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Why the Fed is Taking a Sledgehammer to the Housing Market

By Allan Chernoff

Federal Reserve Chair Jerome Powell and members of his Federal Reserve Board don't seem to be cruel and heartless people, but the fact is they are in the process of killing the American dream of home ownership for millions of families. As the central bank continues to aggressively raise interest rates in its battle to get inflation under control, the housing market is collateral damage. Sadly, it didn't have to be this way.

When the Fed raises its benchmark rate on Wednesday for the seventh time this year, it will cap the most intensive year of monetary policy tightening since 1981 when interest rates soared to double digits in a similar campaign led by Paul Volcker, the Fed chair who slayed inflation but in the process also pushed the economy into a severe double-dip recession. The Fed's mandate is to maintain price stability while attempting to maximize employment, and among its primary tools is the fed funds rate. It's the cost of borrowing for banks. They, of course, pass that cost onto their customers, while also tying their mortgage rates to Treasury bond yields, which have shot up this year, reflecting rising inflation expectations.

For every percentage point increase in mortgage rates, the number of households who can afford a $400,000 mortgage declines by three-to-four million, according to Freddie Mac, the federally-sponsored enterprise that promotes home lending by purchasing mortgages from banks and then selling them as securities to investors. Freddie Mac estimates that 15 million potential homebuyers have been priced out of the housing market this year because, for the first time in history, the average 30-year fixed-rate mortgage rate has more than doubled in a year's time from about three percent to more than six percent.

As rates are rising faster, much faster, than home prices will drop, Americans who refuse to be denied a new home will dig deeper into their wallets, adding to the financial stress of high inflation. More financial pressure may be in the pipeline for the growing number of buyers who are now opting for adjustable rate mortgages, which can easily adjust upward several years down the road, making monthly payments intolerably expensive. The COVID-19 relief program that placed a

federal moratorium on foreclosures ended in July of 2021. Since then, foreclosure filings have been ticking higher, up 57% in November compared to the same month last year, though, for now, they are nowhere near levels hit during the housing crash of 2008.

Had the Federal Reserve been more vigilant on its inflation watch much of this pain could have been avoided. In the first half of last year, inflation was accelerating rapidly, increasing nearly four-fold. By June the Consumer Price Index was clocking in at an annual rate of 5.4%. Yet Fed Chair Powell argued the pickup in inflation was transitory. So, Powell and his Fed governors hung on to their new policy, introduced in 2020, that permitted inflation to run above the Fed's traditional target of 2%. The Fed, at the time, was far more concerned with pumping up the economy than preventing a pickup in inflation. In fact, the central bank was injecting tens of billions of dollars into the financial system every month to ensure easy capital would grease the economy's wheels.

As it turned out, the central bank was helping to fuel the inflation it was supposed to be preventing. The Fed's foot was pressing on the economic accelerator far too long as it persisted in extraordinary efforts to prevent the country from falling into a pandemic-induced recession, rather than protecting consumers from inflation, and it failed to hit the brakes when inflation began to accelerate. A humbled Jerome Powell would later concede it was time to "retire" his description of inflation as transitory and admit, "I think we understand better how little we understand about inflation." Now the Fed is trying to compensate for its mistakes by raising interest rates at the fastest pace in four decades.

With inflation now running at an annual rate of 7.1%, as measured by November's Consumer Price Index, the Fed is trying to slow it through a process that economists call "demand destruction." By raising interest rates, the central bank makes it more expensive to borrow and spend. As the most interest-sensitive sector of the economy, housing gets slammed. The housing market, which accounts for nearly 18 percent of the U.S. economy, is already in a serious recession, with home sales sinking and prices beginning to fall. Other sectors of the economy that rely on borrowing, like auto sales, as well as construction and manufacturing are beginning to feel the pain.

It's not just prospective homebuyers who are suffering the consequences of sharply higher mortgage rates. Homeowners are finding they can't sell their homes for what they were worth just a few months ago. This is particularly troublesome for couples approaching retirement, like neighbors of mine who are looking to downsize. A very comparable home to theirs sold this year in

the neighborhood for an impressive price of more than $1.3 million. But the couple recognize they are now selling into a declining market. They listed the home for just under $1 million. It's as if a chunk of their retirement nest egg has suddenly been snatched from underneath them.

As the housing market slumps, the Federal Reserve is fighting a battle not only to curb inflation, but to restore its reputation as an inflation fighter. Sadly, this is a necessary evil because our country's economic stability requires that we keep inflation under control and that's the Fed's job. If only the nation's central bankers had more foresight, it would not be so hard today for millions of people to achieve the American dreams of home ownership and a secure retirement.

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