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THE FED RATE VS MORTGAGE RATES

THE UNTOLD STORY

BY MARK G. DOTZOUR

"Greenspan and the Federal Reserve just lowered interest rates again. The guy on TV said that lower rates would make houses more attractive to buyers. Why haven't mortgage rates gone down?" Many real estate professionals and mortgage lenders have heard these comments from their clients in the past year. So, what is the answer?

Alan Greenspan and the Federal Reserve (Fed) have no direct control over the interest rates on 15- and 30-year home mortgages. To understand the relationship between the Fed interest rate and mortgage interest rates, one must know the difference between short-term and long-term interest rates. The Fed has direct control over the short-term interest rate but not the long-term rate.

The *short-term interest rate* is roughly defined as the interest rate charged on U.S. Treasury securities that mature from one day to six months later. The *Long-term interest rate* is broadly defined as the rate offered on U.S. Treasury securities that mature in ten to 30 years. Mortgage rates are largely determined by long-term interest rates, most commonly identified as the ten-year U.S. Treasury bond rate.

But if Greenspan does not control mortgage rates, who does? The short answer is this: investors throughout the world who invest in Fannie Mae and Freddie Mac bonds.

Most homebuyers associate their mortgages with the banks or mortgage brokers that had them sign stacks of documents to get the loans. Many people are unaware that most of these loan originators sell the mortgage loans almost immediately to Fannie or Freddie.

How do Fannie and Freddie get money to buy all of these loans? They may sound like government agencies, but in fact they are private corporations trying to make a profit. They obtain money by selling bonds to the worldwide investment community and use the proceeds to buy mortgages.

Fannie Mae and Freddie Mac use the principal and interest from the mortgages to pay principal and interest to their bondholders. So the interest rate on mortgages must be sufficient to entice investors to buy the bonds.

Bond investors determine the interest they will accept based on their perception of the future rate of inflation. If they invest $10,000 for 30 years at 7 percent and the inflation rate is 8 percent, they earn a lot of interest, but the prices of things they want to buy will have gone up faster. Consequently, the mortgage rate is always going to be higher than the expected rate of inflation. As of the date of this writing, the mortgage rate is about 7 percent and the inflation rate about 2 percent. Thus, banks must charge homebuyers roughly 7 percent interest on mortgage loans to generate high enough interest earnings so that Fannie and Freddie can attract bond buyers.

Seeing the "big picture" perspective on all of this requires an understanding of how banks make money. Banks encourage savers to deposit money in the bank and pay savers interest on the deposits. Banks invest the money at an interest rate higher than the rate they pay depositors. One way banks invest the money and earn a higher interest rate is by making personal loans to individuals for cars or boats. Banks make business loans as well.

Banks also have a third option — investing their money in U.S. Government Treasury notes. If they can pay the depositor 2 percent and invest in U.S. Treasury notes at 2.4 percent, they make a profit with no risk. At any given time, a typical bank will not only be making personal and business loans but will also own a significant amount of short-term U.S. Treasury bills.

As mentioned previously, the Fed controls the short-term interest rate known as the Fed Funds rate, or the "overnight borrowing rate." This is the rate that banks charge each other to borrow money for one day. The Fed raises this rate by withdrawing cash from the banking system. Conversely, it lowers the rate by adding cash to the banking system. It does so by buying Treasury securities from member banks. This puts cash in the banks that must be reinvested to earn interest.

When local banks make new loans, cash is infused into the economy. Generally, when interest rates get low enough, businesses borrow more money to purchase new equipment and facilities. Low interest rates also spur consumers to buy cars and boats. So when the Fed lowers the short-term interest rate, it usually does so to stimulate buying.

The Fed does not directly control the long-term market that determines real estate mortgage rates, so does the Fed have any influence on mortgage rates at all? The answer is yes. Remember, mortgage rates are determined by rates on ten-year Treasury bonds. These long-term rates are determined largely by the investment community's perception of future inflation.

If investors feel that the U.S. economy is slow, then inflation is likely to be low. Wage rates and the prices of industrial commodities are unlikely to rise rapidly. Businesses are unlikely to raise the prices of their products. In such a scenario, long-term interest rates are low, and consequently mortgage interest rates are low.

Today the economy is slowing. Companies are laying off people, so wage rates are unlikely to rise rapidly. Sales are slowing, so businesses are unlikely to raise the prices of their products rapidly in the near future. Investors perceive the threat of future inflation to be low, so they are buying Fannie Mae and Freddie Mac bonds at low interest rates. As a result, consumers see lower mortgage interest rates.

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