The Relationship between Monetary Policy and the Housing Bubble

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Abstract. Will monetary policy affect the price of housing and thus lead to a housing bubble? It is well known that the Fed's monetary policy decisions affect the U.S. and the world economy, guiding the direction of the economy through monetary policy adjustments. The real estate market has a huge volume and monetary policy has a profound impact on it. Loose monetary policy can lead to a boom in the real estate market, but too much of a boom can lead to a crisis. This article examines whether monetary policy affects housing bubbles by analyzing the views of Ben S. Bernanke and John B. Taylor and modeling the data to examine whether monetary policy causes housing bubbles.

Keywords: Monetary Policy; Housing Bubbles; Taylor Rule.

1. Introduction

This paper will focus on the correlation between monetary policy and the housing bubble, mainly through the 2008 financial crisis, to analyze the impact of loose monetary policy on housing prices. Here I have to mention the Taylor rule, which is a very important measure of the economy, although the Taylor rule is not a substitute but can be used as a guideline. In 2007, the easing of monetary policy accelerated the housing boom and led to a recession, and my study of Taylor has reinforced my belief that monetary policy has an impact on housing bubbles. However, monetary policy decisions have a profound impact on the economy, especially in times of crisis, and Taylor argues that interest rate adjustments have an impact not only on the housing market but also on oil and even the entire U.S. economy. Especially before the crisis, interest rates had been at a relatively low stage, and the government encouraged residents to buy homes. Those unscrupulous financial institutions took advantage of the loose monetary policy to promote the boom in the real estate market, but unconventional interest rates can have unintended consequences. Ben believes that there is less correlation between loose monetary policy and the housing bubble, and he concludes from data analysis that capital flows into the market are what drive housing price growth. Ben and John also argue for reform of U.S. financial regulation to create a stable financial system. By analyzing the linked articles, I prefer John’s view that monetary policy and the housing bubble are closely linked.

2. Literature Review

2.1 The Accommodative Monetary Policy Had Little Correlation with the Housing Bubble

Ben S. Bernanke's perspective is that the Federal Reserve was a major player in averting the economic crisis and that the Fed tried to avoid it by regulating finance and by using or adjusting monetary policy. “Specifically, they claim that excessively easy monetary policy by the Federal Reserve in the first half of the decade helped cause a bubble in house prices in the United States" (Bernanke 1). Ben focuses on the period 2002-2006, using information available at the time on the state of the economy and policymakers to assess whether policies were reasonable at the time. The Taylor rule is a simple policy rule that usually serves as a guideline for FED policymakers rather than a complete substitute for a full policy analysis. The reason for the conclusion that monetary policy was too accommodative between 2002 and 2006 was that the real federal funds rate was lower than the value listed in the Taylor rule. Ben believes that policy decisions must be made with a long-term perspective because he believes that there is a lag in the implementation of monetary policy. So, for the use of inflation forecasts or actual inflation in the policy rules, he would prefer inflation forecasts. Ben points out that house prices were on an upward trend from 1998 to 2005, and although the

monetary policy was accommodative in the economic environment at the time, he uses data to show that the accommodative monetary policy had little correlation with the housing bubble but was not the main cause.

There is another view that loose monetary policy led to a greater acceptance of financial products by most people. "Low policy rates feed through to monthly mortgage payments more directly when the mortgage interest rate is adjustable and tied to short-term rates" (Bernanke 7). The diverse selectivity of financial products and the variety of variable interest rates on loans led to the housing bubble. Both borrowers and financial institutions held the belief that home values would rise. As long as the price of the house rises, the loan can be refinanced, and both the financial institution and the borrower will be beneficiaries. But a plunge in home prices would have worsened the situation for both parties, and the housing bubble was exacerbated by the operation of financial institutions through those who did not qualify to borrow.

Ben also analyzed the link between monetary policy and housing price inflation in other industrialized countries internationally, and according to the IMF study, monetary policy in basically all countries was looser than the Taylor rule. Although some countries have tighter monetary policies than the Taylor rule, the rise in housing prices is still higher than in the United States. Therefore, Ben believes that the relationship between monetary policy and the increase in house prices is not so strong, but rather the capital flow from emerging markets to industrial countries will have a relationship with the appreciation of house prices. Ben concludes that the diversity of financial products and the declining requirements for borrowers have led to more people entering the housing market. From this point of view, Ben believes that the best way tocurb the housing bubble is to strengthen the regulation of financial institutions. He also suggests reforms to financial regulation that would lead to a robust financial system.

