

not been for these developments, the housing slowdown would probably have triggered significant rate cuts in both countries.

## VI. The Monetary Policy Car Has a New Driver

The housing market and MEW are very important for US monetary policy. Over the past year, the strength of the housing market—and the boost of perhaps 1 percentage point it has given to the annualized growth pace of real GDP—have been important reasons for the FOMC to continue pushing up its federal funds rate target. Overall financial and housing market conditions were even easier than indicated by standard measures such as our Goldman Sachs Financial Conditions Index (GSFCI<sup>SM</sup>). This is remarkable because even the “headline” GSFCI<sup>SM</sup> tightened by far less than in any previous period of sustained Fed rate hikes.

Beyond the very near term, however, the housing market is likely to turn into a force that will offset, not amplify, the impact of still-low long-term interest rates and generally accommodative financial conditions on real GDP growth. Our analysis shows that, even under relatively “moderate” assumptions about house prices and homebuilding, the housing sector could take 1½ percentage points off real GDP growth. An effect of this magnitude is not only suggested by our detailed econometric analysis, but it is also consistent with the experience of the United Kingdom and Australia during their own housing market adjustments over the past two years.

Replacing a 1-point growth boost with a 1½-point drag is a big swing. To be sure, the conclusion that it will push real GDP growth to 1% from the 3½% pace of the past two years would be too simple. An improvement in the trade balance, reduced drag from oil prices, and a pickup in inventory accumulation could cushion the blow to some extent. Still, given the likely size of these offsets, we expect the housing slowdown to push real GDP growth below trend, unless monetary policy is eased significantly.

So why do we continue to forecast two further 25-basis-point hikes and a 5% peak in the federal funds rate? First, the potential boost to homebuilding from the hurricanes and the likely lags between weaker house prices, falling MEW, and slower consumer spending are all likely to make the housing hit a late-2006 rather than early-2006 event.

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*Although we continue to expect further near-term rate hikes, the Bernanke Fed is likely to react to a significant housing hit by easing policy substantially in 2007.*

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Second, the global inventory cycle is providing a powerful near-term boost to the industrial sector. This should keep the labor market firm and offset much of any near-term weakness from housing.

Third, it is no secret that most Fed staffers and officials, probably including the incoming chairman, take a more sanguine view of MEW than we do. They will not keep monetary policy easier in anticipation of a housing market slowdown but will need to be convinced by hard evidence of weaker economic activity.

If and when that slowdown arrives, however, the response is likely to be fairly aggressive. We expect US monetary policy under Chairman Bernanke to be very activist. As long as core inflation is contained, he is likely to try hard to keep economic activity close to potential. In our view, that opens the door to about 100 basis points of easing in 2007.

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