

Monetary Policy and the Housing Bubble

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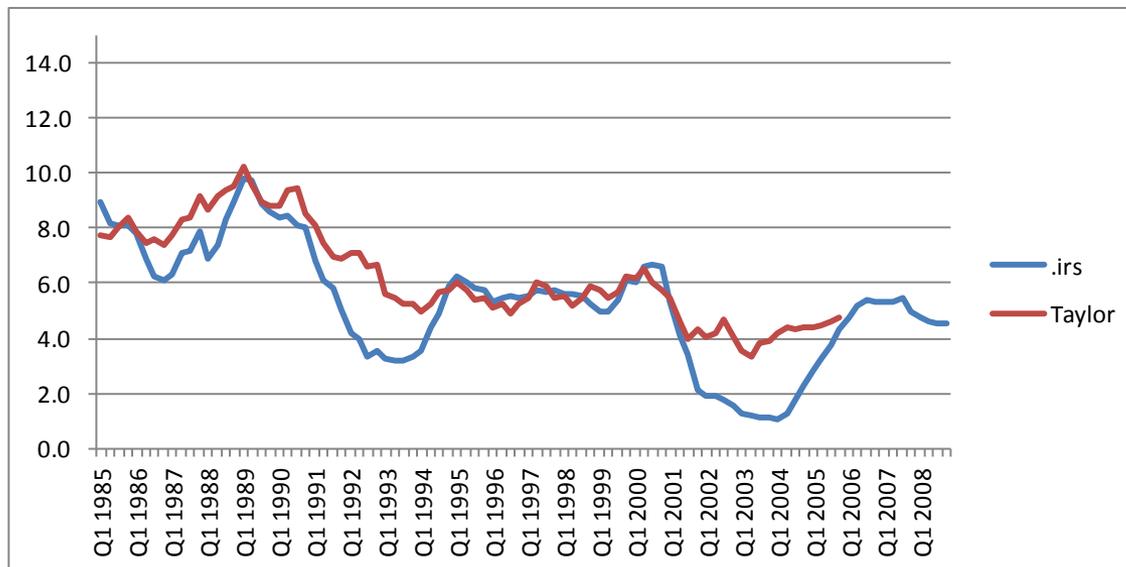
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The paper essentially does five things:

1. Claim that US monetary policy in 2003-2006 was both more or less in line with a Taylor rule, and with historic monetary policy reactions.
2. Claim that monetary policy did only mildly contribute to US housing boom, and not above what would have been expected in standard models.
3. Discuss international evidence of link between monetary policy and house prices.
4. Examine other factors behind the US housing bubble.
5. Discuss possibilities to prevent asset-price bubbles.

US policy in line with Taylor rule?

- Using real time data alone does not result in policy rates being close to a Taylor rule; what is needed is the use of (too low) FED inflation forecasts
- Data as of end-2003 with OECD forecasts



- To examine if interest rates matter for assets prices it is irrelevant whether having exceptionally low (“below Taylor”) interest rates was intentional or not.

“Business as usual”?

- Paper presents model-based evidence that US monetary policy reaction function in 2003-06 unchanged from historical reaction patterns. However, the change of the targeted inflation rate from CPI to PCE – that post-2000 was significantly lower - effectively implies a more accommodating monetary stance (i.e. “below Taylor”). See e.g. Orphanides and Wieland 2008.
- Actual interest rates being within a roughly 4 percentage point wide band around estimated “business as usual rates” is not overly convincing proof for “business as usual”.
- Monetary policy was strongly accommodative for a fairly long time.
- “Business as usual” also contradicts impression of most observers.

Did monetary policy contribute to the US housing bubble?

