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ABSTRACT

On November 25, 2008, the Federal Reserve announced it would purchase mortgage-backed securities (MBS). This program affected mortgage rates through three channels: (1) improved market functioning in both primary and secondary mortgage markets, (2) clearer government backing for Fannie Mae and Freddie Mac, and (3) anticipation of portfolio rebalancing effects. We use empirical pricing models for MBS yields and for mortgage rates to measure relative importance of channels: The first two were important during the height of the financial crisis, but the effects of the third depended on market conditions. Overall, the program put significant downward pressure on mortgage rates.

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1. Introduction

On Tuesday, November 25, 2008 the Federal Reserve surprised almost everyone when it announced that it would initiate a program to purchase up to $500 billion in mortgage-backed securities (MBS) backed by the housing-related government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, and backed by Ginnie Mae.[2] The goal of this new program was to "reduce the cost and increase the availability of credit for the purchase of houses."[3]

There is, of course, a disparity between rates in mortgage secondary markets (i.e., MBS yields) and the rates paid by homeowners to purchase houses in the primary mortgage market. This paper is focused on the question: "Did the Federal Reserve MBS purchase program lower mortgage rates?"

The Federal Reserve's MBS purchase program affected mortgage rates though three channels: (1) improved market functioning in both primary and secondary mortgage markets, (2) clearer government backing for Fannie Mae and Freddie Mac, and (3) anticipation of portfolio rebalancing effects. The first channel reflects the signal to market participants that a large and reliable MBS purchaser would be available in the secondary market under all market conditions. The second

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[2] The U.S. Department of Treasury had already started a modest MBS purchase program. Its program was announced as an expression of support for Fannie Mae and Freddie Mac when these two GSEs were placed into government conservatorship on September 5, 2008.

[3] See http://www.federalreserve.gov/newsevents/press/monetary/20081125b.htm.

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