Popular Economics Weekly

WEEK OF JULY 10, 2006—MORTGAGE MARKET LOWERS ECONOMIC VOLATILITY

Politicians beware of too much regulation of the so-called GSEs—Government-Sponsored Entities like Fannie Mae and Freddie Mac. Regulators have been demanding they cut back on their loan portfolio, yet not only do Fannie, Freddie—along with FHA and VA—supply most of American homeowners' conventional mortgages but they have been a major factor in the economic health of this country.

A University of California, Berkeley, research paper (UCB Fisher Center Working Paper No.298, January 2006) attributes much of the increase in economic stability of the past 2 decades—a period that Fed Chairman Ben Bernanke has called the Great Moderation—to the growth of the secondary mortgage markets, led by Fannie Mae and Freddie Mac.

It was a period that saw a decline in interest rates, lower inflation, with fewer and milder recessions (in 1990-91 and 2001). The volatility of Gross Domestic Product growth also declined substantially from 1988-2004 as compared with the prior 1968-87 period, when the secondary mortgage markets were in their infancy.

The reason? There was less volatility in real estate investment in the latter period, due to the increased liquidity available from the secondary markets' purchase of mortgages. This gave banks and other real estate investors the ability to re-lend their depositors' monies at lower risk to them. The resulting stability has enabled the real estate market to be a cushion for negative shocks to the economy, reducing GDP volatility.

"When the secondary mortgage market is underdeveloped," said the report, "the supply of mortgages will fall whenever the average level of income decreases or interest rates go up. With a well-developed market, on the other hand, the supply of mortgages does not drop dramatically…This makes the growth of residential investment more stable."

We see that today. It was a surge in real estate investment that led the recovery from the 2001 recession at a time when the stock market lost more than 50 percent of its value. Consumers could then tap into their home equity when personal incomes were falling. Incomes, alas, are still below 2000 levels when adjusted for inflation. It was the growth of a secondary mortgage market with its plethora of exotic programs that has reduced the negative impact of the lower income on consumers amid rising interest rates.

Will reduced economic volatility continue? Ben Bernanke seems to think so, as long as he keeps his handle on the inflation brake. It was his opinion that Fed Chairman Greenspan's inflation hawkishness, along with the reduced government spending and lower budget deficits of those years also helped to smooth out the economic bumps.

The question today is whether a slowing housing market and lower consumer spending will keep the Fed's inflation hawks from raising rates further. Inflation adjusted consumer spending for April-May grew barely above inflation and not at all in June. Residential construction employment has fallen 6,800 over the past 2 months in the latest unemployment report, and is only up 7,000 for the year. This compares to 20,000 construction jobs created last year.

In summary, it was the establishment of GSEs as well as financial innovations like mortgage-backed securities that have become important tools for reducing credit risk through greater liquidity and diversification. In fact, Fannie Mae and Freddie Mac's stated mission is to ensure liquidity and stability of the secondary mortgage market by promoting a flow of capital and selling securitized mortgages back to institutional investors. Any attempts to cut back on their lending activities could therefore materially impact future economic growth.

"With a well-developed (mortgage) market, the supply of mortgages does not drop dramatically," concluded the report. "In turn, house prices only mildly react to macroeconomic shocks. This makes the growth of residential investment more stable. Secondary mortgage markets therefore make housing demand less sensitive to the business cycle, making the economy at large less volatile."