Housing, Monetary Policy And The Current Account

Some of us would be no good as politicians. Make a promise, keep a promise, and what do you have except someone, somewhere mad at you. But here's a promise, one made during a recent Columnist Conversation, kept, and that is an examination of the link between monetary policy, the housing market and the U.S. current account deficit.

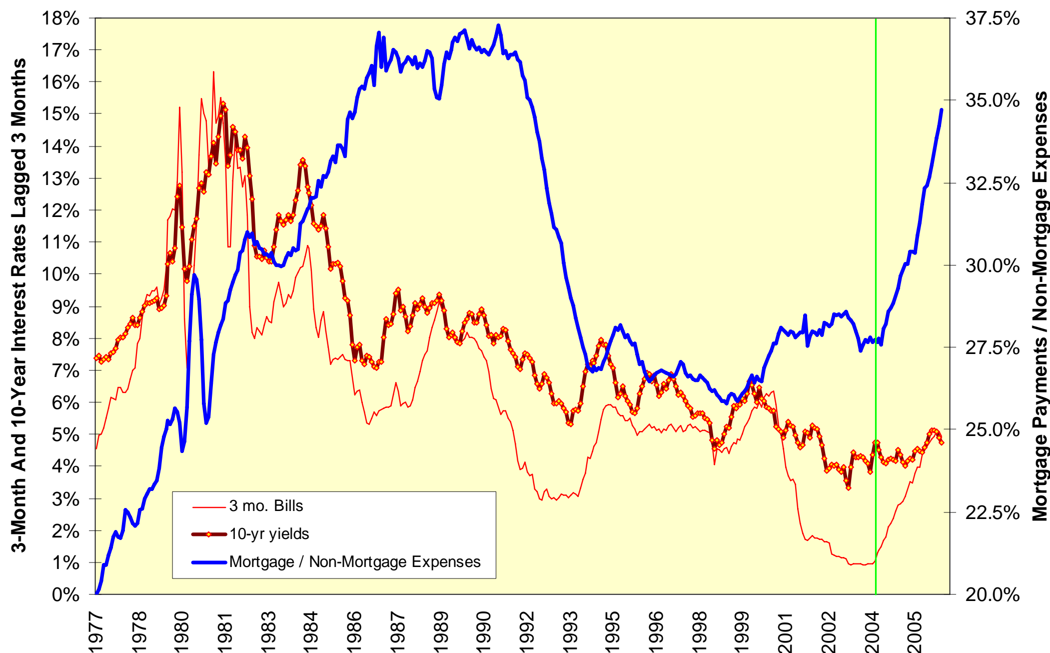
First, let's remind ourselves of the numerous changes in the mortgage market made in the past quarter-century. It used to be prospective homebuyers faced one hurdle, and that was whether their credit qualified for a 30-year fixed-rate loan. Mortgage lending was like running a 31-flavors ice cream store with only vanilla for sale. The Federal Reserve could choke off credit to the housing market by raising short-term rates over the interest rate ceilings savings & loans were permitted to pay under Regulation Q.

Once these ceilings were eliminated and the mortgage derivative market developed, the Federal Reserve was powerless to choke off the flow of credit to housing. We have had two mild recessions since Regulation Q was eliminated beginning in 1981, one associated with the Persian Gulf War and one associated with the bursting of the stock market bubble in 2000.

A thousand flowers bloomed in the mortgage market. Borrowers could pick from adjustable-rate mortgages, option mortgages, balloons, 15-year mortgages and everything in between. As short-term rates more often than not are lower than long-term rates, borrowers gravitated toward the short-end of the yield curve and gambled the yield curve would remain positively sloped and at low rates whenever the time to reset their payments arrived.

