GSE Activity Report

Wednesday, September 1, 2021

Swing Low, But Where's the Chariot?

Summary

A major paper delivered at last week's Jackson Hole Fed meeting shows – we think conclusively – that it's not demographics that keep interest rates so, so low, but wealth inequality. Just as old-school models misread macroeconomics in an age of inequality, mortgage-affordability assumptions premised on low rates thanks to agency guarantees also need re-evaluation when rates stay lower for longer and homeownership becomes ever more the privilege of the rich. It may well be that government programs and new forms of credit enhancement aimed at increasing homeownership and thus combating both wealth inequality and racial inequity need now to battle the high cost of low rates: the increasing inability of younger and lower-income households to amass a downpayment.

Impact

The interaction between inequality and low interest rates epitomizes a vicious cycle. As the paper referenced above authoritatively demonstrates, conventional wisdom is wrong when it comes to demographics as the downward pull on r* (i.e., the neutral rate above and below which a central bank must push and pull to alter macroeconomic policy). Rather, it's inequality in that the richer higher-income households become, the harder it is for central banks to boost consumption and the greater the resulting demand for higher-risk investment assets. This creates increasingly financialized economies in which productivity is dampened, wages are suppressed, and inequality thrives. This in turn pushes rates down farther.

A counter-argument would have it that low rates spur home ownership which boosts the macroeconomy by creating all sorts of new demand. However, in the 1970s, mortgage rates averaged 9% and home ownership was 64.6%. Rates shot up to an average of 12.7% during the high-inflation eighties, but homeownership remained steady at 64.4%, dropping to 8.1% in the nineties with a home-ownership rate of 65%. As the Fed dropped its rates from 2000 to 2010, mortgage rates fell only to 6.3% and the market of course went wild with all sorts of mortgages for all sorts of people, with the homeownership rate rising to 68.1%. Credit risk was the problem, not affordability due to high interest rates. By the time rates sunk to the 4.1% average of the pre-pandemic decade, homeownership was down to 64.8%.

Looking at the home-ownership quandary another way, a new Fed paper finds that only 17% of young Black households own their own homes compared to same-age whites (for whom the homeownership rate is more than double at 46%). The differences are not as stark as household age, but they remain, making it clear that homeownership is getting harder and harder for lower-income, minority families no matter the rate at which purchase mortgages are offered.

Other factors, possibly including disparate impact may be partly to blame for this, as we noted last week. Still, one would expect less of a divide for lower-versus-older minority households if rates were mostly what mattered, especially after taking into account the downward trend in denial disparity ratios

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com

in recent years.

Outlook

The rationale for both GSEs and other government housing-finance programs rests fundamentally on the benefit of some form of federal guarantee that lowers rates, especially for higher-risk loans designed to enhance home ownership's demonstrable public-welfare benefit. However, the flip side of low rates outside the housing sphere is that entry-level households cannot save enough to amass a downpayment even if the downpayment is as low as FHA and, to some extent, the GSEs now allow.

Indeed, when nominal rates are negative after taking inflation into account – and boy are they ever now – savers hoping for a downpayment are peddling backwards. The more they save, the less likely they are to amass enough for a downpayment even as they likely increase other forms of higher-cost household debt. A new Fed staff paper shows just how leveraged households below the 50% median have become and how little homeownership now accounts for what little net worth they have.

As a result, government mortgage-finance entities with a mission may need to look not only at rates and risk, but also LTVs. This of course is done now through the GSEs' MI charter requirement and the role played by FHA and VA, but these backstops clearly aren't on their own enough to achieve equitable, achievable access to home ownership.

This isn't wrong – we know all too well what happens to under-water homeowners under macroeconomic or personal stress. However, just as we are learning that credit risk can be judged differently and even better with alternative data, so too might we be able to redesign credit enhancements to reflect different approaches to equity building. Shared-equity mortgages have been an idea for at least a decade, but the need for structures akin to them has never been so great. Non-predatory structures in which rental payments for a home accrue also to an equity offset are another option, with new forms of MI or other credit enhancement perhaps also deployed to add a risk buffer that reduces the burden on a first-time buyer.

And, of course, there's the flat-out alternative of direct federal assistance for mortgage downpayments. As we've noted before, HFSC Chairwoman Waters is pressing this idea in the budget reconciliation bill. She may well not get what she wants now, but policy may need to turn her way as lower for longer turns into for as far as the eye can see.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com