Low Interest Rates Could Cause Havoc

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When the housing bubble burst, the value of homes plummeted, leaving many homeowners "upside-down" on their mortgage. This means that a homeowner owes more on his or her mortgage than the house is worth. With the exception of foreclosure, being upside-down on a mortgage locks a homeowner into paying for the house. The government continues to exacerbate the situation by keeping interest rates low, says Richard Rahn, a senior fellow at the Cato Institute.

- During the housing bubble, the Federal Reserve printed too much money to feed rapidly rising home values.
- Since the bubble, home prices have dropped an average of 30 percent from their highs.
- Despite this substantial devaluation, markets have not cleared, which means that prices have not adjusted enough to reach a point where the quantity of homes supplied equals the quantity of homes demanded.

The Obama administration and the Federal Reserve lowered interest rates and took steps to reduce the size of the market-clearing drop.

- By keeping interest rates low, the Fed can continue to buy tens of billions of mortgage-backed securities from Fannie Mae and Freddie Mac, which frees up mortgage funds for banks.
- Interest rates cannot be kept low forever, and when the Federal Reserve raises interest rates, housing prices are going to drop everywhere.
- The rise in interest rates is likely to create another group of homeowners who are locked into their mortgages.

For those that have already refinanced their mortgage to get lower rates, they will also become locked in when rates rise because if they decide to move, any mortgage they acquire for a new house will be under the higher rate.

- The low interest rates have also allowed Congress and the Obama administration to spend more money than they otherwise could if they had to pay a higher interest rate.
- If interest rates rise to 8 percent from the current 2 percent level, payments to service the debt would rise from $225 billion a year to $800 billion a year.
- To pay for nearly a half trillion dollars a year more, the government would have to reduce spending.

The government could not borrow the additional interest payment and could not raise taxes because that would cause incredible damage to the economy. Inevitably, the Federal Reserve will raise interest rates, hopefully when growth is higher and unemployment is lower. Until then, current economic policies will continue to subsidize the government and big banks while starving business of capital.

Source: Richard Rahn, "Locking in the Homeowner," Washington Times, March 5, 2013.