2.2 Sthe Housing Boom was Caused by Loose Monetary Policy

John B. Taylor explains that the financial crisis was caused by a boom and bust due to excessive monetary policy but that the housing boom and bust had a direct impact on the U.S. economy. He explains that even if monetary policymakers adjusted interest rates unusually low, it was the result of a measured approach by monetary policymakers, and one can understand that the interest rates were set on purpose. He points out that the housing boom was caused by loose monetary policy and that the excessive boom that led to the housing bust also contributed to the crisis, citing a perceived global savings glut that led to lower interest rates in the U.S. and other countries. However, there is no actual evidence of a global savings glut, but rather the IMF data shows that the global savings rate was low from 2002-2004. The misconception that there is a savings glut may be due to the fact that there is a savings over investment gap in countries other than the United States.

Taylor mentions the impact of monetary policy on subprime mortgages, as the government has overly encouraged homeownership, thus turning a booming real estate market into a depression. " It is important to note, however, that the excessive risk taking and the low interest monetary policy decisions are connected" (John 10). He explains that when a home appreciates in value, the delinquency rate goes down and everything goes in a good direction, but when the price of a home falls even below the mortgage value, all the problems come out. Joh believes that accidents happen when policies are different from the norm, as when loose monetary policy caused a housing boom that led to a crisis. Taylor believes that the sharp rise in interest rates further prolonged the crisis and that the sharp rise in interest rates stimulated the financial crisis. For the 2008 financial crisis, Taylor believes that it should be analyzed whether it is a liquidity problem or a counterparty risk problem. John’s solution to the counterparty risk problem was to increase the transparency of banks or to introduce more capital into banks or financial institutions, and after John’s research and investigation, liquidity was not the main problem nor the means to solve it. The reason why the crisis still exists is that the policymakers of the authorities misdiagnosed counterparty risk as a liquidity problem, so their main intervention will be in monetary policy. But the wrong government interventions instead prolonged the crisis, especially the Economic Stimulus Act of 2008, which did not stimulate

consumption. John mentions the rapid interest rate cuts in April 2008, which reduced the space for adjustable-rate mortgages. John also points out that interest rates and oil prices are closely linked, yet the interest rate cuts have increased the price of gasoline and other commodities. The high price of gasoline will cause car sales to plummet, which in turn will have an even greater impact on the economy. During the financial crisis, the government remedied some financial institutions but bailed out others, which created suspicion of the government, so John believes

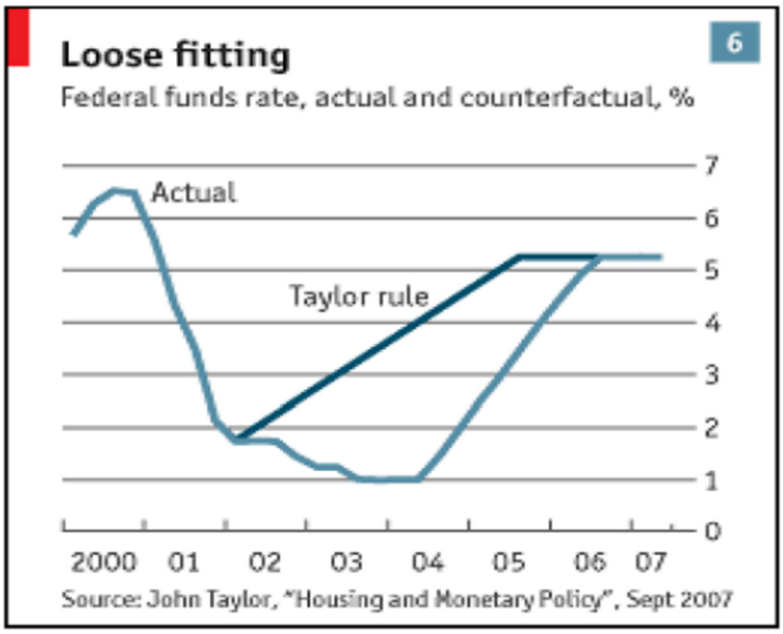


Fig 1. Chart from The Economist, October 18, 2007

"The U.S. Treasury and the Fed urgently needed to develop a new framework for exceptional access to government support for financial institutions" (John 26). John analyzes the 2008 financial crisis and proposes some constructive solutions for financial reform.

