US interest spike could hit home mortgage market and economy

Nick Beams
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The recent gyrations of US financial markets point to growing instability in the economy more generally and the possibility that the limited growth of the past two years could give way to recession.

Just two months ago yields on 10-year Treasury Notes had fallen to their lowest level in 45 years. But since then the price of bonds has fallen sharply, pushing up yields at their fastest rate for more than 20 years.

(The price of a bond and its yield bear an inverse relationship. For example, if a $1,000 bond returning $40 a year sells for $1,000 then the yield will be 4 percent. But if the price of the bond rises to more than $1,000 then the $40 return will represent a smaller yield in percentage terms and vice versa if the price of the bond falls.)

Bond prices have fallen by around 10 percent in the past month, pushing up yields from 3.11 percent to 4.42 percent. One of the ways in which this rapid movement could impact on the rest of the economy is the connection between the bond market and home mortgage interest rates.

With the decline in interest rates over the past two years—sparked by the cuts in short-term rates initiated by the US Federal Reserve—home buyers have been able to refinance their fixed-interest rate mortgages at a lower rate, leaving them with additional cash resources. This refinancing process, coupled with the ultra-low or zero interest rates charged on cars and consumer durables, has played a central role in maintaining consumption spending and keeping overall growth rates positive. But now there are concerns that this process may be coming to an end.

According to the *Economist* magazine, the rise in bond yields, and therefore interest rates, could “choke off” any recovery in the US economy because “home-owners will be less likely to refinance their mortgages, cutting off a primary source of consumer spending; companies will be less eager to borrow, and will pay more when they do; investment banks, which have been sustained by bond trading over the past year or so, will have to look elsewhere for profits.”

An article in the *New York Times* on August 4 made the same warning. Cheap mortgages, which had helped keep the economy afloat, appear to have come to an end with the steep hikes in the bond markets, leading to a reduction in the pace of home refinancing by half in the last few weeks.

While it is still not clear whether the spike represents a permanent increase in long-term interest rates, the events of the past few weeks have done much to puncture the carefully cultivated myth that the Fed somehow exercises “control” over the economy. In fact, the circumstances leading to the gyrations in the bond market reveal that there is considerable perplexity in leading US financial circles.

The latest round in the mortgage refinancing process began last May when the Fed acknowledged concerns about the possibility of deflation in the US economy and indicated that it was not totally dependent on the use of short-term rate cuts as a method of stimulating the economy. So-called “non-traditional” methods may also come under consideration.

This was taken to mean that the Fed could enter the market and buy long-term bonds, forcing the price up and sending yields, and long-term interest rates, down. This led to a rising bond market in June, with yields falling to new lows. Then, there seemed to be something of a reversal in the Fed’s policy. On June 25 it set the short-term rate at 1 percent with a cut of just 0.25 percent, compared to the “market expectation” of a 0.5 percent cut. This move was interpreted as meaning that the Fed had moved away from consideration of long-term Treasuries as a means of keeping interest rates down.

This view received confirmation in Fed chairman Greenspan's semi-annual policy statement to Congress in early July in which he indicated that the Fed still had some leeway in the use of its traditional policy instrument—the easing of short-term rates. According to Greenspan, given the "highly stimulative stance of monetary and fiscal policy" [low interest rates and a growing budget deficit] the Fed had concluded that, "economic fundamentals are such that situations requiring special policy actions are most unlikely to arise."

Previously, it been thought that the Fed would be reluctant to lower rates much below about 0.75 percent and that it would use "non-traditional methods" to steer away from the "zero interest" rate policy of the Bank of Japan. However, Greenspan made it clear that short-term rates could fall further and the Fed stood ready to "maintain a highly accommodative stance of policy for as long as it takes to achieve a satisfactory economic performance."

With the Fed chairman ruling out any immediate turn to "non-traditional" methods, the bond market recognised that the Fed was not likely to be a buyer and started a rapid decline, leading a rise in interest rates.

Besides the actions of the Fed, the spike has been reinforced by the operations of the money market itself. Securities based on home mortgages now constitute the single biggest segment of the bond market—some 35 percent as opposed to 28 percent ten years ago. When interest rates are falling and home buyers refinance their mortgages to take advantage of the lower rates the holders of the securities—institutions such as Freddie Mac, Fannie Mae and pension funds—invest the additional cash they receive in Treasuries, further sending down long term interest rates. However, now that interest rates have started to increase, the process is reversed and the major holders of mortgage-backed securities tend to sell Treasuries, adding further upward pressure on long-term interest rates.

In addition to the uncertainties produced by the apparent policy confusions and/or disagreements at the Fed and the peculiarities of the money market, there are powerful objective tendencies working to push up US interest rates. The latest figures show that in the first quarter of 2003, the US current account balance of payments deficit reached the equivalent of 5.1 percent of gross domestic product, or $544 billion annually, requiring a foreign capital inflow of around $2 billion every business day. But this figure could rise to $3 billion a day in the coming year because of the expanding federal budget deficit which could push the balance of payments deficit out to as much as 7 percent of GDP within 18 months.

There is no historical precedent for the financing of an external deficit of this size and at a certain point a sharp increase in long-term US rates may be necessary to attract funds from the rest of the world. It says something about the state of the world capitalist economy as a whole that one of the main factors keeping them at their present relatively low levels is the near-recessed state of both the European and Japanese economies.