



## **Higher Interest Rates and Florida's Economy**

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The Federal Reserve is focused on bringing the economy in for a soft landing. This is a most difficult feat which the Fed has only accomplished once, in the mid 1990s, when the Fed slowly raised rates and the economy moved off an inflationary and unsustainable fast growth trajectory. The Fed tried this again in 2000, but the popping of the dot com bubble combined with the terrorist attack on 9/11 was too much, and we experienced a short recession.

Over the last year inflation has again reignited. Prices have increased 3.1 percent since last June, compared to just 1.7 percent for the twelve months ending June 2004. And with oil prices sharply higher this year, prices are sure to escalate. So the Fed is compelled to act.

Seven times since last June the Federal Reserve has increased interest rates. The federal funds rate is 2.75 percent, and at the Fed's meeting this week they are expected to increase the rate again to 3 percent. However, they face a real dilemma going forward. First of all, the economy is weakening. Gross Domestic Product grew by 3.1 percent in the first quarter, its slowest rate in two years. Furthermore, oil prices, while off their peaks, are still very high and are causing weakness in consumer spending. So the Fed will become increasingly worried about weaker growth going forward.

Second, and surprisingly, long-term interest rates have yet to move decisively higher despite the 200 basis point increase in the funds rate. As a result, mortgage rates have remained very low. This in turn has overstimulated the real estate markets, triggering a speculative bubble. Long rates have stayed low in part because many of our major trading partners do not want the U.S. economy to slow down and thereby reduce demand for their exports. Asian foreign banks, especially in China, Japan, and Korea, have increased their holdings of U.S. Treasury bonds rather dramatically, up over 63 percent since 2003. This is in part why long-term rates have not increased.

Eventually, this tide will turn and it will turn fast – probably this summer. The ultimate impacts will be to sharply prick the real estate bubble. Florida will feel this impact acutely, especially in Southeast Florida where speculation in new condominiums is rampant. But even here in Central Florida investors have pushed up real estate prices to unsustainable levels, particularly for condominiums and for short-term rental properties. When mortgage interest rates rise significantly this summer, many investors will not be able to find buyers for the contracts they have hoped to flip or for the properties that they hope to sell. Many banks and builders will be stuck with product. In this environment it will be very hard for the Fed to achieve that elusive soft landing.

This is Hank Fishkind for 90.7 FM, WMFE News.

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