

Correlation between Fed Funds Rate and Mortgage rates

I was asked to explain the correlation between Fed Rate Cuts and Mortgage rates at the last meeting; the short answer is that there is no correlation. Why?

The Fed has tools at their disposal to set monetary policy; their most effective tool is setting the Federal (Fed) Funds Rate. The Fed Funds Rate is the interest rate at which private depository institutions (mostly banks) lend balances (federal funds) at the Federal Reserve to other depository institutions. By raising or lowering the Fed Funds Rate the Fed aims to achieve their goals of promoting maximum sustainable output and employment and to promote stable prices [controlling inflation]. If the Fed cuts the rate this helps borrowers with short term rates [think consumer credit cards and corporate lines of credit]. If consumers can lower their monthly debt obligations, they may be inclined to spend more money on goods and services; additionally [perhaps more importantly] if corporations can lower their monthly debt obligations they may be more inclined to spend money on income producing assets, expansion and or employees. The wild card here is the publics' confidence in the Fed achieving its intended goal.

Back to Basic Economics: Supply and Demand.

If we have confidence that the Feds cut will result in sustaining output (economic growth) and promoting stable prices (keeping inflation in line); then the forces of supply and demand will drive mortgage rates upward. Why?

If investors (think billion dollar pension funds and insurance companies i.e. Prudential) are confident that the future will yield positive economic growth; than they will be more inclined to hold larger positions in the stock market (GE, Wal-Mart, etc) and smaller positions in more stable (but less lucrative) U.S. treasuries. This decrease in demand will force the government to pay higher yields (increase rates) on their treasuries to entice investors to buy them. Since mortgage rates will typically follow the U.S. Bond Market rates, they will increase as well.

So in a nutshell; the increase or decrease of the Fed Funds rate dose not correlate to an increase or decrease in mortgage rates; but rather it's the investing publics' confidence on whether the Fed will achieve its intended goal, of sustaining output and promoting stable prices, that correlates to mortgage rates.

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The following information can be found on the website of the Federal Reserve Bank of San Francisco. <http://www.frbsf.org/publications/federalreserve/monetary>

What are the goals of U.S. monetary policy?

Monetary policy has two basic goals: to promote "maximum" sustainable output and employment and to promote "stable" prices. These goals are prescribed in a 1977 amendment to the Federal Reserve Act.

What do maximum sustainable output and employment mean?

In the long run, the amount of goods and services the economy produces (output) and the number of jobs it generates (employment) both depend on factors other than monetary policy. These factors include technology and people's preferences for saving, risk, and work effort. So, maximum sustainable output and employment mean the levels consistent with these factors in the long run.

But the economy goes through business cycles in which output and employment are above or below their long-run levels. Even though monetary policy can't affect either output or employment in the long run, it can affect them in the short run. For example, when demand weakens and there's a recession, the Fed can stimulate the economy—temporarily—and help push it back toward its long-run level of output by lowering interest rates. That's why stabilizing the economy—that is, smoothing out the peaks and valleys in output and employment around their long-run growth paths—is a key short-run objective for the Fed and many other central banks.

What are the tools of U.S. monetary policy?

The Fed can't control inflation or influence output and employment directly; instead, it affects them indirectly, mainly by raising or lowering a short-term interest rate called the "federal funds" rate.

How does monetary policy affect the U.S. economy?

The point of implementing policy through raising or lowering interest rates is to affect people's and firms' demand for goods and services. This section discusses how policy actions affect real interest rates, which in turn affect demand and ultimately output, employment, and inflation.

What are real interest rates and why do they matter?

For the most part, the demand for goods and services is not related to the market interest rates quoted in the financial pages of newspapers, known as nominal rates. Instead, it is related to real interest rates—that is, nominal interest rates minus the expected rate of inflation.

For example, a borrower is likely to feel a lot happier about a car loan at 8% when the inflation rate is close to 10% (as it was in the late 1970s) than when the inflation rate is close to 2% (as it was in the late 1990s). In the first case, the real (or inflation-adjusted) value of the money that the borrower would pay back would actually be lower than the real value of the money when it was borrowed. Borrowers, of course, would love this situation, while lenders would be disinclined to make any loans.



So why doesn't the Fed just set the real interest rate on loans?

Remember, the Fed operates only in the market for bank reserves. Because it is the sole supplier of reserves, it can set the nominal funds rate. The Fed can't set real interest rates directly because it can't set inflation expectations directly, even though expected inflation is closely tied to what the Fed is expected to do in the future. Also, in general, the Fed has stayed out of the business of setting nominal rates for longer-term instruments and instead allows financial markets to determine longer-term interest rates.

How can the Fed influence long-term rates then?

Long-term interest rates reflect, in part, what people in financial markets expect the Fed to do in the future. For instance, if they think the Fed isn't focused on containing inflation, they'll be concerned that inflation might move up over the next few years. So they'll add a risk premium to long-term rates, which will make them higher. In other words, the markets' expectations about monetary policy tomorrow have a substantial impact on long-term interest rates today. Researchers have pointed out that the Fed could inform markets about future values of the funds rate in a number of ways. For example, the Fed could follow a policy of moving gradually once it starts changing interest rates. Or, the Fed could issue statements about what kinds of developments the FOMC is likely to focus on in the foreseeable future; the Fed even could make more explicit statements about the future stance of policy.

How do these policy-induced changes in real interest rates affect the economy?

Changes in real interest rates affect the public's demand for goods and services mainly by altering borrowing costs, the availability of bank loans, the wealth of households, and foreign exchange rates.

For example, a decrease in real interest rates lowers the cost of borrowing; that leads businesses to increase investment spending, and it leads households to buy durable goods, such as autos and new homes.

In addition, lower real rates and a healthy economy may increase banks' willingness to lend to businesses and households. This may increase spending, especially by smaller borrowers who have few sources of credit other than banks.

Lower real rates also make common stocks and other such investments more attractive than bonds and other debt instruments; as a result, common stock prices tend to rise. Households with stocks in their portfolios find that the value of their holdings is higher, and this increase in wealth makes them willing to spend more. Higher stock prices also make it more attractive for businesses to invest in plant and equipment by issuing stock.

In the short run, lower real interest rates in the U.S. also tend to reduce the foreign exchange value of the dollar, which lowers the prices of the U.S.-produced goods we sell abroad and raises the prices we pay for foreign-produced goods. This leads to higher aggregate spending on goods and services produced in the U.S. The increase in aggregate demand for the economy's output through these different channels leads firms to raise production and employment, which in turn increases business spending on capital goods even further by making greater demands on existing factory capacity. It also boosts consumption further because of the income gains that result from the higher level of economic output.

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