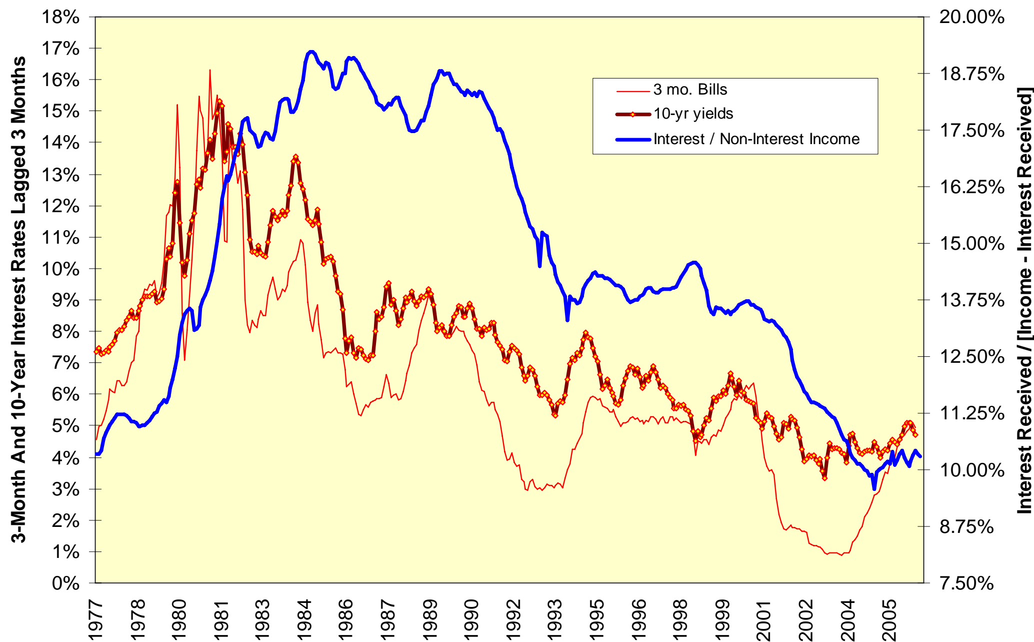
One effect of all this was a much tighter linkage between mortgage payments and short-term interest rates. If we take the ratio of total mortgage payments, principal plus interest, to all non-mortgage personal expenditures and map it against both the three-month and the ten-year Treasury rates lagged three months, we see an immediate response to higher T-bill rates from the start of the Federal Reserve's rate-hike campaign in 2004, marked on the chart with a vertical line.

Interest Rates And U.S. Mortgage Payments

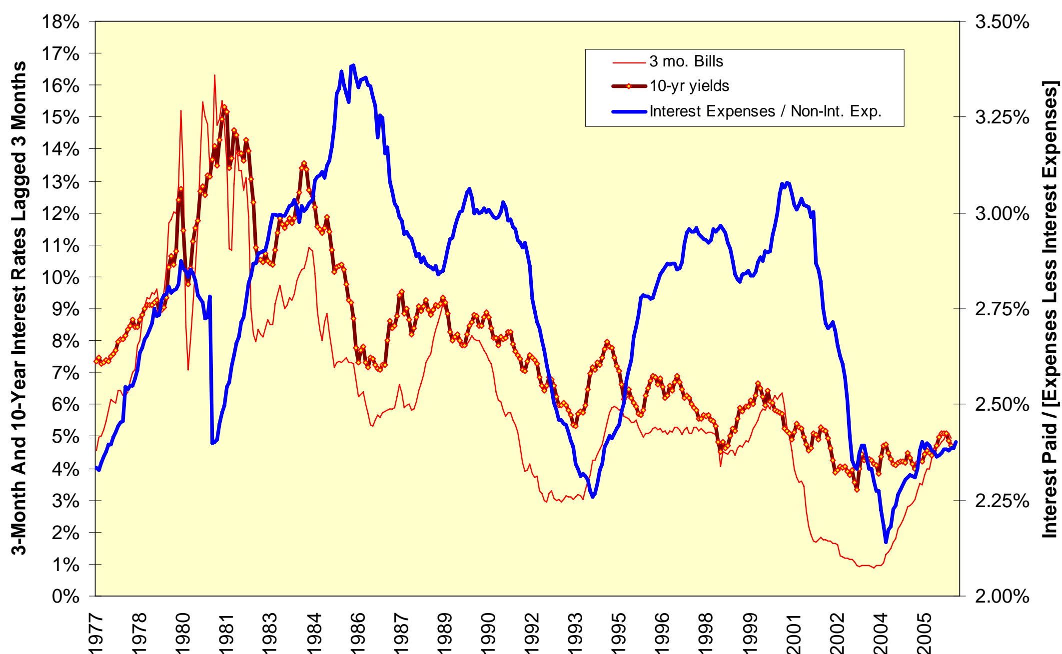


Interestingly enough, the mortgage refinancing wave of 2002-2003 did very little to reduce the ratio of mortgage to non-mortgage expenses. Contrast this to the 1992-1993 experience wherein a decline in both long- and short-term rates led to a substantial change in personal spending patterns. That previous decline in housing expenses does not receive the credit it deserves in setting the stage for the subsequent boom in the late 1990s.

There Are Creditors, Too
For every dollar borrowed, a dollar is lent; many conservative savers felt punished by the decline in short-term interest rates in the 2001-2004 period. How have personal interest income received and interest expenditures *exclusive* of mortgage payments been affected by changes in interest rates lagged three months? The data indicate only a modest response in the ratio of interest income to non-interest income as short-term rates have risen. The dominant feature of the chart is a nearly continuous decline in this ratio since September 1989.

