Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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As we've noted, Sen. Warren and a raft of progressive Democrats are emphatically demanding that the Federal Reserve lower interest rates to promote affordable housing. However, as a new Federal Reserve Bank of Dallas note confirms, low rates don't necessarily make it easier to buy a home because house prices generally rise as rates fall. Worse still, ultra-low real rates eviscerate not just the ability of all but the well-heeled and -housed to save for a down payment, but also for much else that ensures economic resilience and long-term security. Simply put, lower for longer makes the U.S. still more economically unequal, not exactly what progressives want.

The assumption in Sen. Warren's letter and a like-kind one from Chair Brown is that lower mortgage rates reduce the carrying cost of a mortgage and thus make it easier for lower-income households to qualify for a loan. However, this seemingly-obvious conclusion assumes that housing markets are static and, as any real-estate agent will tell you, they aren't.

When rates go down, demand goes up and prices do the same. Or, as the Dallas Fed study observes, a one-percentage-point hike in short-term rates usually lowers house prices by 7.5 percent over two years. Just as intuition suggests that easy money spurs homebuying, so it is that tight money reduces demand and prices respond accordingly.

Or, they do in a normal market and there haven't been any of these since the Fed sent interest rates below inflation-adjusted zero in 2008 and kept them about there until it was surprised to find that inflation wasn't transitory. It then jacked rates up at mind- and market-blowing speed starting in late 2021. Also unsurprisingly, it turns out that rate shocks such as these also distort markets. The Dallas Fed study takes a look at rate shocks, suggesting that house-price stickiness is at least in part due to supply problems independent of the usual demand/rate dialectic because negative real rates for so long distort housing supply.

Households that owned homes over the past decade obtained financing at such ultra-low rates that, as the model predicts, house prices shot up. When the Fed shocked rates with a sudden, meteoric rise, households at the higher end of the price spectrum sat tight because a new home meant a loan at far higher rates. This sharply constrained supply for new entrants able to afford higher-priced housing which, due to all the demand before rates rose, now includes pretty much all the housing supply given all the price hikes, propping up prices at this end of the curve and distorting all that's left. Prolonged ultra-low rates also led homebuilders to follow demand and build higher-priced, more profitable houses.

What lower for longer really means for the economic equality emphasized by progressives is a lot less of it. Those who have houses know that, if rates go up, they're fine where they are and, if rates go down, they're even better off because current loans can be refinanced, equity portfolios

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rise, and more money streams into savings or spending, including that for an even more expensive house that still more tightly chokes the lower-cost end of the price spectrum.

Lower rates thus do not unlock homeownership. Key to affordable housing is more supply, subsidized down payments, and the long-term, moderate rates the Fed's charter stipulates along with maximum employment and price stability.

Progressives are also wrong because low rates do still more damage to vulnerable households. Ultra-low rates also hurt lower-income households because they are likely to spur continuing or even worse inflation. As work from other Federal Reserve Banks shows, the inflation that high rates are intended to cool hurts lower-income households far more than mild recessions and resulting job loss. Families that cannot make ends meet – and that's a sizeable majority – are falling farther and farther behind thanks ironically, perversely, and definitively to ultra-low rates.

As Thomas Piketty showed a decade ago, economic inequality is a cumulative process – the worse it gets, the harder it is to fix. Simple demands for low rates for one public good – affordable housing – fail not only to recognize housing-market reality spawned by sixteen years of ultra-low rates and easy money, but also miss the macroeconomic damage low rates do to those who can least absorb it.