Low rates fuel fears in U.S.

Analysts warn of asset bubble from hot housing market

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WASHINGTON -- Network engineer Louie Guimmule wasn't going to be denied a chance to buy a brand new $1-million (U.S.) townhouse going up in Alexandria, Va.

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So he and dozens of other prospective buyers camped out for a week in early March next to a construction pit in this historic community, across the Potomac River from Washington, D.C. Mr. Guimmule even paid someone to hold his spot in line while he ran home to fetch supplies. "It showed you what kind of demand there was," he told The Washington Post.

The red-hot housing market -- here and across the United States -- has sparked fears of an emerging asset bubble, fuelled by the lowest interest rates since 1958, when Elvis Presley joined the U.S. Army and Nikita Khrushchev became leader of the Soviet Union.

Welcome to the topsy-turvy economy that Alan Greenspan and his U.S. Federal Reserve Board colleagues sat down to ponder on Tuesday. While low interest rates have people like Mr. Guimmule dreaming about home ownership and investors cheering their resurgent stock portfolios, large swaths of the economy remain stalled.

Employment growth is anemic in the wake of a 2001 recession that zapped 2.3 million jobs. Manufacturers have cut employment for 43 consecutive months.

The Fed opted, for now, to keep its trend-setting federal funds rate at 1 per cent, citing "lagging" hiring. Many economists don't expect the Fed to move up until the fall of 2004, and possibly not before the U.S. presidential election in early November.

But a few analysts, and even some of the 12 members of the Fed's interest rate-setting committee are growing uneasy about the easy money policy. They worry that keeping rates this low for much longer may cause a speculative bubble, in stocks and real estate, that could be hard to burst without inflicting collateral damage.

"Some members of the [committee] are already expressing concern that policy is remaining too loose for too long," said BMO Nesbitt Burns chief economist Sherry Cooper.

"There is increasing evidence that U.S. inflation has finally touched bottom and is beginning to stir."

Stephen Roach, chief economist at broker Morgan Stanley, is among the most vocal Fed outsiders pushing for a pre-emptive Fed rate hike -- in spite of the worst job creation slump since the Second World War.

"It is now time to reload the monetary cannon," insisted Mr. Roach, who urged the Fed to immediately hike its key rate to 3 per cent in a recent open letter to Mr. Greenspan. "A failure to do so . . . is a recipe for an endless succession of asset bubbles."

In a report to clients, Mr. Roach said the Fed is caught in risky crossfire between "the forces of inflation and deflation." He conceded that a two-percentage-point rate hike could plunge the United States back into recession and would surely draw the ire of President George W. Bush and the Republicans, who are counting on the low interest rate oxygen to lift the economy before the November election.

But Mr. Roach said the alternative is far worse: another burst asset bubble, like the one that deflated with devastating results through the tech sector in 2001 and 2002.

He points to evidence such as home prices that leaped ahead at an average 15-per-cent annual clip across the United States in the fourth quarter of 2003. In some of Washington's most desirable neighbourhoods, homes have doubled in value since 2001,

when a hijacked American Airlines jet slammed into the Pentagon.

And Mr. Roach said time is running out because Mr. Greenspan clearly doesn't want to be seen to be interfering in the coming election. As a result, there will likely be a rate hike blackout period between July and the November election, he said. That leaves the Fed just two more scheduled meetings in May and June at which to move.

Two days after the Fed's do-nothing meeting this week, The New York Times called for the central bank to "gradually wean the United States of such extraordinarily easy money" to avoid a bubble caused by excessive borrowing by homeowners and consumers.

"Factor in inflation, and Alan Greenspan is essentially lending money at a loss," the Times said. "This cannot go on indefinitely, and it should not go on much longer." The newspaper pointed out that consumers and homeowners have become addicted to debt. Homeowners can get 30-year mortgages at less than 6 per cent and car loans at near zero. That sent mortgage debt soaring to $6.8-trillion last year from $4.9-trillion just two years earlier.

"Americans may be in for a rude shock when the real estate market levels off, and when millions discover that the adjustable rates of their mortgages and other loans can be adjusted upwards," the paper said.

But that's hardly the consensus view. Most analysts, and a majority of the Fed committee, are still convinced that patience is the right course on interest rates.

Lyle Gramley, a former Fed governor and now an economist at Charles Schwab in Washington, argued that "tradeoffs" are inherent in monetary policy decisions, including the risk of bubbles caused by excessive borrowing.

More importantly, though, the economy is still not generating enough jobs to keep consumer spending alive much longer, he said. "I think it would be a mistake to start raising rates now," Mr. Gramley said. "The important thing is to keep the economy growing."

But Mr. Roach said that line of thinking has become a trap. U.S. consumers, most of whom haven't seen their wages grow significantly in three years, are enjoying an artificial and unsustainable lift -- from tax cuts, drawing down savings and extracting equity from inflated home values.

What the U.S. economy needs is to be put on notice that the "central bank is still in charge," he said.

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