

The Effect of U.S. Economic Policies on Real Estate Values

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Author's note: This article attempts to explain the effect of economic policies but does not take a position on the underlying political issues that facilitate them. Factual references have been made to various presidents, but they should not be considered as an endorsement or censure of any of them.

The United States is generally considered a free market economy, and in an ideal free market system, prices of commodities and services rise and fall based on the actions of buyers and sellers in the marketplace. In other words, a free market economy is driven by the laws of supply and demand. However, government economic policies affect any free market system, and in the United States today, their impact has become greater than ever before. Moreover, government actions are becoming an overwhelming factor in the value of every type of real estate, and understanding their impact is helpful to appraisers and assessors in determining market values.

Perhaps the most salient aspect of government intervention in the real estate marketplace is the control of interest rates and the availability of funds for loans. For a proper perspective on this, consider two extremes. At one extreme, imagine how much real estate would cost if no loans were available to purchase it. If every piece of real estate could only be purchased in cash, how many people could afford to buy it? At the other extreme, imagine loans that have an interest rate of 0 percent, that require no down payment, and that are available to everyone regardless of their credit rating or income.

It's the Monthly Payment, Not the Price

What would prices be under each scenario? Because the U.S. economy is credit-driven, most buyers of real estate look at the monthly payment rather than the total cost. Thus, prices would plummet in the first scenario and skyrocket in the second. These price fluctuations are based on the interest rate paid (also known

as the cost of money) and the availability of credit, both of which are to a great extent controlled by the government and, more specifically, the Federal Reserve Bank. The Fed indirectly causes mortgage lending rates to go up or down by setting the interest rate that banks are charged for borrowing from it, and that rate is called the discount rate. The power to set rates has always rested with the Fed, but it has rarely been pushed to one extreme as it has today.

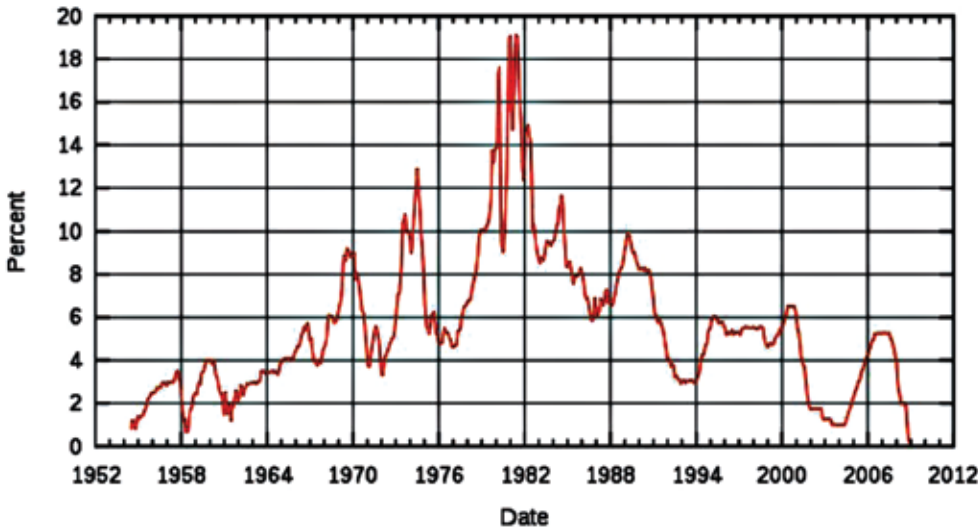
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Historically, the last time rates were pushed to an extreme was under President Jimmy Carter in the late 1970s and early 1980s. At that time the United States was experiencing increasing inflation, and to stem it, the Fed raised rates until a mortgage could cost 18 percent. This rate increase put the brakes on inflation, but it also stopped business in its tracks and lending slowed to a dribble, causing financial failure for many business entities and throwing the country into a recession. The spike in that time period is shown in the figure on page 4.