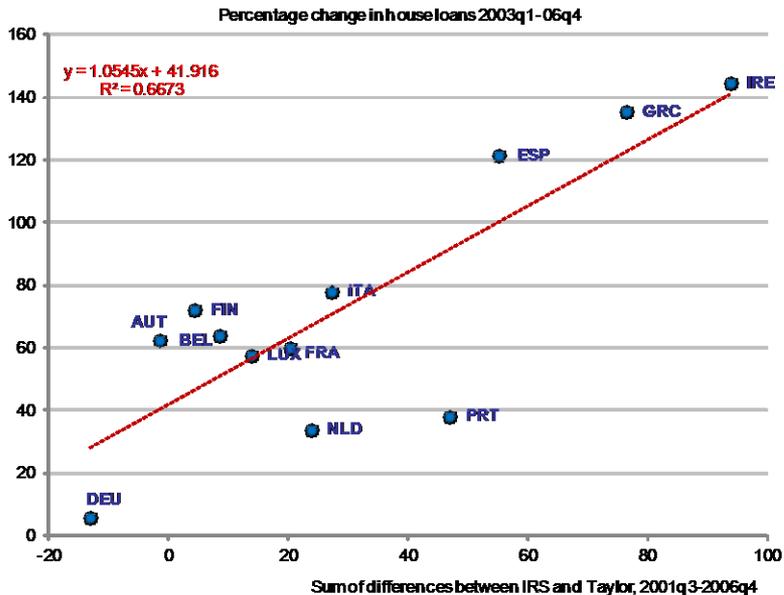
- The paper uses model and VAR analysis to show that monetary policy via traditional channels had some limited impact on housing prices, but can only explain small amount of observed price increases.
- That seems fair insofar as recent boom had also many other determinants.
- However, strongly accommodative monetary policy for prolonged periods may have non-linear effects not fully captured in the models.
- Also, it is often argued that loose monetary policy together with other developments (as lack of effective oversight) may have multiplicative effects.
 - Paper acknowledges possibility of such multiplicative effects, but does not control for them.
- Finally, communication that rates were low for a protracted period, and would only gradually increase:
 - basically was invitation for financial sector to leverage up, likely increasing amount of capital provided to housing finance.
 - presumably led to larger initial downward effect from short to long rates (with link of housing activity possibly stronger for long than for short rates).
 - Unfortunate that long rates are not used in the VAR analysis.
- => Lack of major potential channels throws doubt on results.

International evidence

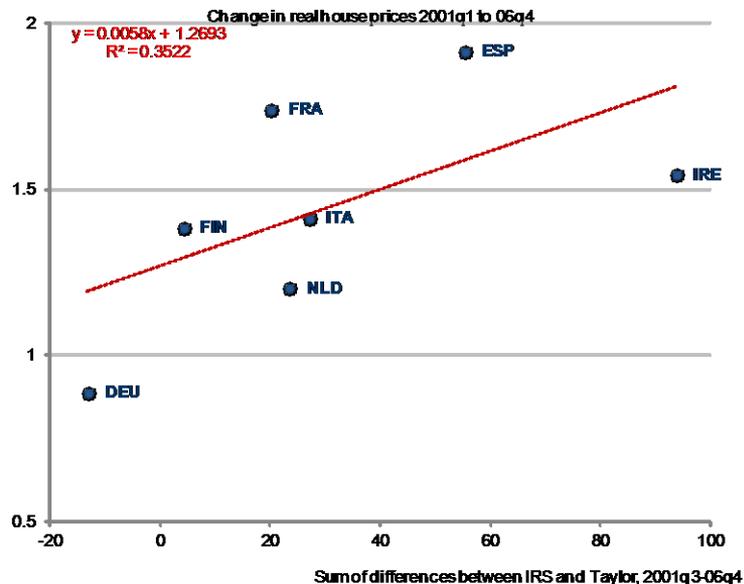
- The paper examines correlations for cross-country data of monetary policy with different measures of housing activity. Similar charts have been provided by Ahrend et al. (2008), the Spring 2008 OECD Economic Outlook, and the Fall 2009 IMF World Economic Outlook.
- Taken together, these charts show that :
 - Various measures of housing activity and house prices are positively correlated with a measure of how much monetary policy deviated from a Taylor rule.
 - The strength of the positive correlations depends on the considered country sample.
 - Correlations are stronger for housing activity indicators than for prices.
 - Correlations are particularly strong when looking at euro area countries.
- In any case, simple correlations are just a first step as many other variables potentially affect housing activity (and especially housing prices). A full fledged econometric analysis would be required.
- Still, it is amazing how well variables are correlated, especially for euro area countries (see *e.g.* Ahrend 2010).

Figure 2. Deviation from Taylor rule versus various measures of housing activity in the euro area

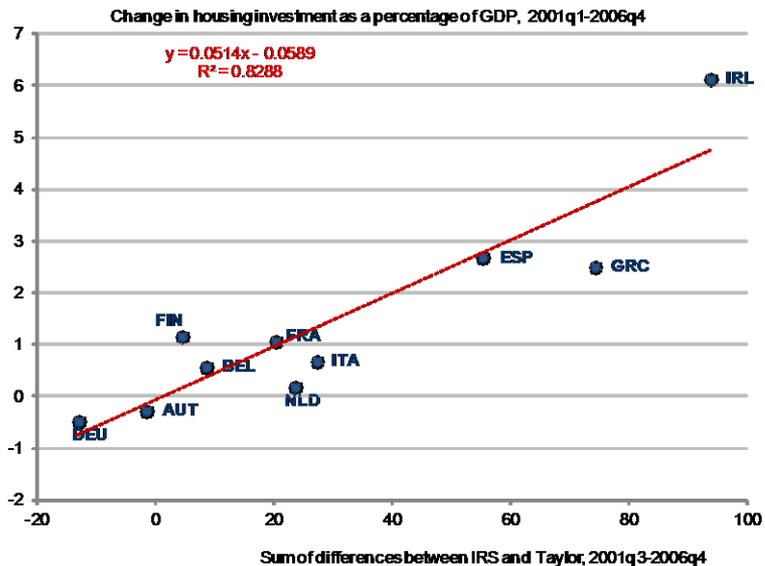
House loans versus deviation from Taylor



