the Mortgage Bulletin

Week of December 11th, 2006

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FOMC controls mortgage rates - true or false?

The correct answer is "false," and here's why.

The FOMC (federal open market committee) will meet on December 12th for the 8th and last time this year to discuss, debate, and determine if a tweak to short term interest rates is necessary.

This committee reviews economic and financial conditions and based upon this review, establish monetary policy designed to balance price stability and long term economic growth. The committee takes one of three possible actions each time it meets: increases rates, decreases rates, or leaves rates alone.

The most visible tool used by the committee is the federal funds rate. The fed funds rate is the rate at which depository institutions (banks) lend at the Federal Reserve to other depository institutions overnight.

An increase in the fed funds rate triggers events which ultimately increases the cost of borrowing and thus slows economic growth. A decrease in the fed funds rate has the opposite effect.

If the committee leaves the rate alone, it is evidence of their assessment that the economy is in balance and needs neither a push nor a pull. They usually phrase this something like "the risks of inflation and economic growth are roughly the same."

A commonly held perception is that the FOMC controls mortgage rates. That is to say, when they raise rates that mortgage rates will increase and when they lower rates, mortgage rates will decline.

That perception is not accurate, no matter how widely held.

It is important to know that the FOMC does not "control" mortgage rates.

There is, however, a direct and immediate connection between FOMC action and rates for home equity lines of credit since these loans are based on the Prime Interest Rate. This is because banks adjust their prime lending rate point per point to match any change in the fed funds rate.

The Prime Interest Rate is the interest rate charged by banks to their most creditworthy customers (usually the most prominent and stable business customers). The rate is almost always the same amongst major banks.

The WSJ (Wall Street Journal) bank prime rate right now is 8.25% and the fed funds rate is 5.25%. If the FOMC increases the fed funds rate to 5.5%, major banks will immediately raise the prime rate a corresponding .25%; to 8.5%.

The impact of FOMC action on mortgage rates is more long range. This is because mortgage rates are influenced by real and anticipated inflationary trends and it takes a long time for FOMC action to impact the economy.

If investors are sanguine about inflation, they are encouraged to invest in long term mortgages, and this tends to drive mortgage rates down. If they are worried, this tends to drive mortgage rates up.

Thus, increases by the FOMC, which slow the economy and prevent inflation, can ultimately be beneficial to mortgage rates. This might help explain why mortgage rates can sometime immediately react in the opposite direction to FOMC action.

Back to the FOMC meeting on the 12th. It is unlikely that the fed funds rate will be moved either up or down because economic data indicates that the economy is neither overheating nor in decline. Inflation and economic growth seem to be in balance.

In keeping with this assessment, it is unlikely that mortgage rates will move much in either direction at least through 2006. (Only three weeks until 2007!)

Conforming Loans to $417,000			
Type	**Rate**	**APR**	**Trend**
30 Yr FIX	6.125%	6.111%	↑
5/1	5.875%	7.369%	↑
Jumbo Loans over $417,000			
30 Yr FIX	6.250%	6.311%	→
10/1	6.250%	7.306%	↓
5/1	6.125%	7.422%	→
10 Yr Bond		4.775%	↑
Prime		8.250%	→

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