Popular Economics

Promoting the Popular Understanding of Economics

Popular Economics Weekly
Week of August 13, 2007

Credit Crunch Worsens

In order to understand the abrupt changes in mortgage interest rates, it helps to understand what is going on in the secondary mortgage markets. The so-called secondary market is where most mortgages are sold by banks, mortgage banks, thrifts, and anyone else who funds loans, so they can lend another day. And events this week caused the Federal Reserve to radically shift its bias—and monetary policy—from an inflation danger to the growing danger of slower growth and higher unemployment.

The credit crisis was triggered by borrowers defaulting on their loan payments. This in turn meant that the investors who bought those pools of mortgages—usually in the form of bonds—lost income. Their investments were then worth less, which caused many to want to take their money out of the investment funds.

And when many clamor to withdraw funds, it is much like a run on the bank. Since such funds generally have a limited amount of cash on hand to pay those wanting refunds, they borrowed from their banks. And since banks also have a limited amount of cash on hand, they turned to the Federal Reserve to borrow more money.

Because of the turmoil, secondary market investors (usually mutual, hedge, or pension funds) have been reluctant to buy more mortgages. Why? Until it is known exactly how many mortgages will default, investors cannot measure the risk and so price of their investment. But that won't happen until we work through more of the $1 trillion in adjustable rate mortgages (ARMs) on the books as their payments continue to adjust upward.

In light of these facts, it is hard to understand why the Fed has taken so long to lower interest rates—as it did Friday with a one-half percent cut in its overnight discount window rate. The damage to economic growth and consumers' pocketbooks by the credit shortage is far more than that inflicted by a small jump in the inflation rate. It is borrowers not being able to meet their mortgage payments—which are as high as 8.5 percent for even prime borrowers with ARMs—that is causing the squeeze in the first place. And lowering short-term interest rates will help to lower the mortgage payments on those ARMs.

The inflation news has been benign of late, as gas prices have fallen. Both wholesale and retail prices rose slightly, while industrial and service sector production fell. Also, the NAHB/Wells Fargo housing market index fell two points in August to 22, which means about one fifth of builders nationwide think the market is "good." A year ago, the index was at 33. Two years ago it was at 67.

The Commerce Dept. also reported that housing starts (construction) and permits continued to decline. Residential Construction is down 37 percent from their peak of last year, while commercial construction continues to hum along.

PPI and CPI—Wholesale (PPI) prices rose 0.6 percent, but the core rate rose just 0.1 percent without food and energy. Finished wholesale goods are up 4 percent in a year, mainly due to 2.5 percent rise in energy prices. Meanwhile July retail (CPI) prices rose just 0.1 percent, core rate rose 0.2 percent. This is because energy prices fell 1 percent (read gas prices) at the retail level!

Housing Starts
U.S. home builders cut back again in July, starting construction on the fewest number of new homes in

more than 10 years, the Commerce Department reported Thursday. Housing starts fell 6.1 percent to a seasonally adjusted annual rate of 1.381 million, the lowest since January 1997. Meanwhile, authorized building permits dropped 2.8 percent in July to a seasonally adjusted annual rate of 1.373 million, the lowest since October 1996.

The Fed only cut the more expensive loan rate to banks, but has not yet acted on the fed funds rate that controls the Prime Rate and ARM indexes of mortgage holders. But Friday's cut is a sign that central banks may begin to lower interest rates in earnest. In fact, this writer believes a fed funds rate cut sometime before the next September 18 FOMC meeting is now a foregone conclusion, as I have said.

Copyright © 2007