The Fed Exits from Mortgage-Backed Securities

Joseph E. Gagnon argues that the Fed's purchase of mortgage-backed securities during the crisis helped lower interest rates and says pulling back now entails risks.

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Steve Weisman: Is it appropriate for the Federal Reserve board to pull back from buying mortgage-backed securities, which it started at the height of the financial crisis? This is Steve Weisman at the Peterson Institute for International Economics, with Joseph Gagnon, senior fellow at the Institute, who has studied this very issue, written about it, and is here to explain it. Joe, thanks for coming.

Joseph Gagnon: You're welcome, Steve. Good to be here.

Steve Weisman: First, tell me what the Fed has done and what's the importance of it.

Joseph Gagnon: Beginning at the peak of the financial crisis in November 2008 and then increasing in March 2009, the Federal Reserve announced and began buying large quantities of mortgage-backed securities that were guaranteed by the housing agencies, including Fannie Mae, Freddie Mac, and Ginnie Mae. The Fed also bought some of the debt of those agencies and also bought some longer-term Treasury bonds. The intent, in all three cases, was to push down interest rates at longer maturities, longer-term interest rates including mortgage interest rates for homeowners, but also just generally across the economy, longer-term interest rates to help stimulate the economy.

Steve Weisman: They bought and in some cases guaranteed some other debt instruments, didn't they?

Joseph Gagnon: There were a number of actions the Federal Reserve took in the crisis, but most of them were really oriented toward its very short-term problems and specific financial markets. And this was the one thing that they took that was really oriented toward the longer-term interest rates.

Steve Weisman: In this category, how much are we talking about?

Joseph Gagnon: It was big. It was $1.7 trillion of purchases of these longer-term assets, which is a huge amount.

Steve Weisman: Now that they've stopped purchasing them, are they going to sell them?

Joseph Gagnon: I don't think so. The minutes of the latest meetings say that they're going to let them run off naturally, which means that when you refinance your mortgage or you sell your house, you prepay your mortgage or you basically pay your mortgage before it's due. And those payments will trickle up to through the mortgage-backed securities to the Federal Reserve and they will not replace them. Basically the amount that they're holding

will gradually decline by that factor. And for the immediate future, they have promised only to do that and not to sell any actively, but they reserve the right to sell them if they change their minds. But for now, they're not going to sell them.

Steve Weisman: You've participated in a study that examines whether or not this action by the Fed in a crisis helped avoid making the crisis worse or maybe even [helped] get us out of the crisis. What was your conclusion?

Joseph Gagnon: Our conclusion was that it did work. It actually worked quite notably but our best estimate of the effect of these purchases was to lower longer-term rates—for example 10-year Treasury rates, but also 30-year mortgage rates—by about 50 to 60 basis points. That's a little more than one half of a percentage point, which is not a huge amount but it's an amount that moved across all assets. So, corporate bonds yields fell, mortgage rates fell. Mortgage rates actually fell by even more for a while because they had been unusually high during the crisis, and that fell too. But then on top of that, all long-term yields fell because of the Fed's actions, and we estimate that the long-term rates will stay lower than they otherwise would be for a long time, gradually unwinding as these assets are gradually maturing and being repaid. But that would probably take many years.

Steve Weisman: Can you tell whether that actually had an effect on the real economy?

Joseph Gagnon: That is hard to say because we can never be sure what one action does for the whole economy when many other actions are going on. I would note that at the same time the Treasury was borrowing a lot, the debt was rising. That would actually tend to push up interest rates. So the Fed in some sense was just holding back the rise of interest rates that otherwise would have happened, but it still is important because we're better off having low interest rates to stimulate activity. We actually did have about $2 trillion of homeowners refinancing to lower rates last year. That helps reduce homeowners' monthly payments, which is about $11 billion or $12 billion a year in savings that they can spend in the economy. We had the record-breaking year for corporate bonds once again because they got [much] lower rates, partly because of this policy action that helps businesses to finance their investments in plant and equipment and hire new workers. So, we're sure that it had an effect. It probably had some effect on the dollar and on the stock market too, but measuring that is very difficult.

Steve Weisman: Is the Fed moving too quickly to pull out? After all the recovery is very precarious.

Joseph Gagnon: Personally I have argued that the Fed should be doing even somewhat more of this. And at the previous Peterson Perspectives, we've talked about that. So, of course, I think exiting right now, or at least ceasing to do more—I think they should do more.

But I would stress that one thing some people worry about was when they [the Fed] stop buying these assets. They finally completed the program last week, but they had been winding it down for many months and scaling it back and announcing [their plans] ahead of time. And in fact, as we predicted in our paper, this didn't have a big effect on market yields because markets had already priced it in. One thing we learned in our paper is that when the Fed does these things, most of the effect on the markets happens even before they start buying them because what matters is what they say they're going to do. That's really quite interesting.

And so, saying that they're going to stop, but doing it ahead of time, turned out not to lead to a big effect when they finally did stop. However, that's not to say that if they did more, they couldn't lower rates further. And if they sell them, rates could go back up. So, rates could go either down or up, depending on whether they sell these off or buy more.

Steve Weisman: What's the Fed's thinking in moving now? Does this show that they're more confident that the economy is recovering?

Joseph Gagnon: I think from reading the minutes of their last meeting, which [was] in mid-March, they see recovery starting under way but they still noted how tentative it was, how big the risks were. And they also noted how actually core inflation, if you take out energy prices, has actually been coming lower than they expected. So, there are a number of worries I think still ahead. And the unemployment rate remains way above where they want it to be or expected it to be, and they're worried about the cause of that.

I think actually the real reason there they're not doing more is that they've done a lot as it is, and this is a new policy, and it perhaps needs to be studied more and understood more. They're unchartered waters as it is and they didn't feel like sailing even further toward the edge of the ocean, as it were. I believe the world is round and there's no edge of the ocean. But there may be some people that think that if they sail further, they will fall off the cliff. So, I think there's a bit of caution there.

Steve Weisman: Joe, thank you very much.

Joseph Gagnon: You're welcome.