ECONOMICS: US PERSPECTIVES

HOSTAGE TO FORTUNE: US WEALTH CYCLES & MONETARY POLICY SHIFTS

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Over the past 20 years, the ratio of household net worth to income has been on a volatile ride—rising to historical highs only to drop back sharply and swiftly to postwar norms. In our view, this volatile ride is closely tied to a fundamental shift in the implementation of monetary policy and a change in the measurement of inflation. Unless there is a reset of policy or the inflation measurement, this volatile ride will continue.

More Volatile Wealth Cycles

Historically, cycles of household wealth (defined as the ratio of household net worth to income) have moved in a fairly narrow band, with little net movement over most of the postwar period. In other words, gains in wealth have more or less mirrored gains in income. In fact, when it was first published in 1952, the ratio of household net worth to income stood at 518%—exactly where it stood 42 years later, in 1994 (*Display 1, next page*).

That is not to imply that wealth and income cycles run in parallel. Usually one will run faster than the other in one cycle and then the lead will change in the next one. Even so, the proportional gains in wealth and income over eight business cycles—of different speeds and durations—from the early 1950s to the mid-1990s were essentially equal to one another.

However, that pattern of "equality" and limited volatility ended in the mid-1990s. Since then, the ratio of net worth to income has been more elevated and volatile. For example, the ratio rose to a new high of 627% in 1999, and then sharply plunged to 539% in just three years (in 2002)—a direct consequence of the sharp equity market correction. Four years later, in 2006, the ratio once again soared to yet another all-time high (660%), a direct result of the rapid increase in housing prices. The ratio fell a mere two years later, tumbling to 514% in 2008, close to the long-term average, reflecting the concurrent sharp declines in real estate and equity prices.

By the end of 2014, the ratio of net worth to income had once again climbed into the record-setting territory beyond the tech-bubble heights—standing at 638%, as equity and (to a lesser extent) real estate prices posted solid gains in the previous several years.

While each of these three strong wealth cycles has unique characteristics, they also share certain features that are inextricably linked to monetary policy.

A Shift in Monetary Policy

Monetary policy plays a key role in wealth cycles because inflation of all types (in goods and services or financial and real assets) is ultimately a monetary phenomenon. Importantly, there was a fundamental shift in the implementation of monetary policy in the mid-1990s. Up until that time, policymakers had used monetary targets—first M1 and later M2 measures—to convey the focus of their policy decisions and to help monitor the performance of the economy. But due to structural changes in the financial sector, the relationship between money growth and the economy on one hand and money and price trends on the other broke down, forcing policymakers to abandon monetary targeting.

At that time, policymakers shifted away from money targeting to focus almost exclusively on real short- and long-term interest rates, which placed increased emphasis and importance on an accurate measurement of inflation. Initially, the change in policy tools did not apparently

have any substantive impact on monetary policy. But a few years later, there was a key change in the data source for the measurement of housing costs in the consumer price index (CPI). In our view, that fundamentally changed the price signal that policymakers were receiving from the traditional price gauges.

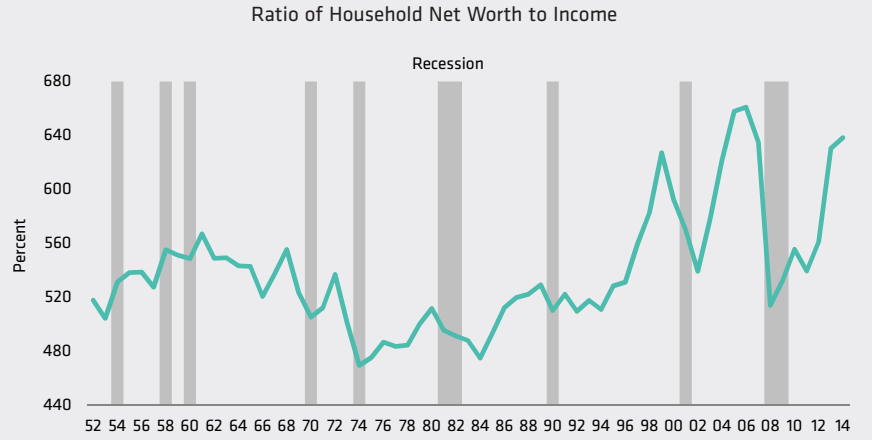
What Prices Matter?

