The Daily Dish

Should the Fed Ignore Housing?

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Tomorrow afternoon at 2:00 the Federal Open Market Committee (FOMC) – the policymaking vehicle for the Federal Reserve – will announce its latest decisions on interest rates and quantitative easing. In advance of the decision, two long-time financial policy experts, Jim Parrott and Mark Zandi, took to the pages of *The Washington Post* to send a message to the FOMC: "It's okay to cut interest rates now." Obviously, there are lots of opinions about the future of Fed policy. But Parrott and Zandi are thoughtful and seasoned analysts, so it is worth considering their arguments. Also, they are dead wrong.

Essentially, they make three main points:

- The personal consumption expenditures (PCE) price index is a flawed measure of inflation;
- The Fed should target non-housing inflation; and
- Cutting interest rates would actually help reduce inflation: "The tool the Fed is using to drive inflation down is doing precisely the opposite."

Let's take them in reverse order. As veteran readers of Eakinomics are well aware, shelter inflation is the largest remaining inflation challenge. As measured by the consumer price index, shelter inflation peaked at a year-over-year rate of 8.2 percent. While it has fallen to 5.5 percent, the pace of descent has been painfully slow.

Parrott and Zandi argue that this is due to the high interest rates themselves:

> The primary driver of the painfully high cost of owning a home is a long-standing supply shortfall. For years, the supply of homes to rent or own has fallen well below demand in much of the country, sending rents and home prices alike to historic highs…High interest rates have made the situation still worse by making it harder and more expensive for builders and developers to finance new construction…This breakdown in the housing supply pipeline is lifting the cost of buying and renting, driving up the very measure of inflation on which the Fed is relying.

The problem with this argument is that even the authors note that the same supply shortfall existed when interest rates were much lower. And the magnitudes are all wrong. Even if the Fed cut rates sharply, the amount of new building that could quickly be brought online is tiny compared to the stock of houses. It simply would not produce a sizable supply response.

The second argument is that the Fed should simply ignore housing costs:

> Most developed countries treat owner-occupied housing as an investment and exclude it from their inflation estimates. Yet, in the United States, it's given more weight than any other good or service tracked in the two preferred measures of inflation. If the Fed followed the sensible lead of the rest of the developed world and removed this variable from its measures, it would find that inflation is right on its target at 2 percent.

This is just silly, and particularly convenient that it lands on the 2 percent target. But it does cost homeowners something to occupy their home, and the majority of households are homeowners. Ignoring that cost just means that for a majority of homeowners the Fed would have a deliberately incomplete measure of the cost of everything the household consumes, and therefore a poor measure of inflation. It would also treat renters and homeowners differently for inflation purposes, which makes no sense. Impairing the data used for Fed decisions cannot possibly be the route to better policy.

Finally, Parrott and Zandi come out firmly against the "rental equivalent," which is (as they put it) measuring the "cost of homeownership by estimating the rent a homeowner would pay for a similar home nearby." But it is far from clear why they oppose it. In part, it seems that there might not be a perfect match for each homeowner's house, so the rental equivalent is off the mark. Okay, agreed. But why is perfection the benchmark only for housing? There are lots and lots of issues in measuring prices.

They also note that some homeowners didn't just buy their homes, so their mortgage rates and other aspects of the rental equivalent are lower. Fine, but the core PCE price index that is based only on market transactions is still running at 2.5 percent year-over-year, so this does not change the bottom line. And the Fed's job is to control inflation in market prices because it is those prices that control decisions made by producers and consumers; there is no reason to disqualify a good-faith estimate of market prices.

Parrott and Zandi would like lower interest rates. Fine. But these are not reasons for the Fed to deliver them.