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Locking in the homeowner

Low interest rates enrich the government and starve the economy

By: Richard Rahn – March 5, 2013

It is estimated that up to a quarter of all American households still owe more on their mortgages than their homes are worth. Many of these people have been able to refinance their home loans with much lower interest rates, but that does not solve the problem because they have a balance sheet problem rather than a cash-flow problem.

Those who owe more on their homes than they can sell them for, and who have little other savings or assets, are "locked in" to their existing homes. Even if they have a better job offer in a location too distant to commute, they may not be able to take the job because they cannot afford the mortgage payments on their existing homes, cannot sell for a price higher than their mortgage, or cannot afford rent or house payments in the new location.

The Obama administration and the Federal Reserve are largely responsible for the problem. The Fed printed too much money to feed the housing bubble of the past decade. Even though homes have generally dropped in price an average of 30 percent from their highs at the top of the bubble, this price decline in many markets has been insufficient to "clear the market." The administration and the Fed took actions to try to reduce the size of the necessary market-clearing price drop, with the result that more than a half-decade later, many people are still "underwater" in their homes.

The father of experimental economics and Nobel laureate Vernon L. Smith has been arguing that policies to reduce interest rates for homeowners, rather than allowing prices to fall to clear markets, are going to lead to worse problems. At the moment, the Fed is buying tens of billions of mortgage-backed securities from the two large government-sponsored mortgage companies, Fannie Mae and Freddie Mac. This enables the Fed to buy mortgages from banks and others to keep a good supply of mortgage funds available at low interest rates. The problem is that this may be causing another housing bubble in some markets, which the Fed is, at some point, going to have to pop by raising interest rates, causing another drop in housing prices everywhere.

Those who have low-interest mortgages might well be able to afford the payments, but they cannot sell their houses for a price sufficiently high to pay off the debt -- again, they are locked in. At the same time, all of us who have refinanced our mortgages to obtain the lower rates will also find that we are locked in, even if the price of our houses is higher than our mortgage balances.

The reason homeowners with low mortgage balances relative to the price of their homes are locked in is that if they wish to move, any new home they might buy will have a higher interest rate mortgage than the mortgage they are now paying -- a double lock-in.

At the government level, the Fed policy also has created a double lock-in. By buying so much of the debt of the government at very low interest rates, the Fed has enabled Congress and the administration to spend more than they otherwise could if they had to pay the full, real-market interest rate on the government debt. At the moment, the U.S. government is paying only about $225 billion a year on its $16 trillion debt. If it had to pay normal interest rates of, say, 6 percent rather than 2 percent, its interest payments would be something in the order of $800 billion, or roughly a half-trillion dollars a year more. Most of this additional interest payment would have to come out of spending, because to try to borrow this additional amount would result in an interest-rate spiral concluding in the inability to sell any debt. If Congress tried to increase taxes to cover the additional debt payments, the tax increase would need to be so large as to put the economy in a deep recession, or worse, resulting in a great fall in revenue.

The Fed acknowledges the impossibility of buying more and more government debt forever at almost zero interest. Thus, it has said at some point -- when growth is higher and unemployment is lower -- it will raise interest rates. Its current policies are keeping growth stagnant, however, because the Fed is, in effect, misallocating capital by subsidizing the government, the big banks and some big companies with artificially low interest rates, while starving the job-creating, midsize and highly entrepreneurial companies of needed funds. The Fed and the Obama administration are now locked in a fiscal death dance.