Mortgage Rates and Housing Bubbles

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***Abstract*— Due to record-breaking inflation, the FED has begun increasing interest rates. Increasing interest rates will impact the housing market, specifically mortgage rates which can negatively impact both potential homeowners and sellers. There are multiple policy options that the government can use to address this, such as President Biden's Build Back Better Act, as well as other more general measures.**

***Keywords*— mortgage rates, inflation, housing market, interest rates**

I. Executive Summary

This policy brief will discuss interest rate alterations and how they have impacted the housing markets, specifically since the onset of the pandemic and in light of recent increases in interest rates. The issue at hand will be described, the various policy positions/prescriptions will be outlined, and a final understanding will be developed.

II. Overview

Ever since the pandemic has arisen, the economy has been altered in all aspects, especially the financial sector. As a way to stimulate growth, the FED targeted a 0% interest rate which resulted in cheaper mortgages. However, the Federal Reserve has voiced intentions to raise their interest rates to combat rising inflation. The question at hand is how this projected increase in federal reserve interest rates impacts the housing market.

A. Pointed Summary

- The FED has projected increase in interest rates
- There is the threat of a housing bubble where prices rise at an unsustainable rate before collapsing
- Housing affordability has become more difficult for potential buyers
- Increased mortgage rates impact buyers and sellers

A. Relevance

As noted before, the FED's target of a 0% interest rate led to a decrease in mortgage rates. In fact, by December 2020, 30-year mortgage rates hit an all time low of 2.68%. This low rate incited a large, quick upshift in the demand for housing thus leading to an increase in the prices of housing. This is illustrated by the fact that median housing sales spiked at the beginning of the pandemic and reached an all time high of $408,000 by the final quarter of 2021. However, the Federal Reserve recently increased their interest rates to 0.25% from 0% in mid-March alongside a forecast of six additional hikes throughout 2022. This announcement is a reaction to the 8.5% inflation - the highest rate in 40 years. This sudden increase in interest rates has correlated to rising mortgage rates and a potential housing market crash.

B. History

After the September 2001 World Trade Center terrorist attacks, the Federal Reserve drastically decreased interest rates in an effort to maintain economic stability. This allowed for larger amounts of people to purchase real estate, helping to keep the national economy afloat. The Fed maintained the low interest rates through 2004, resulting in a sharp boom in real estate and financial markets and a "dramatic expansion of the volume of total mortgage debt." From 2004 to 2006 the Fed gradually increased interest rates in order to maintain stable inflation rates. Therefore, existing mortgage rates reset at considerably higher rates than most homeowners anticipated. As a result, the U.S. housing market experienced a housing bubble, where home prices rose too high to the point of collapse. A credit crisis unraveled in 2007 due to credit markets financing the housing bubble. The steep decline in economic activity from 2007 to 2009 is known as

the Great Recession. One form of response to the great recession was the Dodd-FrankWall Street Reform and Consumer Protection Act, which President Obama signed in 2010, giving the federal government "expanded regulatory power over the financial sector." The act targeted banks, mortgage lenders, and credit rating agencies, establishing new government agencies assigned to oversee aspects of the financial system. Following these policies, as well as other monetary and fiscal reforms, like lowering a vital interest rate to nearly zero, the economy eventually recovered.

III. Policy Problem

A. Stakeholders

For buyers, rising interest rates makes homes exceptionally more difficult to purchase, resulting in decreased demand for home investments. For example, if a person could afford a 4% rate on a 30-year fixed mortgage on a home worth $500,000, their monthly mortgage payment would be about $2,300. However, if they only qualified for a 5% rate on the 30-year fixed mortgage, their monthly payment would increase to about $2,600, which is a 13% increase. During the peak of the subprime mortgage, prior to the Great Recession, they would have been able to qualify for the $500,000 mortgage. However, when interest rises, they would lose purchasing power—meaning they no longer be able to qualify. Rising interest rates also affect the sellers. Since most potential buyers can only afford homes at lower costs, the market value of home sellers' homes are substantially decreasing.

B. Risks of Indifference

Without addressing rising mortgage rates, homeownership will become farther and farther out of reach for many Americans. However, it is still critical that the record breaking inflation the U.S. economy is experiencing be addressed, seeing as the record high inflation is just as harmful to Americans as the rising mortgage rates. Without addressing both these issues, working-class Americans will continue to suffer financially.

Not only does not addressing the cost of homeownership harm potential buyers, but it also will harm sellers as well. With rising inflation already at a record-breaking rate, sellers are also more vulnerable to financial hardship. Thus, without addressing the rising mortgage rates, sellers will be unable to sell homes without lowering their cost/value, meaning sellers will not be able to sell homes at a value that will allow them to keep up with inflation.

IV. Policy Options

In President Biden's proposed Build Back Better Act, his legislation includes over 50 billion dollars in tax incentives and subsidies to construction companies to construct, purchase, or renovate low-income affordable housing. Though the bill passed in the House, it was shot down in the Senate after West Virginia democratic Senator Joe Manchin withdrew his support.

There are also a couple general approaches available to incentivize and promote housing affordability. First, state and local zoning laws prohibit the construction of anything more than single houses in a lot of land in the majority of U.S. cities. Reducing these regulations would allow construction companies to spread their construction and land costs over multiple houses such as duplexes, townhouses, or apartment buildings, therefore decreasing prices (see table figure). An expansion of housing vouchers to low income families alongside increasing funding to the Low Income Housing Tax Credit (LIHTC) to incentivize construction of affordable housing are actions available that Congress can also take to help low-income families with housing affordability.

Table 1: Redeveloping single-family lots with more homes increases affordability

	One-family detached	Townhomes (3)	Condo bldg (6 units)
Acquisition	$ 1,000,000	$ 1,000,000	$ 1,000,000
Construction costs			
• Demolition & site prep		$ 100,000	$ 100,000
• Hard costs: labor & materials		$ 1,140,000	$ 1,476,000
• Soft costs: design & permitting		$ 124,000	$ 157,600
Financing Costs		$ 62,000	$ 78,800
Developer Fee		$ 181,950	$ 210,930
Total development costs		$ 2,607,950	$ 3,023,330
Construction loan interest		$ 172,125	$ 199,540
Equity Return		$ 219, 068	$ 253,960
Total cost/resale price	$ 1,000,000	$ 2,999,143	$ 3,476,830
Resale price per unit	$ 1,000,000	$ 999,714	$ 579,472

V. Conclusions

The Federal's Reserve's announcement of future interest rate increases has radically reversed the housing market compared to 2020 and 2021. Though the federal fund interest rate has only increased once so far from its initial 0% during the pandemic, the housing market has already adjusted and mortgage rates and housing prices have drastically increased. Besides Biden's failed Build Back Better Act, there has been no move made so far by Congress to help families with housing affordability. Incorporating aspects of Biden's plan, such as tax breaks, increased funding for companies that construct affordable housing, or zoning reforms are viable and relatively inexpensive actions that Congress can take in response to the volatile housing market.

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