

Monetary Policy and the Mortgage Market

Eric S. Rosengren
President & CEO
Federal Reserve Bank of Boston

Federal Reserve Bank of New York

December 3, 2012

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

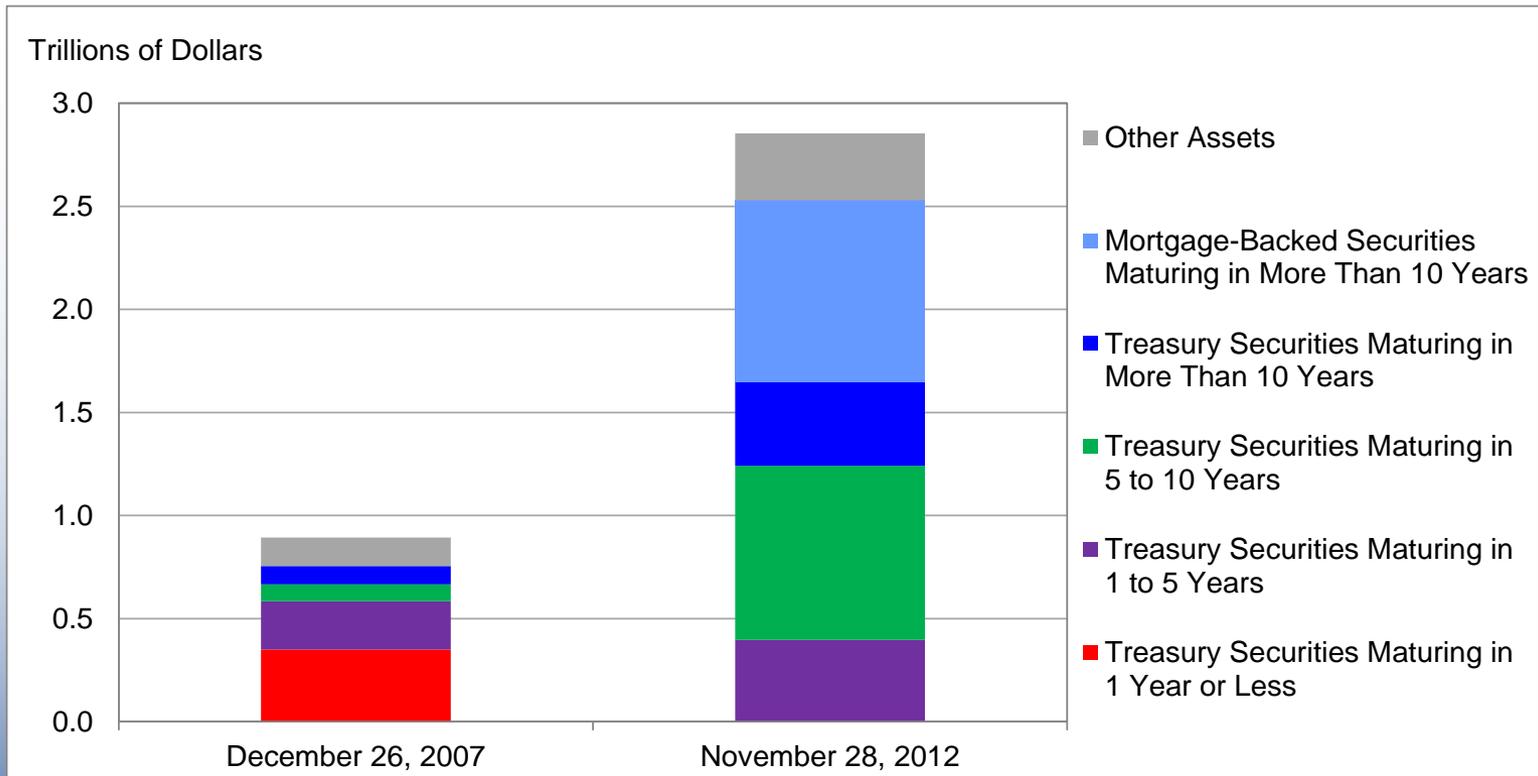
Changes in Composition of Federal Reserve Balance Sheet

