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

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

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