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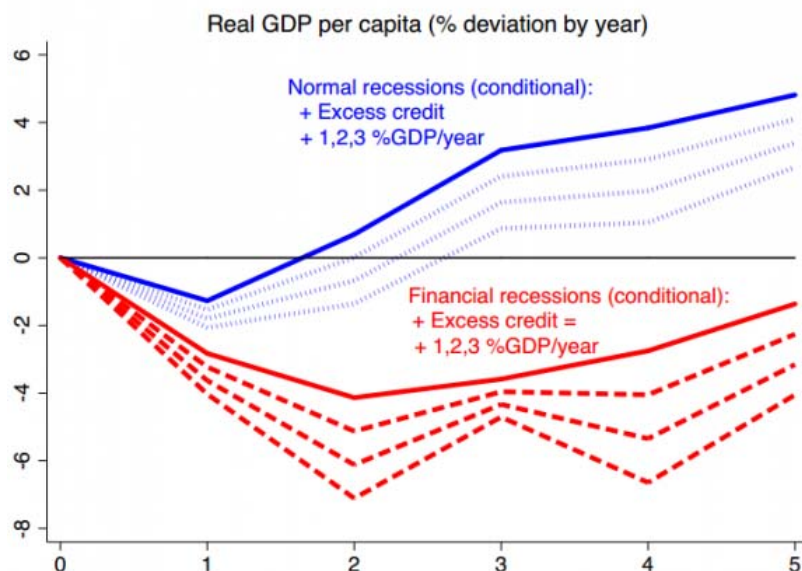
Easy money, housing bubbles, and financial crises

Matthew C Klein Jan 09 08:30 11 comments

Housing booms are wasteful — and the subsequent busts are deeply destructive. Worse, they have become bigger and more frequent since the 1970s. An important new paper from Oscar Jorda, Moritz Schularick, and Alan Taylor places the blame on structural changes in the financial sector that exacerbate the impact of excessively loose monetary policy.

This is a continuation of earlier research on the drivers of credit booms and their impact on GDP using data from more than a dozen rich countries going back to 1870, which we covered in detail here. For those who don't want to reread that post, the two important takeaways are, first, that the growth rate in private borrowing during an economic expansion predicts the severity of the subsequent downturn even when there is no financial crisis:

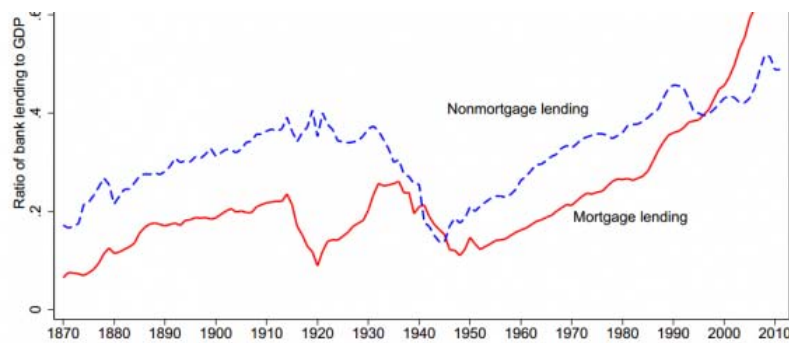
Figure 3: Conditional Paths, Continuous excess credit treatment



And second, that the growth of the financial sector since the 1970s can be attributed almost entirely to the explosion of mortgage credit (mostly residential but also commercial) rather than lending for business investment or traditional consumer borrowing:

Figure 2: Bank mortgage and non-mortgage lending to GDP, 1870–2011: Average ratio to GDP by year for 17 countries





Notes: Mortgage (residential and commercial) and non-mortgage lending to the business and household sectors. Average across 17 countries. See text.

In other words, housing debt really matters.

The new paper ties these earlier findings to a new dataset on house prices in 14 rich countries that goes back more than a century to test whether excessive house price appreciation and a booming supply of mortgage debt can serve as a useful predictor of financial crises. Using similar techniques as they did in their earlier paper when they studied the impact of private credit booms on GDP, they find that “over a 5-year window run ups in mortgage lending and run ups in house prices raise the likelihood of a subsequent financial crises. Mortgage and house price booms are predictive of future financial crises, and this effect has also become much more dramatic since WW2.”

That message may not sound so novel nowadays but it’s worth remembering that many economists and policymakers were quite sanguine about the mortgage boom right up until it turned into a bust. Many thought the debt burden was perfectly manageable because of the commensurate rise in home prices, even as economists such as Janet Yellen were justifying those unusually high prices in part because of financial innovation that made it easier to extract equity by borrowing more against their houses.

(The reality was closer to the reverse: “financial innovation” increased the amount of purchasing power available to buy housing through lower minimum down payments and a huge explosion in the volume of nontraditional products.)

More interestingly, the economists connect their research to the realm of monetary policy by looking at changes in short-term interest rates attributable to exchange rate pegs rather than domestic business cycle conditions. (Basically, deviations from a Taylor-style rule imposed by membership in the gold standard or a post-WWII currency bloc.) Since borrowing costs ought to move up and down with expectations of growth and inflation, this methodology allows the economists to capture the impact of only those changes in interest rates that can’t be justified with standard models.

They find...

robust evidence in support of a direct mechanism linking short-term rates, mortgage lending and house prices. Through the term structure, long-term rates respond to short-term rates, thus affecting the price of mortgages. In response to easing monetary

conditions and hence a decline in the price of mortgages, mortgage lending expands. Rising house prices improve the value of the mortgage's collateral, and with it a bank's asset position and its ability to lend further. **Loose monetary conditions are causal for mortgage and house price booms, and this effect has become much more dramatic since WW2.**

This provides historical heft to Tobias Adrian's and Hyun Song Shin's earlier finding that the level of short-term interest rates affects the incentives of financial firms to expand or contract their balance sheets, which in turn affects asset prices and the real economy.

As Jorda et al put it, "central banks have reasons to worry about the side-effects of loose monetary conditions" because these effects can prevent policymakers from achieving their goals on inflation and real growth. That would mark a big change from past practice. It would also reignite the debate about whether rich countries can attain something close to full employment without relying on the unsustainable stimulus provided by bubbles in housing and other forms of excess investment. Perhaps one silver lining of the crisis is that it may have made central banking a bit more interesting.

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