- 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

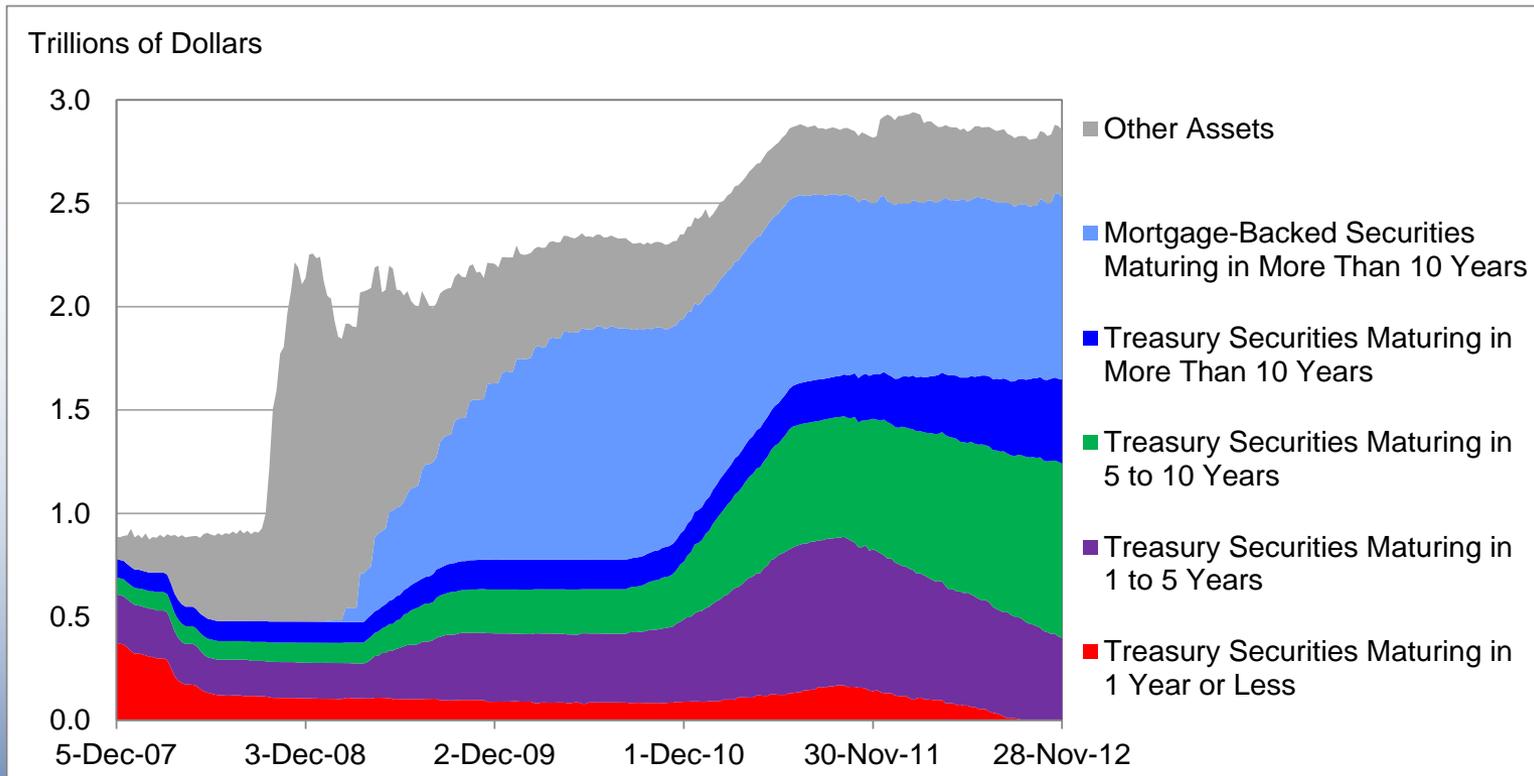


Source: Federal Reserve Statistical Release H.4.1 / Haver Analytics

