inflation. If actual GDP is in line with the potential GDP of the economy and inflation is on track to meet the central bank's inflation target, then interest rates will be neutral. The economic growth will neither accelerate nor decelerate. If the economy is operating beyond its potential GDP, then rates will rise. While an economy operating below potential GDP will see rates fall.

The crucial issues are measuring where the economy is, where it is heading and timing suitable policy responses. Some economists have suggested that the rate reductions undertaken by the Fed lasted far too long. When the economy began to grow, US interest rates were some three percentage points below their neutral level.

In 2001, despite the weaknesses in the broader economy, the US housing market was still strong. Annual price increases of 10% were still expected by many market observers. Some individuals were buying houses "off plan", before they were built; and selling again before building had been completed. Profits were good.

House builders responded to the surge in demand. The number of housing starts jumped from 1.5m, at an annual rate, in August 2000 to a peak of 2.3m in January 2006. In 2005, housing construction accounted for 6.2% of GDP, the highest share since 1950.

Even when the Fed began to raise rates, mortgage rates rose more slowly. Oil economies were benefitting from the high price of oil and were reinvesting profits in the US. China, on an export boom, was generating lots of dollar sales which were being reinvested in the US. These flows of funds were then lent to home borrowers and the housing binge continued. Only when Fed rates rose further, and mortgage rates eventually rose, did the cost of borrowings become excessive. Then homes were repossessed, property prices fell, lenders became nervous and the Fed cut rates.

Questions

1. Identify the macroeconomic topics within the case.

2. Identify the microeconomic topics within the case.

3. To what extent are microeconomics and macroeconomics independent of each other?