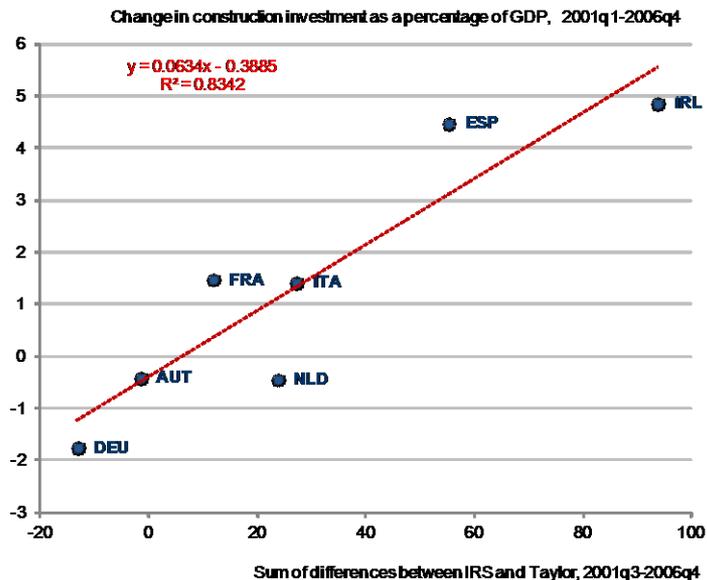
House prices versus deviation from Taylor



Housing investment versus differences between IRS and Taylor



Construction investment versus differences between IRS and Taylor



- Correlation could be spurious. However, it is hard to think of convincing candidates for variables that are simultaneously strongly connected to housing market activity and deviations from a Taylor-rule, and that itself would not be strongly influenced by monetary policy.
- Causation may go both ways. Strong housing activity may temporarily increase economic growth above trend, thus leading to an output gap that would be reflected in Taylor-rates. However, while this would imply that monetary policy may not have had a role in setting off housing-market buoyancy, it would nonetheless be largely responsible for its continuation by not reacting (strongly enough) to it.
- The simple evidence presented *e.g.* in Ahrend (2010) does not constitute final econometric proof for a causal link from prolonged monetary ease to housing activity, but is however suggestive of it.

- There is also some econometric evidence for a correlation of pre-crisis deviation from Taylor-rates with a proxy for the strength of financial crisis. This could reflect larger imbalances in countries with greater deviations from Taylor rates (see Ahrend et al., 2010).
- The discussed paper presents interesting evidence that “below Taylor” rates in large US cities – which can probably be seen as some sort of equivalent to euro-area countries – were also related to strong housing activity. It would be nice to see more detail about methodology and results.
- Maybe some important lessons could be learned for euro area countries by looking at how US entities adjust to boom-bust cycles.

Other factors behind US housing bubble / Possibilities to prevent asset price bubbles

- The paper examines in detail other reasons behind US housing bubble. Of particular interest are calculations of increases in borrowing capacities through the use of non-traditional mortgage products.
- While I think that monetary policy can contribute to asset price bubbles, this does not mean that it can always prevent them at acceptable costs. So I strongly agree with the conclusions of the paper that – as trying to achieve two or three objectives with one tool is suboptimal – (macroprudential) regulation not only provides you with a second instrument, but also with one which can be better targeted and dosed against asset price bubbles.

References

- Ahrend, R., Cournede, B. and R. Price (2008), “Monetary Policy, Market Excesses, and Financial Turmoil”, *OECD Economics Department Working Paper No. 597*, March 2008.
- Ahrend, R. (2010), “Monetary Ease: A Factor behind Financial Crises? Some Evidence from OECD Countries”, *Economics*, No. 2010-12, April 2010.
- Ahrend, R., Arnold, J. and F. Murtin (2010), “Have More Strictly Regulated Banking Systems Fared Better During the Recent Financial Crisis?”, *Applied Economic Letters*, forthcoming.