Other Government Intervention

Because of the current economic problems in the United States, government intervention in the real estate market has been increasing. The current \$8,000 tax credit for qualified buyers, the lowering of interest rates for certain buyers in distress, and

Figure. Federal Funds Rate (effective) July 1954 to December 2008



other programs have had a marked effect on real estate prices. The FHA (Federal Housing Administration), the VA (Department of Veterans Affairs), and the USDA (U.S. Department of Agriculture) have always offered low-interest-rate or no-money-down loans, but the effects of these have been fairly constant. However, specific stimulus programs, although perhaps offered with good intentions, tend to disrupt the market and stop it from finding its normal equilibrium by keeping values higher because of the incentives. Such interventions also tend to cause spikes in the market, particularly in the low end of values, since many of these programs help entry-level buyers. Programs that help people keep their homes by offering special interest rates are beneficial to those having problems, but they also stop the market from normalizing and often only put off a foreclosure to a later date.

In other words, for markets to recover, they often have to go through adjustments and corrections that cannot proceed when special programs interfere with the process. Appraisers need to be aware of the effects of such programs as they try to determine the present value of *future worth*. For instance, if a special program is about to end and sales appear to have increased since its advent, a trend towards lower prices might be expected when the assistance terminates.

Unintended Ramifications of Low Interest Rates

Keeping interest rates low causes difficulty for people who are trying to save, for those

who live on fixed incomes with interest from savings, and for those who are trying to save for retirement. Many retired persons relying on income from savings have seen their incomes drop drastically in the past decade. Consider the difference in income for the person who has \$500,000 in the bank. The current CD (certificate of deposit) or money market rate is about 1.5 percent, which returns an annual yield of \$7,500. Just a year or so ago, the rate was about 5 percent, which would yield \$25,000 a year. Many years ago, an 8 percent rate would have yielded \$40,000. At the 8 percent rate, the person might have enough income to live on, but not at the current, lower rate. So those with money in savings are essentially penalized when rates are held down to benefit those who borrow.

Another result of these low rates is that some people have been lured into riskier investments, such as stocks, and have suffered losses. Had the rates stayed higher, many of them would have left their money in Federal Deposit Insurance Corporation- (FDIC-) insured accounts. Some of these people may have also invested in real estate seeking higher returns, which helped expand the recently burst bubble, and then suffered a loss when the real estate market collapsed.

Another by-product of the low rates is over-borrowing—particularly in the business sector. When money is cheap, businesses tend to spend more and expand when they might not have otherwise. The consequence of this is obvious—many companies that geared up for the overheated economy caused by the bubble are

now faced with over-capacity and higher fixed operating costs as the demand for goods has diminished.

Moreover, most business loans are not long-term loans, and many lenders are no longer interested in renewing current loans, which can put even a viable business in a predicament. Many commercial real estate borrowers face the same problem. Commercial loans are normally made with a renewal period every 3 to 5 years, but they are amortized over a longer period, generally 20 to 25 years. Lenders generally tell commercial borrowers that renewal will not be a problem when the loan is made, but now things are changing.

Values are dropping, and many lenders are not renewing commercial loans, including those that have been paid on time. In one particular instance, a commercial loan for a shopping center for \$6 million was not renewed, even though the borrower had good credit and the center was performing well. The answer from the bank was that it did not want to continue lending on commercial properties because of the dismal outlook.

The exact numbers are not known, but according to the Real Estate Roundtable, there is about \$6.7 trillion of commercial real estate in the United States carrying \$3.1 trillion in debt (Real Estate Roundtable 2009). Deutsche Bank estimates values have declined 35–45 percent since 2007 (Lindmark 2009) and that approximately \$2 trillion in commercial loans will need renewal by 2013. Of these, an estimated \$400 to \$450 billion won't qualify for refinancing (Gailand 2009). Other reports estimate the figure at closer to \$800 billion. The question is, "How far will the government go in an attempt to avert this crisis?" Will it guarantee new loans for these properties? The government's action, or lack thereof, will have a major effect on commercial real estate values for years into the future.

