Monetary Policy and the Mortgage Market

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Transmission or “Pass Through” of Monetary Policy

- How significantly do large scale purchases of MBS impact rates to consumers?
- Many factors can influence the transmission mechanism
  - Market structure of mortgage lenders
  - Cyclical nature of refinancing
  - Changes in borrowers’ credit profile
  - Changing role of GSEs
  - Expectations of future monetary policy actions
Yields Have Been Responsive to Purchases

- Immediate impact on MBS securities has been quite large – event studies
- Rates faced by consumers have declined quite significantly
- Research in NY/Boston white paper
Important Empirical Issue

- Policy question – how well transmission of unconventional policy works
- Household spending held up well despite fiscal uncertainty – monetary actions have been effective in supporting housing
- Strong case can be made for continuing to purchase $85 billion a month after “Operation Twist” expires – topic for discussion at next week’s FOMC meeting
Changes in Composition of Federal Reserve Balance Sheet

- Large-scale purchases as well as forward guidance seek to flatten the yield curve, encourage longer-term borrowing

- Today I will focus my comments on asset purchases
  - Composition may be as important as size of balance sheet
  - No credit risk – both Treasuries and MBS purchases guaranteed by the government
Figure 1
Federal Reserve System Assets

December 26, 2007 and November 28, 2012

Source: Federal Reserve Statistical Release H.4.1 / Haver Analytics
Figure 2
Federal Reserve System Assets

December 5, 2007 - November 28, 2012

Source: Federal Reserve Statistical Release H.4.1 / Haver Analytics
Reserves-Focused Monetary Policy

- Bank reserves viewed as the primary source of accommodation

- Minimize risk by buying short-term securities
  - Self liquidating – balance sheet can shrink quickly
  - Avoid interest rate risk

- Problems – little impact on market interest rates, and little evidence reserves alone provide much stimulus
Figure 3
Excess Reserves and Inflation in the U.S. and Japan

January 1990 - September 2012

Percent Change from Year Earlier

United States

Trillions of Dollars


0.0 0.5 1.0 1.5 2.0

Excess Reserves (Right Scale)

Core Personal Consumption Expenditure Price Index (Excluding Food and Energy) (Left Scale)

Percent Change from Year Earlier

Japan

Trillions of Yen


-3 0 3 6 9 12 15 18 21 24 27 30 33 36

Excess Reserves (Right Scale)

Core Consumer Price Index (Excluding Food and Energy) (Left Scale)

Source: Japanese Ministry of Internal Affairs and Communications, Bank of Japan, Federal Reserve Board, BEA / Haver Analytics
Figure 4
Growth in Real Bank Lending in the U.S. and Japan
1991:Q3 - 2012:Q3

Index, 1991:Q3 = 100

- Domestically Chartered U.S. Commercial Banks
- Major and Regional Japanese Banks

Note: Loans were adjusted for inflation using GDP deflators.
Source: Federal Reserve Board, Bank of Japan, BEA, Cabinet Office of Japan / Haver Analytics
Spread-Focused Monetary Policy

- Remove duration by purchasing long-term Treasuries and MBS
- Reduce cost of longer-term borrowing to households and firms
- Unconventional for a reason
  - To shrink the balance sheet quickly requires asset sales (not automatic)
  - Interest rate risk from asset sales
Figure 5
Mortgage Rates and Treasury Yields

June 1, 2007 - November 28, 2012

Source: Federal Reserve Board, WSJ / Haver Analytics
MBS Purchases

- How substitutable are MBS and Treasury securities?
  - Both are government guaranteed
  - If duration is main characteristic for investors then they may be viewed as close substitutes
Why prefer MBS?

- Market may be segmented (investor preferences)
- Prepayment an important difference
- Spread between Treasuries and MBS varies over time
- If segmented, MBS may be more effective in lowering housing costs – and may be most effective when housing prices are beginning to rise
Figure 6
Share of Homeowners in Their Homes for at least 10 and at least 20 Years

Prepayment

- Even with higher rates, prepayment occurs
  - Job relocation causes home sales
  - Need a larger house as family grows
  - Need a smaller house as children leave

- Many mortgages not held to maturity
- Advantage if want to shrink balance sheet
- Disadvantage to prepayment may be that at times affects pass-through
Impaired Market Functioning

- Treasuries remain highly liquid in crisis as investors seek security and liquidity
- Mortgage markets not as liquid, potentially resulting in large spreads to Treasury during a flight to quality in times of stress
- Fed purchases of MBS may improve market functioning – 2008 an example
- May be capacity constraints to amount of purchases or sales
Figure 7
Rate on 30-Year Fixed-Rate Mortgage

November 3, 2008 - November 28, 2012

Source: WSJ / Haver Analytics
Figure 8
Moody’s Seasoned Baa Corporate Bond Yield

November 3, 2008 - November 28, 2012

Source: Federal Reserve Board / Haver Analytics
Figure 9
S&P 500 Index

November 3, 2008 - November 28, 2012

Source: WSJ / Haver Analytics
Figure 10
Recent Activity:
Housing Starts, Mortgage Rates and Home Prices

July 2012 - October 2012

Source: U.S. Bureau of the Census, FHLMC, FHFA
Summary and Conclusion

- This conference is an important contribution to understanding the pass-through/transmission of MBS purchases.
- Mortgage rates and other rates are lower as a result of Fed actions.
- Policies have contributed to household spending for autos and houses.
- Faster economic growth encouraged by accommodative monetary policy.