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Money's Two Cents

What's really keeping mortgage rates down?

Posted by Joe Light
September 23, 2009 5:02 pm

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What is

Mortgage rates are below 5% again. But they might not stay that way for long — even though the Federal Reserve reaffirmed its ridiculously low, 0% to 0.25% target for the federal funds rate.

Yes, it's great for borrowers that the Fed kept its target rate so low. But the text you should really care about is this little tidbit from the Federal Open Market Committee's policy statement:

> "To provide support to mortgage lending and housing markets and to improve overall conditions in private credit markets, the Federal Reserve will purchase a total of $1.25 trillion of agency mortgage-backed securities and up to $200 billion of agency debt. The Committee will gradually slow the pace of these purchases in order to promote a smooth transition in markets and anticipates that they will be executed by the end of the first quarter of 2010."

COURTESY: KELLER WILLIAMS REALTY

You see, for the last nine months or so, the Federal Reserve has stocked up on mortgage-backed securities to relieve that troubled area of the credit market. So in addition to keeping its target rate low, the Fed gave homebuyers an additional boost by buying up $650 billion worth of MBS from Fannie Mae and Freddie Mac. At its end, the buying program will eat up $1.25 trillion-worth of the distressed securities.

Why should you care? Because as long as the Fed buys gobs of mortgages, mortgage rates stay especially low.

What's unclear is how much the Fed's moves are helping. According to one estimate from Calculated Risk, a well-regarded economics blog, it's probably depressing mortgage rates by about 0.35%.

The program was initially set to expire at the end of this year, but now the Fed says it will stretch the program through the first quarter of 2010. Granted, 0.35% might not seem like much help, but the difference between the payments on a $400,000 mortgage with a 5% rate and one with a 5.35% rate is more than a thousand bucks a year. Don't buy a house just because mortgage rates are low — home prices are still falling in many areas — but for those on the fence about refinancing, this should be welcome news.

Speaking of homes, props go to Carla Fried for pointing out the questionable benefits of the first-time home buyers tax credit a few days ago. It seems that many economists, on both the far left and the far right, agree with her. Check out this roundup of opinions over at the *Las Vegas Sun*. It quotes economists from the libertarian Cato Institute, the liberal Center for American Progress, and the Brookings Institution. They all had the same message: The tax credit is too expensive and doesn't work. Voices in support? Realtors and politicians. Go figure.

Here's a thought. The Fed didn't have a choice about extending the purchases of mortgage backed securities. The reality is nobody else wants them! Without the Fed's purchases money for new mortgages will dry up.

Freddie Mac and Fannie Mae were partly responsible for the present crisis and continue to be a problem. The way forward is for banks to retain and manage their own mortgage portfolios and not securitise them but that will mean less money for property purchases. However in the long term the economy will benefit from a more stable property market.

Posted By Jeff Gray. Margate, England: September 24, 2009 4:30 am

At 4x income, home prices still need to fall considerably to be affordable. In the middle years of the last century, home prices were about 3x income. That left a middle class family money for a new car every few years, a modest vacation, and the ability to save and give to church or charity good percentages of income. It also allowed families to live off one income and to support three to four children on average. Do home prices leave that much flex in the average middle class budget today? To ask the question is to answer it. Until we get back to that point, home prices are too high.

Posted By Kent, Birmingham, AL: September 24, 2009 2:08 am

Matt, the Fed has the ability to 'create' money without 'printing' it by either lending money to member banks via electronic tranfer or by buying something, such as loans or securities. The net result is that the seller or borrowing bank has a LOT more cash that didn't exist before, so the money supply grows. It works in reverse, too.

Home prices will eventually hit a stable point when the median income can afford the median home, and we're getting there: price about 4x income.

We really need to stop 'juicing' home prices with all of these tax breaks and subsidies. It creates bubbles, hurts affordability, and wastes money that could be better spent elsewhere on things other than oversized, overpriced houses.

Posted By Mike, Redwood City, CA: September 23, 2009 10:39 pm

Hey Tim in San Diego. How about this scenario. They bought it with an FHA loan which is insured by the government. Since they only had to put 3-1/2% down if the price of the home falls, they will be underwater very quickly. So what happens then? Well they walk away from the home and the tax payer is not only out 8K but also the FHA has a bad debt on their books. So us the taxpayers foot the bill for both the 8K and the mortgage. No wonder realtors and politicians are in support of it. The Realtors make a lot of money writing the loan with no risk and the more money they make the more they have to lobby the politicians. It's a beautiful thing how our government works.

Posted By Tim in Michigan: September 23, 2009 9:08 pm

It's going to be interesting to see what happens to home values when this tax credit ends. If this program influenced a person to buy a home and their home value falls by $8k next year they'll realize they didn't really get an $8k tax break, they took out an $8k, 30 yr loan.

Posted By Tim, San Diego, CA: September 23, 2009 7:02 pm

Where does the $1.25 trillion come from?

Posted By Matt, San Francisco, CA: September 23, 2009 5:57 pm

The special first-time home buyer tax credit may very well be too expensive and no long term fix…However, anecdotally I know of several families that would not have been motivated to go out and buy their first house without it. Plus, the inflationary aspects of the tax credit are precisely what the overall economy, the housing market and consumers (generally) have and will continue to need to counteract declining income and a deflationary economic environment.

Posted By Jeff Minich, Bronxville, NY: September 23, 2009 5:39 pm

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