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

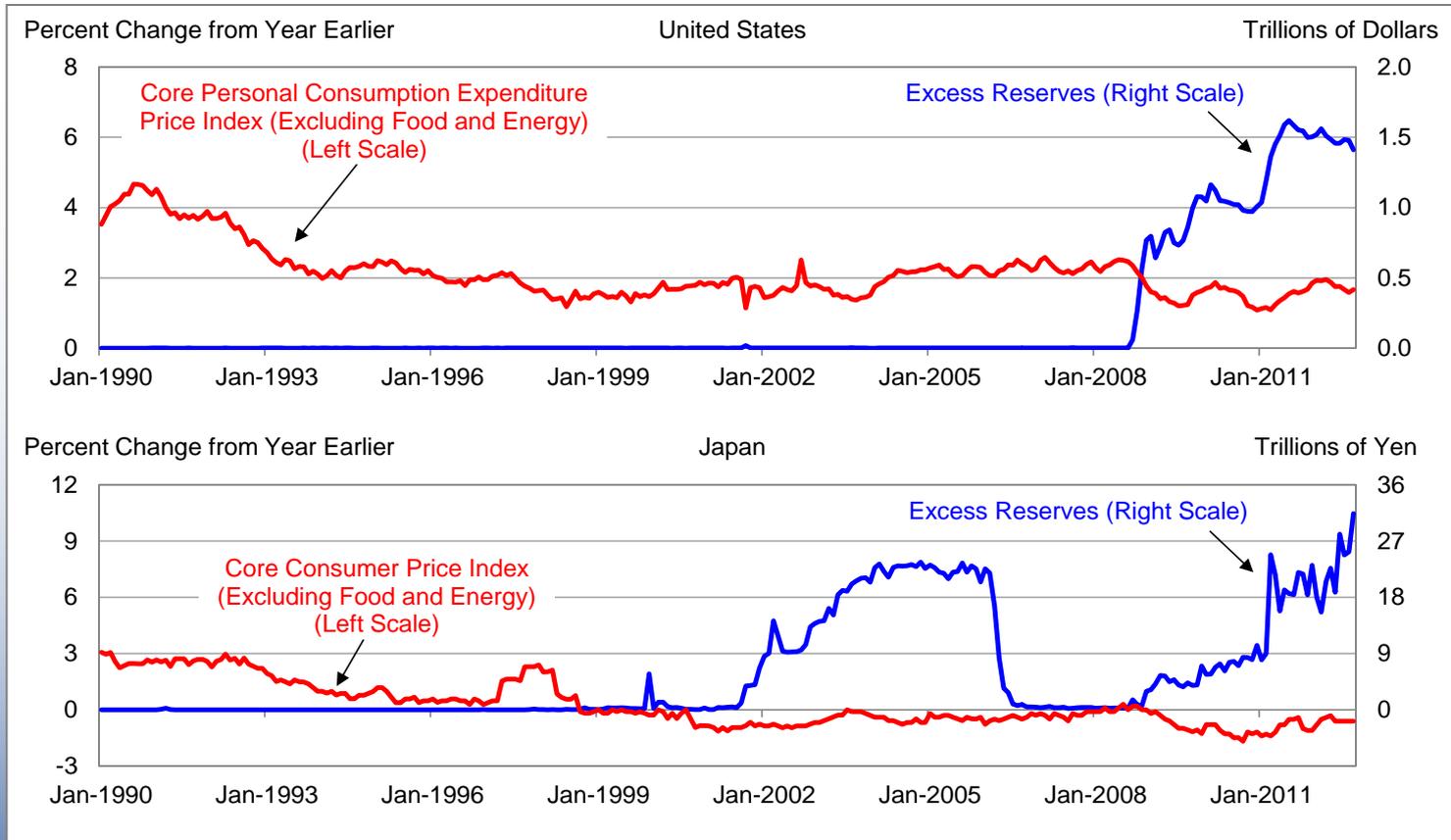
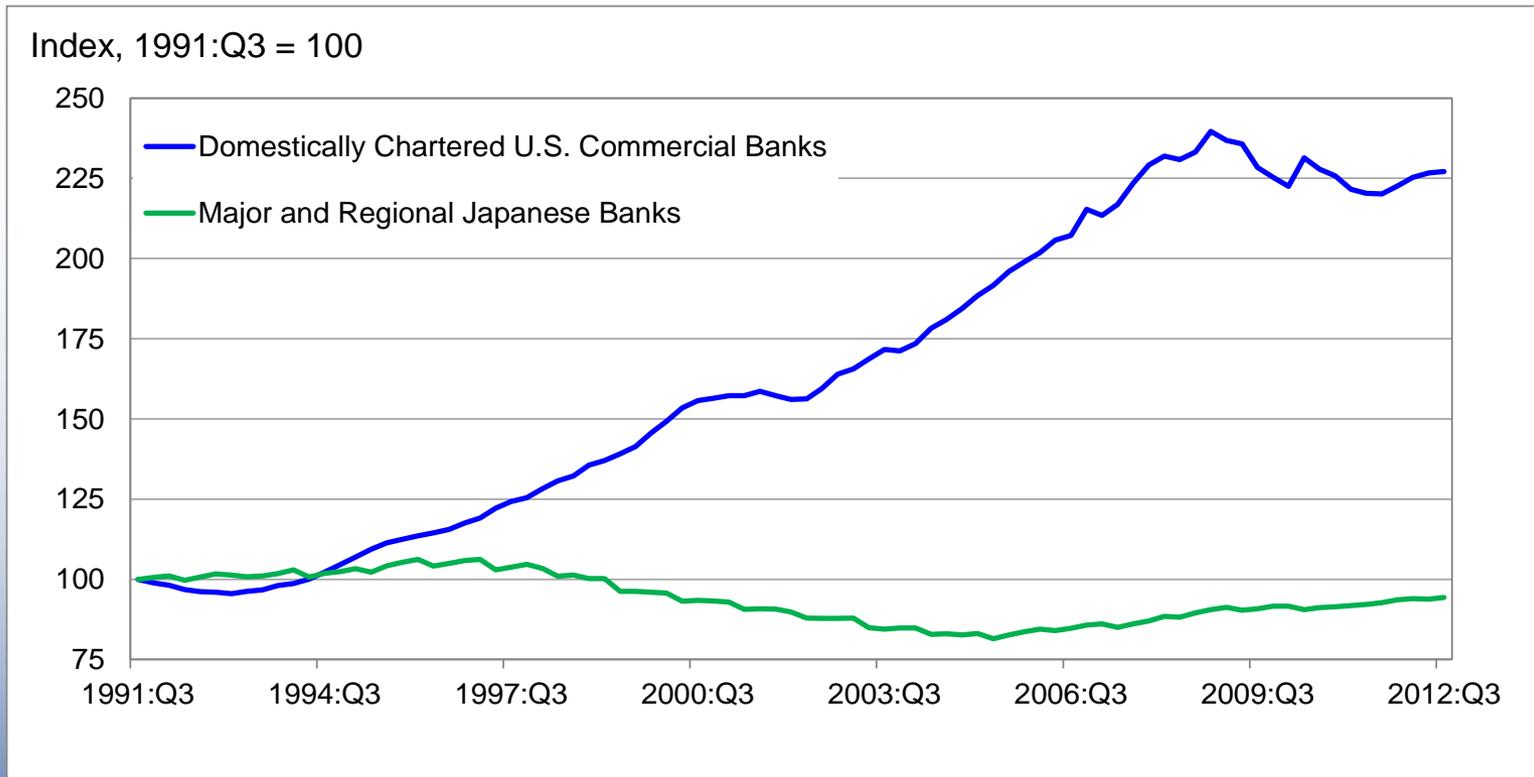


