

The Central Regulators' Role In Asset Values And Burst Bubbles

The Federal Reserve and central banks may best serve the commercial real estate market by adhering to a free-market policy.

BY THOMAS MORGAN

There is an interesting development in the wake of the subprime mortgage crisis: central banks, the regulators of monetary policy in their respective countries, have begun to debate whether they should play a more active role in monitoring and impacting asset prices.

While the discussion is centered on home and stock prices, the resulting policy initiatives could have major impacts on commercial real estate participants.

The debate goes something like this:

Central banks have historically seen their roles in the context of monitoring overall economic growth and using monetary policy to maintain price stability and control inflation. Therefore, the Federal Reserve and other central banks have focused on consumer prices to track inflation and not the price of homes, stock prices and other financial assets.

In the case of the Fed, it does count figures representing owners' equivalent rent in its calculations, but this measure amounts to only about 15 % of the overall measure of inflation. Other central banks, notably the European Central Bank and the Bank of England,

have no accounting for home or asset prices at all.

In no event has the Fed or any central bank ever looked specifically at commercial real estate asset prices in their analyses, but this policy may change.

Most will agree that the job done by the central banks has been laudable, with the First World having experienced relative control over inflation for the past 20 years. This price and inflation stability has contributed directly to overall economic growth and real increases in worldwide standards of living.

In the U.S. commercial real estate industry, the general stability in interest rates managed by the Fed has contributed to a general increase in asset prices and a corresponding decrease in cap rates across most asset classes.

Specifically, the indirect link between Fed interest-rate policies and commercial loan pricing contributed to an environment of easily available financing at relatively inexpensive costs. This stability in interest rates offered commercial lenders the ability to underwrite both short-and long-term transactions without much regard for possible downturns in cap rates or increases in borrowing costs.

With this climate in place, just as the home owner could count on the ability to refinance a low-cost adjustable-rate

home mortgage later, so could the commercial real estate lender count on some other lender to refinance them out of a project.

Most exit strategies underwritten by lenders in this environment, in fact, included as justification the ability to refinance the deal at prevailing commercial mortgage backed securities (CMBS) rates and terms.

Bubble prevention

But, just as the recent run-up in home prices has resulted in an economic bubble, there is a sense that commercial real estate prices are artificially inflated in a similar way due to the low-cost financing that has been available.

Furthermore, many pundits are predicting a general decline in commercial asset prices of as much as 20% in the coming year as a result of the market corrections taking place.

The question is whether central banks, having contributed to this problem with an adherence to low interest rates, could and should do more to mitigate development of these bubbles in asset prices - and especially commercial real estate asset prices. The theory goes that if the central banks can, in fact, minimize the development and fallout from economic bubbles, we will have even greater stability with corresponding positive benefits.



Proponents of increasing the role of central banks in managing asset prices point to the fact that evidence that the wealth effect of increasing home and stock prices disproportionately affects consumer confidence and spending.

Economists in this camp point to easy credit as a key motivator for this behavior. The rationale is simple: Knowing that assets can be leveraged inexpensively has caused individuals to borrow and spend more with little regard to real increases in cash flow.

This enhanced purchasing demand artificially increases asset prices beyond real economic growth and contributes to the bubbles that wreck havoc to economies when the bubbles burst.

On the flip side, many economists do not ascribe to this theory of asset price inflation and insist that this wealth effect is in fact de minimus.

One of the key elements of the debate is whether central banks should act to prevent asset bubbles from occurring, or wait for the burst and then manage the resulting chaos. Proponents of a more active central bank role argue that the banks should raise interest rates when asset prices are rising fast to prevent the development of the bubble in the first place.

The free market

The difficulty with all of this reasoning is the remote chances that the central banks can properly separate what constitutes “irrational exuberance” from bona fide free market price increases. Even if the banks can do so, the question then becomes whether the antidote does more damage than the disease its trying to cure.

What would have happened if the Fed, for example, had adopted a policy of increasing rates to control real estate price increases during the past few years? One could argue that residential and commercial price increases would have in fact been curtailed, but at what cost?

An increase in interest rates affects the whole economy - of which real estate is just a part. Would this type of policy have triggered downturns in spending in other parts of the economy?

The answer is probably yes, and the cumulative impacts difficult to predict.

Moreover, the fact is that a healthy respect for free-market economics should still be the dominant driver of government monetary policy. The Fed and other central banks of the world should continue to focus on price stability and controlling inflation, and should include some measure of asset prices when considering overall price movements.

This role, however, should be very limited. Asset prices for homes, stocks and other investments are not like other components of the price index. Asset prices for commercial real estate are even less so.

For example, the price that a developer is willing to pay for a parcel of land in Manhattan - as well as the price that an individual is willing to pay for the condo that is developed on that parcel - should not influence whether the Fed increases interest rates.

Central authorities have tried to regulate real estate prices in the past. Take the case of rent control. This policy, while initially attractive to obtain votes, has been an unmitigated disaster as properties have gone without capital reinvestment and windfalls of low rent have accrued to many unintended beneficiaries.

Most in the real estate industry would prefer to let the free market set these asset prices with the Fed on the sidelines, even if those investments are fueled by irrational exuberance.

Several commercial real estate investors polled for this article would prefer to operate in an environment of relatively stable capital costs, and decide for themselves what an asset is worth.

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