Manipulating the Money Supply

The Fed controls the money supply by setting interest rates, but how can the Fed make money out of thin air? Is the money supply limited, or can the United States print and spend as much money as it wants to? The answer is that the money supply is not limited, because it is not tied to gold or

any other commodity, as it was in the past, so it can be expanded by simply printing more of it. Until 1972, the United States was on the gold standard, which meant that the dollar was redeemable for 1/35th of an ounce of gold, under a system that was called Bretton Woods. President Nixon took the United States off that standard in 1972, and the dollar then became what is known as fiat currency. The following is a definition of fiat currency from businessdictionary.com, followed by a simpler one from Merriam-Webster Online:

Fiat currency: *Common type of currency issued by official order, and whose value is based on the issuing authority's guarantee to pay the stated (face) amount on demand, and not on any intrinsic worth or extrinsic backing. All national currencies in circulation, issued and managed by the respective central banks, are fiat currencies.* (<http://www.businessdictionary.com/definition/fiat-currency.html>)

Fiat money: *money (as paper currency) not convertible into coin or specie of equivalent value.* (<http://www.websters-online-dictionary.org/definition/fiat+money>)

Nevertheless, there is no perfect monetary system. The gold standard is also a flawed system, because a currency linked to it is subject to the fluctuation of gold supplies and the changing demand for gold. However, the fact remains that when a currency is not linked to a commodity, it is always more susceptible to inflation, and if economic policies include increasing debt, the potential of extreme inflation is very likely. History has shown that fiat money, over time, inexorably becomes worth less as more of it is printed.

The Dollar as the Reserve Currency of the World

All modern governments use fiat money, but the dollar has been the reserve currency of the world for many decades and has this status because international finance is often transacted in dollars, governments around the world invest in dollars, and oil is purchased in dollars, among other things. The Chinese government is the biggest investor in dollars, Japan is second, and the United Kingdom and oil producing countries are a distant third and fourth. After them, many other countries have

smaller holdings. Foreign governments buy dollars because the United States has been the most stable economy in the world, and as the premier superpower, it has the most powerful military. Consequently, the United States has been able to use its fiat money on an international scale, which has allowed it to borrow more money than other countries, through the issuance of Treasury bills, notes, and bonds (treasuries). As Bevan (2005) notes,

Unlike other countries that are constricted by issues such as balance of payments and debt, the United States developed a system whereby it issues a fiat currency that the rest of the world must use.

Selling Dollars around the World

However, the unique position the United States holds in the world is beginning to change, and one reason is the marked increase in spending that it has recently indulged in. Budgets in the past have often increased 20 or 30 percent, but the current administration is spending 3.5 times the previous budget and it is still increasing. This spending has been used to help the economy in a time of crisis, but the result has been that the countries that buy dollars are having second thoughts about continuing their investments. They realize that as more dollars are printed, inflation must ensue, which will reduce the value of their holdings. But if they pull out of dollars quickly, the United States will suffer economically, which will decrease its buying power, causing economic woes for these countries, because they depend on the United States as a primary market for their goods. Consequently, they are not pleased with the situation, as evidenced by the following quote from a Chinese official:

"We hate you guys, but there is nothing much we can do." Luo Ping, a director general at China's Banking Regulatory Commission, saying Beijing will continue to buy U.S. Treasury bonds despite concerns about the dollar. China has nearly \$2 trillion in foreign-currency reserves—February. (Verbatim, *Time*, December 28, 2009)

For this reason, some countries appear to be slowly pulling out of dollar investments. On a weekly basis, the United States sells treasuries for government funding. They are sold in various forms:

4-week, 3-month, and 6-month bills and 3-, 5-, 7-, 10-, and 30-year notes. Besides foreign central banks, bidders are individual investors, pension funds, mutual funds, and other buyers.

The more bidders and the more they are willing to pay, the lower the yields the Treasury has to pay on these securities, lowering the U.S. government's financing costs. Treasuries are still selling, but there is currently a slowdown, especially for the longer term notes. Thus far there have been no "failed" auctions, which would occur when the government cannot get \$1 in bids for every \$1 in securities sold. But that has happened in the United Kingdom, and it may happen in the United States soon (Larson 2009).