Figure 4

Growth in Real Bank Lending in the U.S. and Japan

1991:Q3 - 2012:Q3



Note: Loans were adjusted for inflation using GDP deflators.

Source: Federal Reserve Board, Bank of Japan, BEA, Cabinet Office of Japan / Haver Analytics

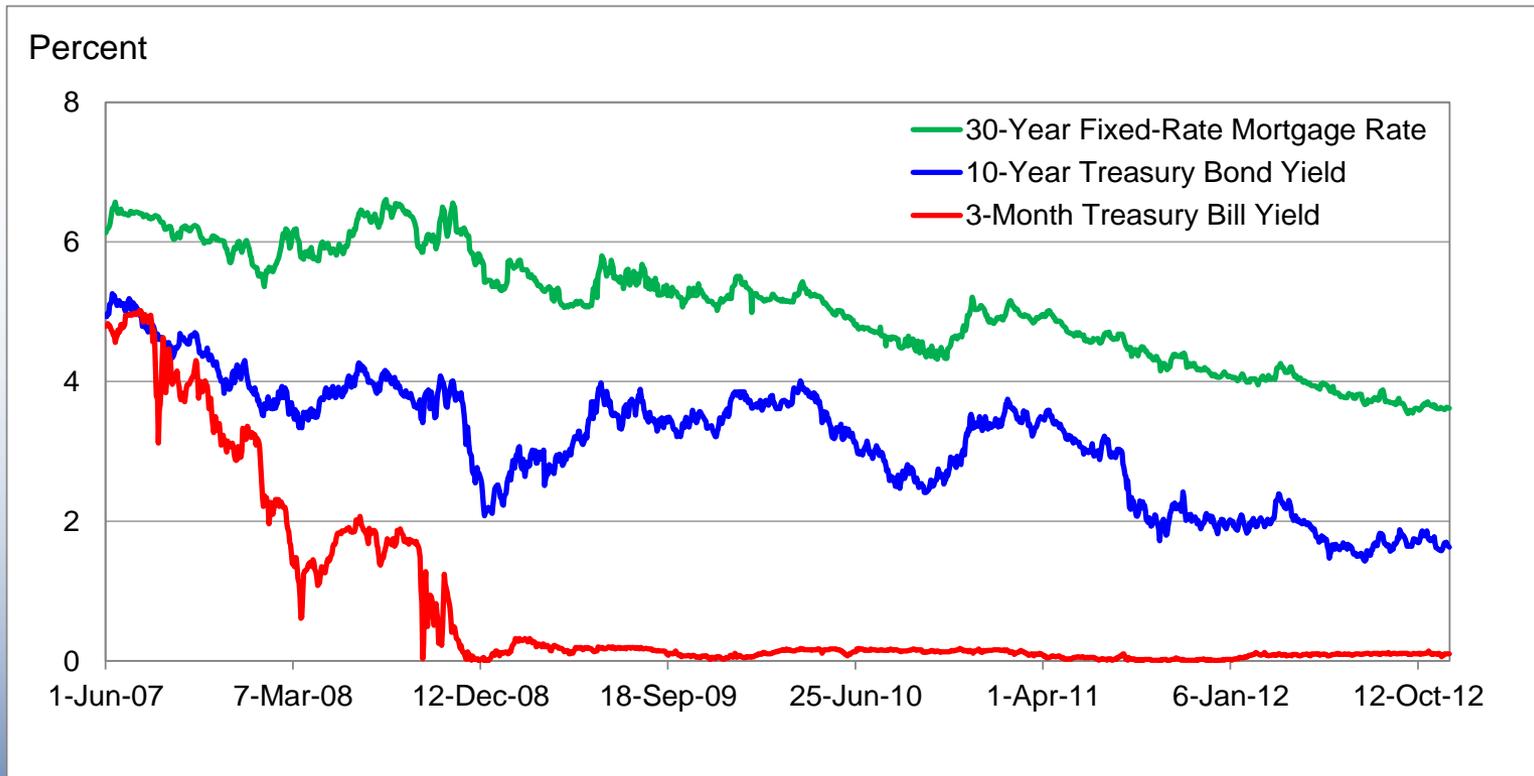
Spread-Focused Monetary Policy

- 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

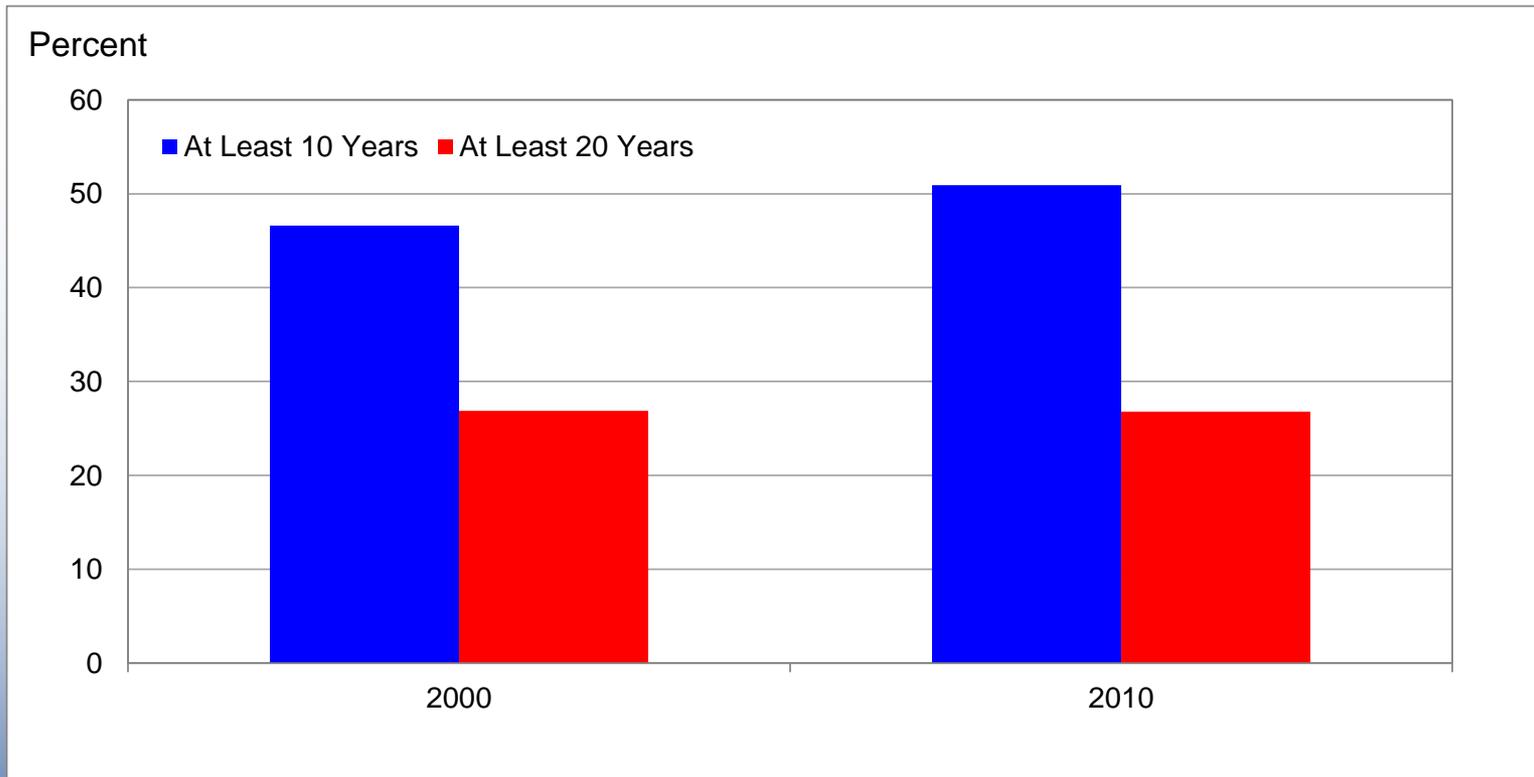
Why prefer MBS?