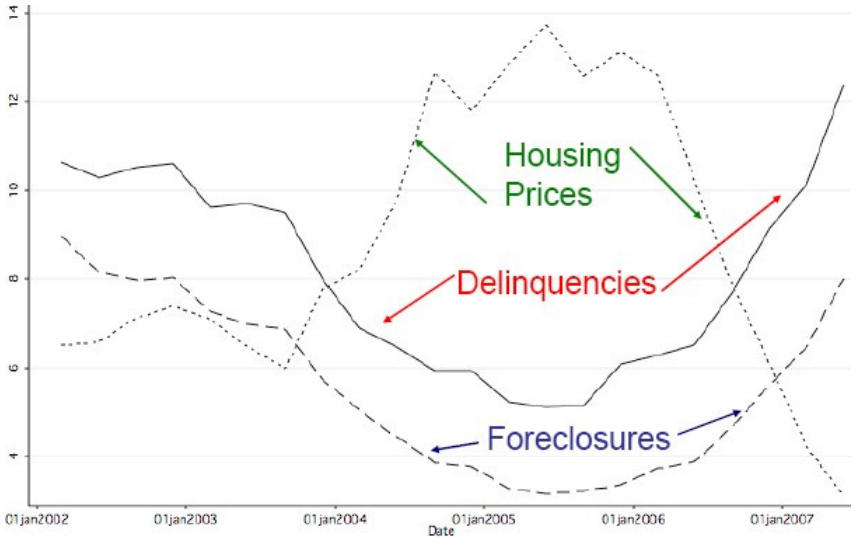


Fig 2. Housing Price Inflation and Subprime ARM Delinquencies and Foreclosures

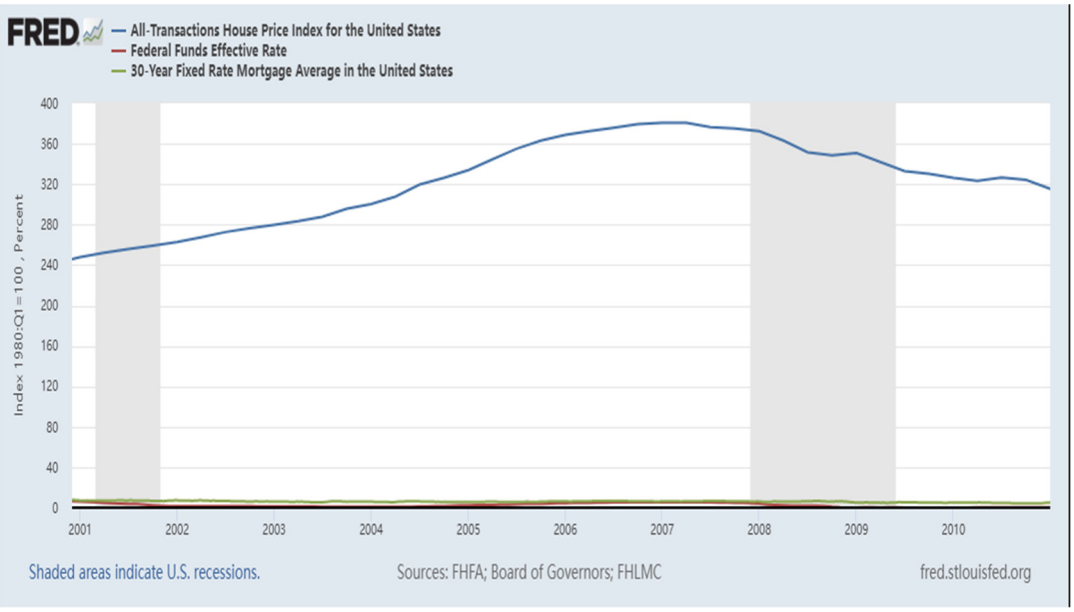


Fig 3. Fred economic data

3. Conclusion

This paper analyzes the correlation between monetary policy and housing foam by studying the impact of loose monetary policy on housing prices after the 2008 financial crisis. As a very important economic criterion, Taylor rule has also been applied in the field of American real estate. The research findings of this paper are as follows: first, interest rate adjustment is used in the real estate market through a variety of transmission mechanisms. The low interest rate level has boosted the real estate foam under the loose monetary policy. Secondly, excessive financial speculative capital flowing into the real estate market is also a major factor driving the growth of house prices.

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