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The Theories behind the System

When I teach appraisers about this subject, at the beginning of the class I generally ask if they know the first rule of economics. No one yet has given the answer that I was taught in my university economics class. The answer is somewhat unsophisticated, "There is no free lunch." That, at least, was the view of some economists who believed in what has been called *laissez-faire capitalism*, which essentially means that markets should be allowed to take their own course without intervention. Merriam-Webster's Dictionary defines *laissez faire* as follows:

1: a doctrine opposing governmental interference in economic affairs beyond the minimum necessary for the maintenance of peace and property rights.

However, there is a juxtaposed view that has appeared to prevail over this concept. It began with an economist whom

Franklin D. Roosevelt consulted during the Great Depression and has remained popular to this day.

That economist was John Maynard Keynes, and in 1936 he advised Roosevelt that the economy could be controlled by using government intervention, including what today is called *stimulus funds* (Keynes 2007). His consultations with Roosevelt resulted in a huge increase in public spending, some of which started the WPA (Works Projects Administration), which became the largest employer in United States at that time, and the CCC (Civilian Conservation Corps), which also produced jobs.

Keynes also believed that excessive savings was bad, because it slowed the economy (the less people spend, the less economic activity), and he thought that debt was good and should be used by governments in their manipulation of the economy. This is a gross simplification of his theories, but the scope of this article does not permit a more detailed explanation. However, the following quotes regarding Keynes are instructive.

In 1971, Republican U.S. President Richard Nixon proclaimed, “we are all Keynesians now” (Lewis 1976). In 1999, *Time* magazine named Keynes one of the 100 Most Important People of the 20th Century (http://en.wikipedia.org/wiki/John_Maynard_Keynes) and reported that, “His radical idea that governments should spend money they don’t have may have saved capitalism” (Reich 1999). An article in the U.K. publication, *The Financial Times*, stated that Keynesian economics has provided the theoretical underpinning for the plans of President Barack Obama, Prime Minister Gordon Brown, and other global leaders to rescue the world economy (Giles, Atkins, and Guha 2008).

From Nixon to Obama, both Republicans and Democrats have embraced Keynes, and many have believed that his theories would cause continued prosperity. The current Fed Chairman, Ben Bernanke, believes that the United States could have avoided the Great Depression if the government had spent more money and lowered interest rates more. As noted in the following comment, he has specific views on the subject.

The financial crisis has made Federal Reserve Chairman Ben Bernanke’s book Essays on the Great Depression a hot seller. . . Bernanke, a former Princeton University economist, is considered the pre-eminent living scholar of the Great Depression. He is practicing today what he preached in his book: Flood the system with money to avoid a depression. (Cauchon 2008)

Before Bernanke wrote his book, Milton Friedman, economist and advisor to President Reagan, stated that he believed that lowering interest rates (known as monetarism) would have kept the United States out of the Great Depression, in opposition to Keynes, who claimed that large-scale deficit spending was the only way out. Bernanke agrees with Friedman, and said so in a speech celebrating Friedman’s 90th birthday on November 8, 2002. Addressing Friedman’s ideas that the government was to blame for the Great Depression by not lowering interest rates and freeing up funds to borrow, Bernanke said, “You’re right, we did it. We’re very sorry. But thanks to you, we won’t do it again” (Bernanke 2002).

Tale of Two Theories

In the Great Depression, jobs were created by the government, but the money supply was not expanded the way it has been in the current crisis. Essentially, Keynes’s ideas have been implemented (stimulus funds) in conjunction with Friedman’s ideas (low interest rates). In addition, huge bailouts have been made for various companies and industries. Chairman Bernanke and many others believe that if these measures had not been implemented, the country would be in dire financial straits and in a depression as severe as the one that occurred in 1929.