This data change occurred in 1997. The Bureau of Labor Statistics (BLS) announced that it was no longer using a sample of owner-occupied homes to measure housing costs for homeowners, because it couldn't find enough available units to match the characteristics of owner-occupied housing. At the time, this change in the data sample for owner-occupied housing didn't raise any concerns or red flags for analysts, academics or policymakers regarding the accuracy and relevance of consumer price data. But it should have, because the issue had initially been raised nearly 15 years earlier, in 1983, when the BLS shifted to a rental equivalence concept.

The issue of data samples and quality was first flagged in the early 1980s, when the BLS raised the idea of shifting the measure of owner-occupied housing from an approach based on house prices to an approach based on rents. According to the 1981 Comptroller General's report, "the sample of rental housing units that BLS currently uses to measure changes in rent costs may not be suitable for estimating homeownership costs by rental equivalence. The rent sample BLS uses represents rental dwelling units, not owner-occupied housing units. Most owner-occupied housing units differ substantially from many rental units. To implement rental equivalence in the CPI, enough rental units must be found similar to owner-occupied units in size, location and quality to enable to construct a sample that represents owner-occupied houses accurately."

In our view, this shift in the measurement of owner-occupied housing costs had three important effects. First, it widened the gap between the published measure of housing inflation and the actual rate of housing inflation, because the rental market and the housing market are two distinct markets. Second, the shift in data source reduced the volatility in the reported measure of housing inflation: rent changes tend to be slower and often come much later in the cycle than house prices do. Finally and most importantly, the shift made published headline and core consumer price inflation measures more stable. However, it was less reflective of easy money and credit policies, because it didn't capture the true price trends in housing—the most cyclically and credit-sensitive sector in the economy.

Display 1
Since the Mid-90s, Wealth Cycles Have Become More Volatile



Through December 31, 2014
Source: Federal Reserve Board and Haver Analytics

In fact, in the late 1990s and the mid-2000s, the reported rates of headline and core inflation created the impression—if not the illusion—that generalized inflation was not a compelling issue. This often influenced policymakers to keep official rates lower than what otherwise would have been the case. For example, in the late 1990s, the rate of house price increases accelerated by 300 basis points, while the pace of rent increases accelerated only 50 basis points. The rate of house price acceleration was even more dramatic during the housing boom of the 2000s, when it exceeded the pace of rent increases by 400 basis points.

Wrong Price or Wrong Basket?

Even over the past three years, when policymakers have been worried about inflation being too low, average house price increases have outpaced rent increases by roughly 300 basis points per year. If owner-occupied housing costs in the CPI were more representative of actual trends in the housing market, then the published measures of inflation would be much closer to, if not above, policymakers' so-called price stability targets.

The issue regarding house prices and general inflation is not new. But once again, we have to ask: If a rise in housing prices is not inflation, then what is it? Also, if realized housing costs are not in an aggregate price index, how useful is this gauge?

These questions lie at the heart of the operational issues of inflation targeting. Maximum transparency and operational efficiency require policymakers to select a price index that is well known, broad-based, accurate and timely.

Although policymakers have shifted their operational focus away from money targeting and toward inflation targeting, we are not aware of any research by Fed staff that concluded that the CPI (or its sister series, the personal consumption deflator) would be ideal for monetary policy. It appears that these price series were selected for convenience purposes, since they were well known and timely. Any

serious analytical review of the past 20 years would conclude that these series are not useful policy gauges, because they had failed to alert policymakers to any price imbalances before each of the prior downturns.

If published price series are not accurately measuring actual economic transactions and prices, policymakers will be making decisions based on misleading, if not inaccurate, information—resulting in suboptimal outcomes.

We are not asserting that monetary policy and its implementation is solely responsible for the more volatile ride in wealth cycles, but levels of and changes in interest rates constitute basic pricing mechanisms for the valuation of assets. So we do think a large part of the increased volatility in wealth cycles over the past two decades is linked to the Fed's monetary policy, as it based its decisions on an inflation metric that's not broad and fully compiled with market prices—and therefore misses important cyclical swings in economy-based price trends. Moreover, since policy decisions fail to respond to house price increases but attempt to cushion abrupt house price declines, this asymmetrical policy response adds to the volatility in wealth cycles, making future fortune hostage to the past. And in our view, unless there is a reset of the policy framework or the inflation measurement, this volatile ride will continue. ■