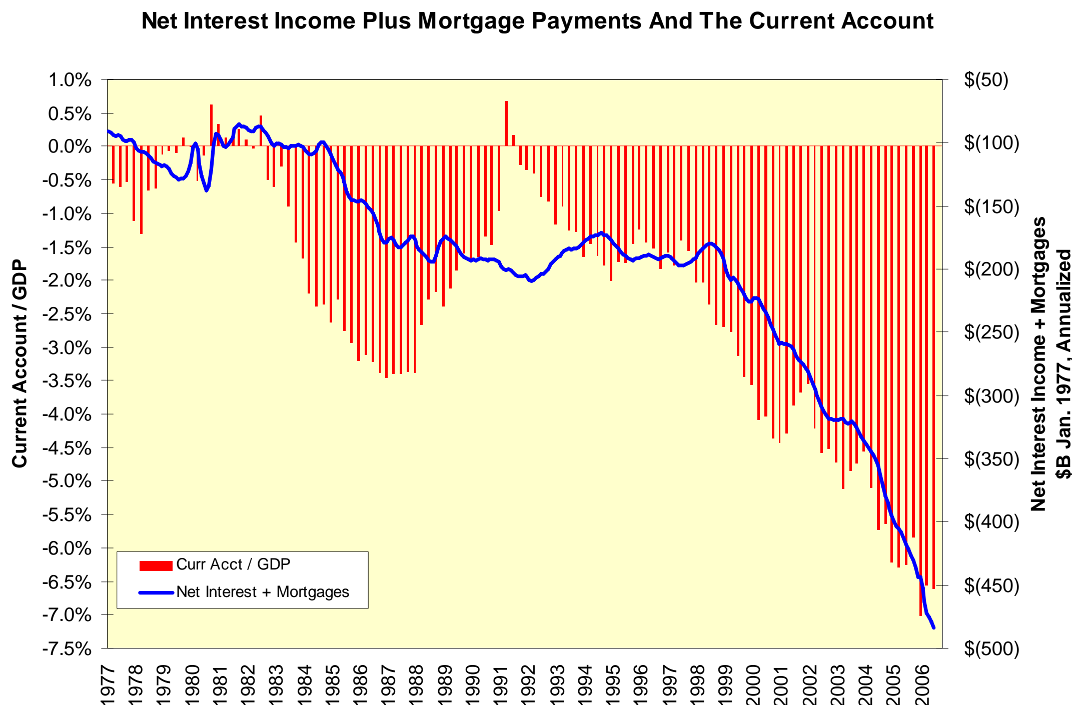


Is there a parallel observation for the ratio of interest expenses to non-interest expenses? No: This particular ratio climbed almost immediately once short-term rates, once again lagged three months, began their ascent in 2004. We can conclude from these twin observations American consumers can be characterized as floating-rate debtors virtually unresponsive to interest rate changes in their savings habits.



Casting The Net Upon The Waters

If we net personal interest income and expenditures and add total mortgage payments thereto, we obtain a net interest rate expense (less cumulative mortgage principal repaid) whose rate of change parallels the current account expressed as a percentage of GDP.



This is not a case of spurious correlation. One of the consequences of the massive U.S. capital surplus is nearly 50% of interest rate payments on Treasury securities and approximately 19% of the interest rate payments on corporate bonds flow outside of the U.S. to foreign creditors.

Higher short-term interest rates would decrease the American capital surplus and by definition decrease the current account deficit. Lower short-term rates would have the opposite effect.

Enter The Federal Reserve

Now let's return to the original point of discussion, whether the Federal Reserve can in some way be "blamed," a value-laden word if ever there was one, for the housing bubble and its aftermath. The long social experiment in generation-low interest rates between 2001 and 2004 had the effect of increasing housing prices – houses are bond-like capital assets – and increasing the total amount of mortgage debt outstanding while reducing the net interest rate income received by creditors.

These lower rates had their desired effect, stimulating consumption. As we can see in the course of the current account, much of that consumption was met by imports. It is quite fair to summarize this as saying American consumer demand was satisfied by Chinese and other exporters' supply.

The dollars exported in payment for these goods are a claim on American assets and must be recycled into dollar holdings by someone. As capital is fungible, the ballooning American capital surplus included foreign purchases of mortgage securities, either directly or indirectly. In a post-Regulation Q world filled with mortgage derivatives, the marginal financer of U.S. housing, therefore, is the foreign investor.

If higher short-term interest rates clamp mortgagors' wallets and lead to a decreased capital surplus / increased current account deficit, foreign investors will have fewer dollars to invest in American mortgages and other financial assets. Housing will be shut down in this process just like it was pre-1981 when the Federal Reserve could disintermediate savings & loans from mortgage lending.

If the fears of weak housing hurting the consumer prove true – a big "if" – the reduced capital surplus will exacerbate any ensuing recession both in the U.S. and abroad.