On the other end of the spectrum, the more classical economists might say that none of the government’s actions have been proper, nor will they work for very long. The “no free lunch” crowd believes that making credit easy, throwing money at the problem, bailing out failing institutions, and lowering interest rates only puts off a day of reckoning that must occur, as the market finds equilibrium. Many of these economists believe that massive inflation will follow the expansion of the money supply and that bubbles in markets such as real estate are only prolonged

when rates are held down and incentives are offered to purchase homes.

Whichever of these theories one might favor, the fact remains that the ramifications of the economic policies of the United States are becoming a reality as time goes on, and as they unfold, they can be analyzed to obtain some idea of what they portend for the future. Consequently, it is important for appraisers to understand them to the extent that they influence real estate markets, so that estimates for values can be made with a grasp of the direction in which the economy is headed.

Predicting Based on What Is Known

It goes without saying that no one knows the future, but to reiterate, it certainly helps for appraisers to be able to understand economic policies enough to determine how they might affect real estate values. People make educated guesses based on past and current knowledge in many aspects of their lives. For instance, prior to traveling, if there is a report of inclement weather, people prepare even though it is only a forecast. At present, interest rates are the lowest they have been in at least six decades, so it may be reasonable to expect that they will go up in the future.

As discussed, the U.S. government must sell treasuries to continue to get funding, and recent auctions for these have proved that purchasers are less enthusiastic than in the past. Their desire to purchase is waning because of the abrupt increase in U.S. spending—a harbinger of inflation, which they know will diminish their holdings. The government itself is aware that interest rates must rise to continue to fund the debt; see the article “Nowhere to go but up: Managing interest rate risk in a low-rate environment” in the FDIC publication *Supervisory Insights* (Clair, Touhey, and Turbeville 2009). The title itself reveals what we already know from historical knowledge—rates can only go up because they have nowhere else to go. The discount rate is about the lowest it can be, so there is virtually no more margin to reduce it and make money any cheaper. The FDIC article deals more with short-term rates than long-term rates, but if yields increase in the short term, investors will likely stop investing in the longer term notes; this has

already occurred to some extent, based on recent auction results of treasuries.

Nevertheless, rates will not go up without a struggle, because the Federal Reserve is trying to keep rates down for as long as it can. Chairman Bernanke is aware that in 1937–1938 the Fed prematurely hiked rates, which many think prolonged the Great Depression by causing a “double dip” in the economy. The Fed is concerned that history will repeat itself 70 years later, so it is likely that it will only increase rates when it is forced to, due to treasuries selling at lower rates. However, it is also possible that it will seek another way to keep them down to continue the status quo. Nevertheless, it would appear that a rate increase must come eventually.

Possible Results of an Interest Rate Increase

If real estate buyers purchase based on the monthly payment and not on the total price, then an increase in interest rates will cause a decrease in prices, if all other variables remain constant. Refinancing activity will also decrease if rates go up even 1 percent, and sales will slow, causing a further decline in economic activity and real estate values.

When this situation is analyzed to include other variables (because in reality they do not remain constant), the prognosis will vary depending on the economic circumstances of the locality. Supply and demand is still foundational—in some areas there is an excess of properties; in others demand is stronger. Moreover, since building activity is low, demand should increase over time as existing properties are absorbed. One caveat to this conclusion is that if unemployment continues on its current upward trend, foreclosures may put more properties on the market, slowing absorption.

Inflation on the Horizon

Since real estate is still in a crisis mode in many areas and foreclosures are continuing, it might appear unusual to expect a substantial increase in inflation. However, as the United States continues to increase the spending, borrowing, and printing of fiat money, inflation appears to be an inevitable, although perhaps belated, result. It is

already appearing in the increase in commodity prices, which many have invested in because of their lack of confidence that the dollar will hold its value.

Imagine a driver looking in the rearview mirror. The closest change coming from behind may be higher interest rates, and following that may be a slower residential real estate market, which continues to decline in value as interest rates increase. Coming with that is a commercial real estate debacle, which will lower prices in that segment of the market. However, there is also a small speck that currently is barely recognizable—inflation. It can be seen more clearly in certain commodities, but before it manifests itself in real estate, there will probably be further declines in value. Inflation may be years away, but it is coming eventually.

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