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Inside the Fed in 2006: A Coming Crisis, and Banter

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WASHINGTON — As the housing bubble entered its waning hours in 2006, top [Federal Reserve](#) officials marveled at the desperate antics of home builders seeking to lure buyers.

The officials laughed about the cars that builders were offering as signing bonuses, and about efforts to make empty homes look occupied. They joked about one builder who said that inventory was “rising through the roof.”

But the officials, meeting every six weeks to discuss the health of the nation’s economy, gave little credence to the possibility that the faltering housing market would weigh on the broader economy, according to transcripts that the Fed released Thursday. Instead they continued to tell one another throughout 2006 that the greatest danger was inflation — the possibility that the economy would grow too fast.

“We think the fundamentals of the expansion going forward still look good,” [Timothy F. Geithner](#), then president of the Federal Reserve Bank of New York, told his colleagues when they gathered in Washington in December 2006.

Some officials, including Susan Bies, a Fed governor, suggested that a housing downturn actually could bolster the economy by redirecting money to other kinds of investments.

And there was general acclaim for Alan Greenspan, who stepped down as chairman at the beginning of the year, for presiding over one of the longest economic expansions in the nation’s history. Mr. Geithner suggested that Mr. Greenspan’s greatness still was not fully appreciated, an opinion now held by a much smaller number of people.

Meanwhile, by the end of 2006, the economy already was shrinking by at least one important measure, total income. And by the end of the next year, the Fed had started its desperate struggle to prevent the collapse of the financial system and to avert the onset of

what could have been the nation's first full-fledged depression in about 70 years.

The transcripts of the 2006 meetings, released after a standard five-year delay, clearly show 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.

"It's embarrassing for the Fed," said Justin Wolfers, an economics professor at the University of Pennsylvania. "You see an awareness that the housing market is starting to crumble, and you see a lack of awareness of the connection between the housing market and financial markets."

"It's also embarrassing for economics," he continued. "My strong guess is that if we had a transcript of any other economist, there would be at least as much fodder."

Many of the officials who appear in the transcripts have since spoken publicly about the Fed's failings in the years before the crisis. But the transcripts provide a raw and detailed account of those errors as they were made. Evidence of problems in the housing market accumulated at each meeting of the Federal Open Market Committee, which sets policy for the central bank.

"We are getting 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," George C. Gynn, then president of the Federal Reserve Bank of Atlanta, said at the June meeting.

The committee consists of the governors of the Federal Reserve and the presidents of the 12 regional banks.

"The speed of the falloff in housing activity and the deceleration in house prices continue to surprise us," Janet Yellen, then president of the Federal Reserve Bank of San Francisco, said in September.

One builder she spoke with, she said, "toured some new subdivisions on the outskirts of Boise and discovered that the houses, most of which are unoccupied, are now being dressed up to look occupied — with curtains, things in the driveway, and so forth — so as not to discourage potential buyers."

For a famously private institution known for its cryptic, formulaic statements, the meeting transcripts offer a rare glimpse of senior

officials in relatively unguarded conversation, somewhat akin to the tapes that some presidents have made in the Oval Office. The Fed officials exchange jokes, gossip about people who are not present, and speak much more frankly about the economy and policy than they did in the public remarks that they made contemporaneously.

The results are unlikely to burnish any of their reputations, inasmuch as they could not see the widening cracks beneath their feet. But the Fed's chairman, Ben S. Bernanke, appears as the most consistent voice of warning that problems in the housing market could have broader consequences.

The general consensus on the board, summarized by Mr. Geithner, was that problems in the housing market had few broader ramifications. "We just don't see troubling signs yet of collateral damage, and we are not expecting much," he said at the September meeting.

Mr. Bernanke initially agreed, telling colleagues at his first meeting as chairman, in March, "I think we are unlikely to see growth being derailed by the housing market."

As the year rolled along, however, Mr. Bernanke increasingly took the view that his colleagues were too sanguine.

"I don't have quite as much confidence as some people around the table that there will be no spillover effect," he said.

As for Mr. Geithner, who became Treasury secretary in 2009, his spokesman, Anthony Coley, said, "Secretary Geithner was an early source of initiative at the Fed to reduce risk and make the financial system more resilient even before 2006."

Some Fed officials argued that a housing slowdown would be good for the broader economy.

"I really believe that the drop in housing is actually on net going to make liquidity available for other sectors rather than being a drain going forward, and that will also get the growth rate more positive," Ms. Bies told colleagues at the committee's June meeting. Ms. Bies could not be reached for comment Thursday.

And even Ms. Yellen did not believe that the problems in the housing market would have broader consequences. "Of course, housing is a relatively small sector of the economy, and its decline should be self-correcting," she said.

One fundamental reason for this blindness was that Fed officials did not understand how deeply intertwined the housing sector and financial markets had become. They also were convinced that financial innovations, by distributing the risk of losses more broadly,

had increased the strength and resilience of the system as a whole.

“I would say that the capital markets are probably more profitable and more robust at this moment, or at least going into the six-week opportunity, than they have perhaps ever been,” Kevin Warsh, the Fed governor who watched Wall Street most closely, said at the meeting in September 2006. Three months later Mr. Warsh said almost exactly the same thing. He did not respond to an e-mail seeking comment Thursday.

For the Fed 2006 began with the departure of Mr. Greenspan, who presided in January over his final meeting as Fed chairman and was then widely regarded as the epitome of a central banker, a master who had guided the American economy through almost 20 years of remarkably consistent growth.

“I’d like the record to show that I think you’re pretty terrific, too,” Mr. Geithner said in adding his voice to the chorus of tributes at that final meeting. “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.”

Ms. Yellen said: “It’s fitting for Chairman Greenspan to leave office with the economy in such solid shape. The situation you’re handing off to your successor is a lot like a tennis racquet with a gigantic sweet spot.”