September 10, 2010

Policy may have created the housing bubble, but which policy is to blame?

There is little dispute that misguided policy choices led to the housing boom-bust cycle from which we are still recovering. The debate about which policies were most culpable, however, rages on. The latest chapter in this dispute is now available in the proceedings from this year's edition of the Kansas City Fed's Jackson Hole Economic Policy Symposium.

In defense of monetary policy, Charles Bean, Matthias Paustian, Adrian Penalver, and Tim Taylor—all of the Bank of England—write this:

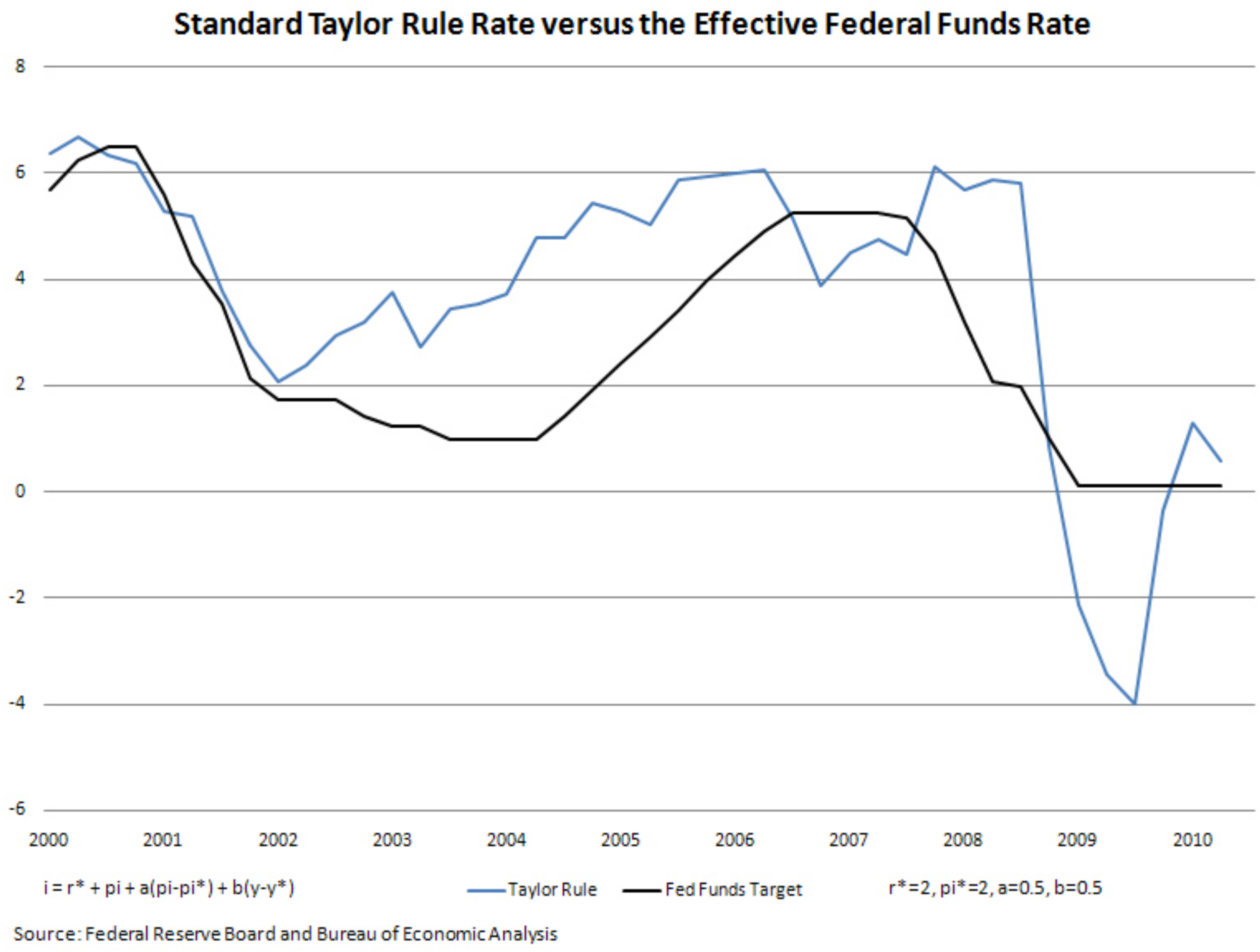
> "We argue that while relatively low policy rates compared to past experience contributed to the growth in credit and the rise in house prices in the run-up to the crisis, they played only a modest direct role."

Stanford University's John Taylor (still) isn't buying it:

> "Their conclusion differs from mine for several reasons. First, they do not take account of much empirical work completed since the 2007 Jackson Hole conference. For example, Jarocinski and Smets (2008) of the European Central Bank estimated a VAR [vector autoregression] for the United States and found evidence that 'monetary policy has significant effects on housing investment and house prices and that easy monetary policy designed to stave off perceived risks of deflation in 2002-04 has contributed to the boom in the housing market in 2004 and 2005.' In a more recent study focusing directly on deviations from policy rules, Kahn (2010) of the Federal Reserve Bank of Kansas City finds that 'When the Taylor rule deviations are excluded from the forecasting equation, the bubble in housing prices looks more like a bump.' "

I added the links to the papers cited by Taylor because they are thoughtful challenges by thoughtful people, and they deserve to be considered (though the Jaroconski and Smets article requires some tolerance of relatively sophisticated econometrics). That insightfulness, of course, does not mean they are completely persuasive; I still have my doubts.

Most of you are familiar with this picture of the "Taylor rule" referenced above—which prescribes a funds rate target based on the deviations of output from its potential and the deviation of inflation from a presumed target of 2 percent—compared with the actual path of the policy rate:



(enlarge)

Bean et al. make note of a speech from the beginning of the year by Chairman Bernanke in which he in turn notes (among other things) that the period in which policy deviates from this particular Taylor rule is also a period in which the lending standards were dramatically relaxed. To give but one example, data collected by my colleague Kris Gerardi indicate that in Massachusetts the median loan to value ratios (LTVs) for all borrowers rose from 0.82 in 2000 to 0.9 in 2006. For subprime borrowers, LTVs rose during that period from 0.85 to 1.0. The statistical results cited in Taylor's response do not control for such developments, making it difficult to come to a strong causal conclusion.

Second, this observation (from the Bean et al. paper) introduces even more uncertainty regarding the robustness of the chain of events leading from low interest rates to the housing bubble:

> "Chart 1 shows that both UK and euro-area policy rates were less noticeably out of line with their respective Taylor benchmarks. That too is striking. Indeed, in the United Kingdom, they were actually above the benchmark for much of the relevant period, even though the United Kingdom saw one of the larger run-ups in debt and house prices during this period. And, in the euro area, countries such as Spain experienced substantial house price booms, while countries such as Germany did not. That need not imply that monetary policy was innocent in the run-up to the crisis…But this is hardly compelling evidence for assigning the central role to monetary policy, suggesting that other factors were more important."

As the Bank of England authors suggest, monetary policy was not necessarily innocent. But at a minimum, it's worth keeping in mind that the monetary policy transmission mechanism is a good bit more complicated than any simple story would indicate.

By Dave Altig, senior vice president and research director at the Atlanta Fed

September 10, 2010 in Housing, Monetary Policy | Permalink