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Would Higher Interest Rates Boost the Housing Market?

By Daniel Indiviglio

This possibility contradicts conventional wisdom, but there could be something to it

When mortgage interest rates are low, consumers may be more enticed to buy a home. This logic is straightforward enough: financing is cheaper, so buying is more attractive.* But in a recent blog post, Mark Calabria at the Cato Institute challenges this commonly-held view that low mortgage interest rates are good for the housing market. He suggests aiding housing by raising rates instead. Is this assertion crazy, or could there be something to it?

The Conventional Wisdom

It is certainly true that lower interest rates will make buying a home through a fixed-rate mortgage more attractive to borrowers. Nobody doubts this fact. Obtaining a mortgage with a lower interest rate lowers the price you have to pay for your home inclusive of financing.

But this explanation only captures half of the story: what about lenders? Borrowers may love mortgages with very low interest rates, but banks hate mortgages with low interest rates.

The Supply Side

Let's look at what Calabria says:

> The Fed should start raising rates. First, what bank wants to make a mortgage at 4% when their cost of funds in a few years will easily be above that? Just like any price ceiling, artificially low rates cause shortages. In this case current Fed policies are reducing the supply of credit, making it harder for potential borrowers to get mortgages (yes, if you can get a mortgage, the price is great). When rates do go up, which they will, such will put downward pressure on prices, better to take that hit now.

He's talking about the supply side of the equation. Consumers demand mortgages and banks supply them. If a price ceiling is created, then you'll run into a supply shortage. In this case, this happens for two reasons.

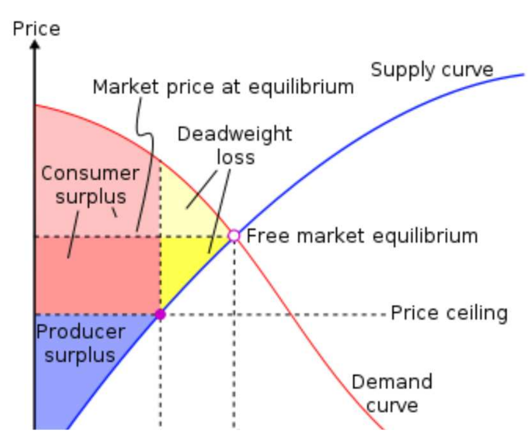
First, the lower the interest rate, the higher the interest rate risk. As Calabria notes, in future years, mortgage rates will certainly rise. That will make the relative value of mortgages originated at ultra-low interest rates lower. It could even cause the bank to lose money on the mortgage if its cost of funds rises above the low mortgage interest rate.

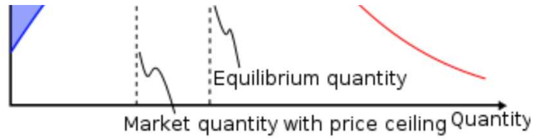
Second, interest rates help to compensate banks for risk. If banks were getting higher interest rates, then they might be more willing to provide consumers more credit. But at rates like 4%, those loans had better be pristine if the bank wants to ensure that its default risk is covered by the small amount of interest it receives.

Very low interest rates are a reason why banks aren't providing many mortgages these days. Banks would prefer if mortgage interest rates were higher. You can see this by their recent efforts to avoid interest risk by adjustable-rate mortgages reemerging. In the first half of 2011, they accounted for 13.4% of all originations, up from just 6.3% in 2009.

Where the Balance?

We have a conflict when it comes to interest rates. The higher they are, the happier banks will be. The lower they are, the happier consumers will be. This might seem like a problem, but it's a problem very common to economics: it's the story of supply and demand searching for an equilibrium. Eventually the market finds a price equilibrium for a good. This occurs at the largest quantity of goods sold where the most consumers will purchase it for a price at which suppliers are willing to sell it. Here's a chart that you might have seen in Economics 101 (found via Wikimedia Commons):





The price ceiling above is like forcing interest rates lower than what banks would prefer. You can see that fewer goods are sold at this price, which makes sense considering that credit is tight for mortgages. Higher interest rates would allow banks to provide more supply. But banks would not be wise to demand interest rates that are too high or the demand for mortgages would decline. So the market would find its equilibrium.

What About Broader Interest Rates?

Calabria's specific assertion deserves a little more attention. He says that the Fed should start raising rates. This is a little different from saying that mortgage interest rates should be allowed to reach their natural equilibrium. Currently, the Fed's actions are helping to keep mortgage interest rates artificially low, because it is exercising an extraordinary policy of pushing down longer-term interest rates. Under normal circumstances, the Fed only directly affects short-term rates.

In practice, however, the the effect of short-term interest rates on mortgages is a little more complicated. Many banks are funded by short-term borrowing. When the Fed pushes those rates lower, it actually allows banks to profit more from long-term lending.** So banks could provide more mortgages when short-term rates are low, because they'll find mortgages relatively profitable thanks to their low funding costs. As a result, an ideal situation for banks might be one where short-term interest rates are kept low by the Fed, but it allows longer-term interest rates to rise.

A broader problem could be lurking here, however. Short-term interest rates sometimes lead to higher inflation expectations. To the extent that banks believe that inflation will increase, they will choose to lend sparingly. That's because inflation makes loans lose value.

At this time, however, inflation expectations aren't rising. So generally, keeping short-term interest rates low for the time being might make sense if we want banks to lend more. But keeping mortgage interest rates very low as well could be counterproductive. At these rates, relatively few mortgages are actually being given to borrowers.

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*Note: For those who want to argue that lower interest rates raise home prices, see this post that debunks the view that interest rates directly affect home prices.

**Note 2: This logic applies to a regular yield curve, where long-term rates are higher than short-term rates.

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