- 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

2000 and 2010



Source: U.S. Bureau of the Census, Decennial Census (2000), American Community Survey (2010, 1-Year Estimates) 15

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

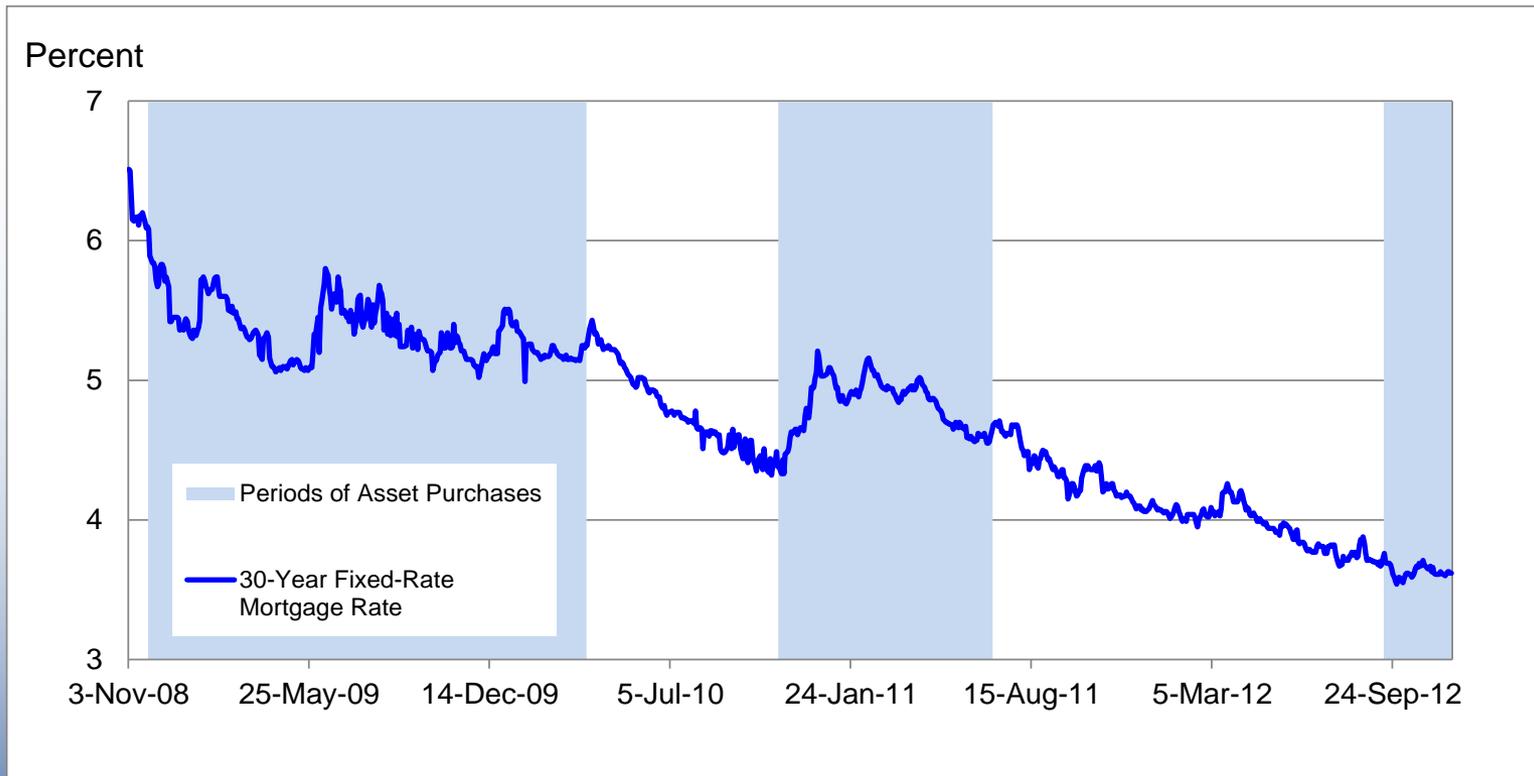
Impaired Market Functioning

- 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

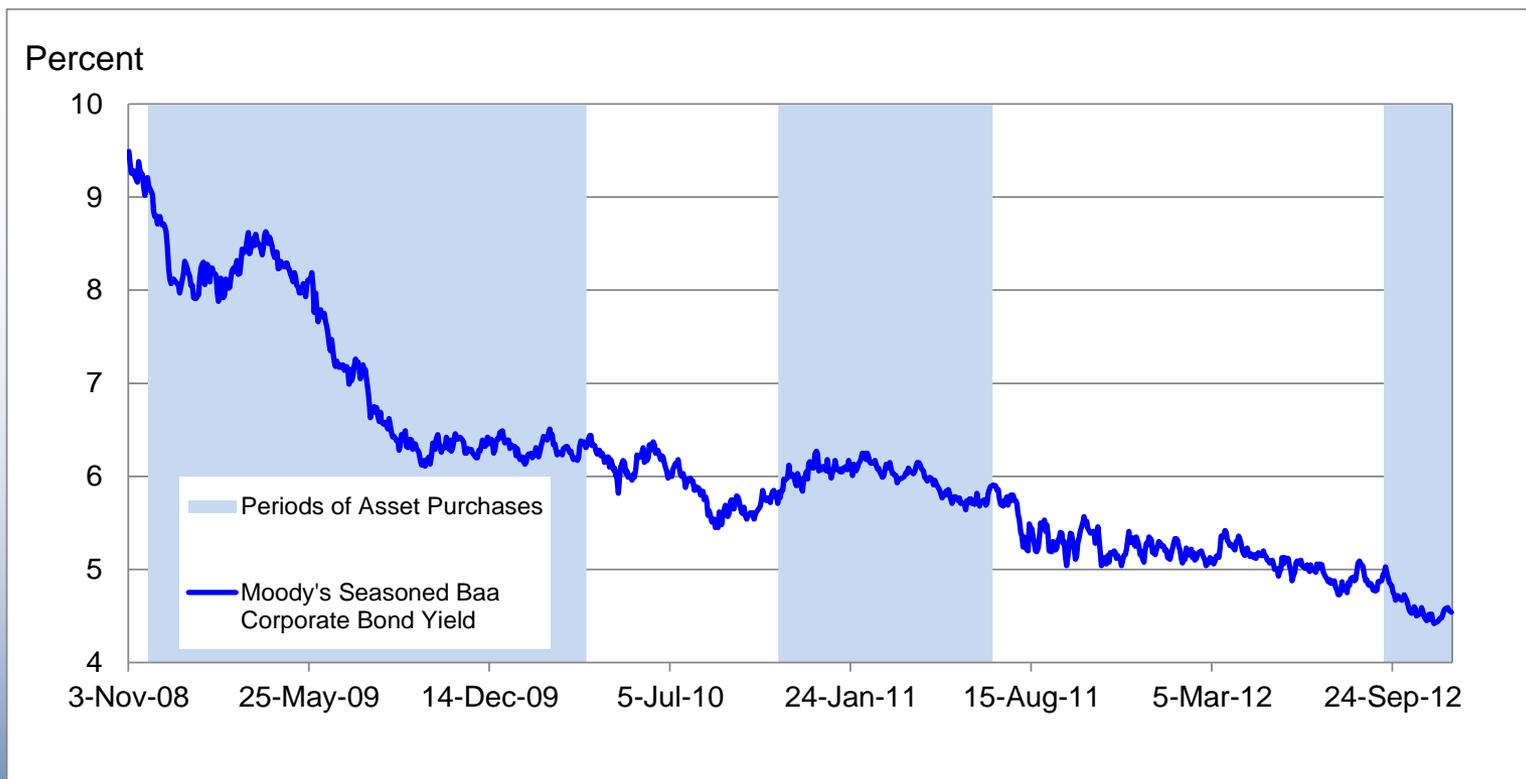


Source: WSJ / Haver Analytics

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

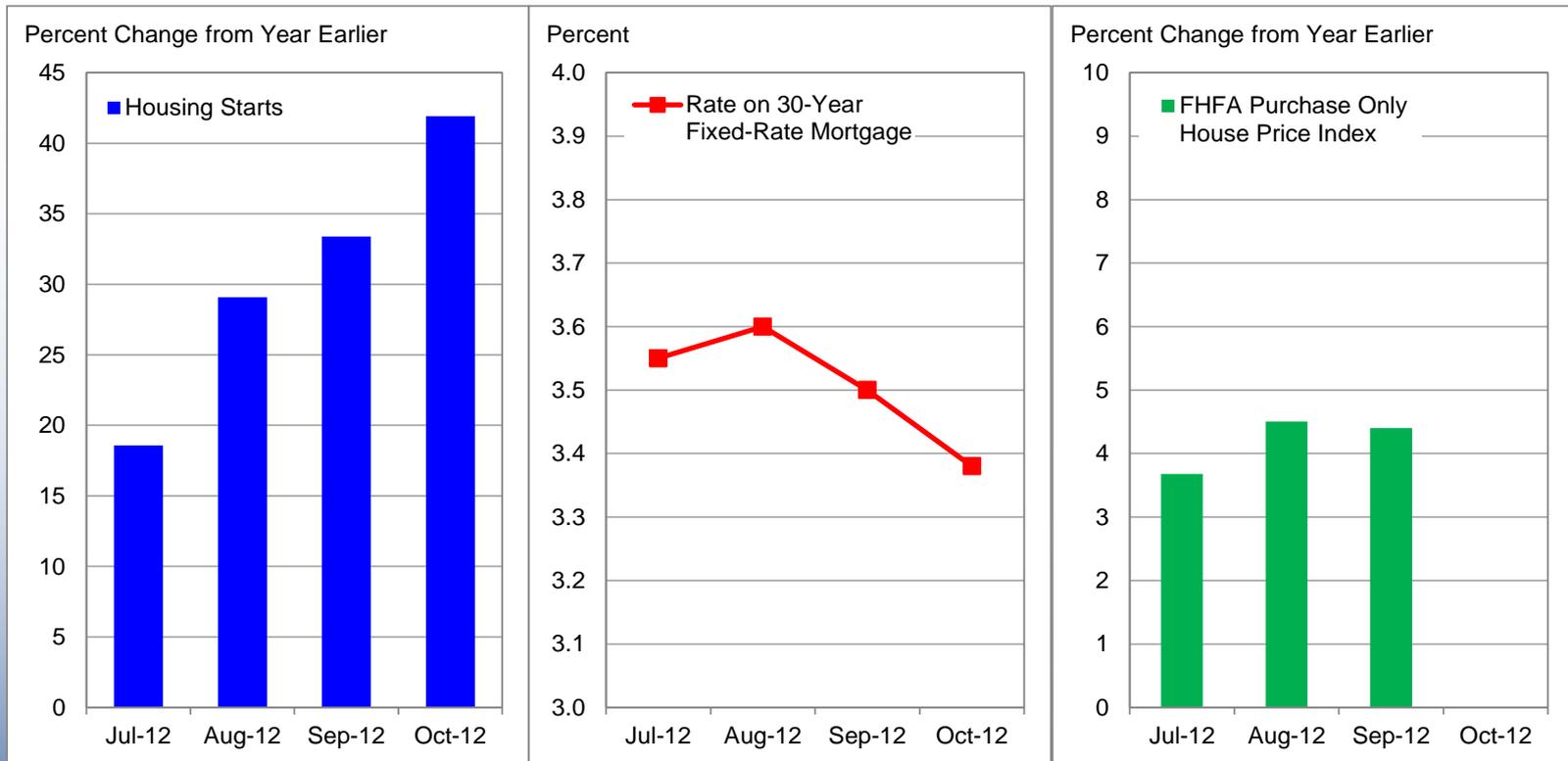


Source: WSJ / Haver Analytics

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