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Housing Finance and Monetary Policy

comments by

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Summary of Paper

- Paper divides 19 countries (9 EA countries, VS, UK, Japan etc.) into 2 groups based on several *indicators of mortgage market flexibility* (LTV ratio, equity release, mortgage debt / GDP, variable / fixed rate).
- *VAR model* is estimated for each country. Average impulse responses by group indicate that higher development leads to better transmission, through *residential investment* (all indicators) and *consumption* (equity release, variable rate).
- To rationalize results, a *DSGE model* is constructed (2 sectors, patient / impatient consumers, collateral constraint). Simulations of impulse responses to monetary policy shock confirm that both residential investment and consumption more responsive given more mortgage flexibility (low down-payment, variable rate).

Introduction

- Topic interesting from *micro-economic perspective* since housing major part of households' wealth, so important channel for monetary transmission.
- Currently topic especially interesting, since trigger of credit crisis was *US sub-prime mortgage crisis*.
  - Monetary policy better adapted to *institutional characteristics of mortgage system* (equity release, variable / fixed rate) might have averted / reduced crisis.
- Robustness of paper's results are increased by using both an *empirical* and *theoretical* approach.
- First, comments on empirical part (*VAR model*), then on theoretical part (*DSGE model*), finally some general remarks.

Comments on the VAR model (1)

- Paper mentions that countries like NL are characterized by mortgages with *fixed rates throughout duration*. In reality most mortgages variable rate with slow adjustment.
  - Classifying US as fixed-rate country also misleading in light of current crisis.
- *IMF index of mortgage market development* is mentioned in paper's empirical part, but not further used in the analysis.
  - When used for classification, what results does it produce?
  - Is it possible to exclusively use the index, given that it is *synthetic* and has *considerable overlap* (loan-to-value ratio, equity release) with the other factors?

Comments on the VAR model (2)

- *Mean impulse responses* are studied for 19 countries in varying subgroups.
  - Since countries vary enormously in size (from Belgium to US), would it not have been better to take *weighted averages*?
  - Results could be more representative. Would they be different?
- VAR model is estimated on the period 1980q1 – 2007q4, during which many *institutional changes* took place on the housing market.
  - Next to "cross-country heterogeneity" there is likely *intertemporal heterogeneity within countries* (cf. remarks on Spain, Italy). Still, institutional characteristics all recently measured.
  - Has the VAR model been checked for *structural breaks*, e.g. around the creation of EMU, dotcom crisis?

Comments on the DSGE model (1)

- Crucial characteristic of the model is that when the *collateral constraint* is binding, all borrowers are at the constraint.
  - One would expect however that as the constraint weakens ($\chi\downarrow$), less borrowers are constrained.
  - May significantly influence results since “collateral-contraint effect” is 1 of 3 transmission channels in model.
  - Is the collateral constraint always binding? What happens for example in the case of a large negative policy rate shock?
- In the VAR model the *pooling of countries* is rejected, but in the DSGE model pooling is implicitly assumed.
  - Significant *cross-country heterogeneity* is therefore ignored. Relevancy of the model for the euro area is questionable.
  - Why not calibrate the model directly to countries such as the US or UK? In the case of the euro area, a *multi-country model* would in principle be necessary.

Comments on the DSGE model (2)

- Both the VAR and DSGE models produce *average impulse response functions* to a monetary policy shock.
  - Why are these impulse responses not directly compared, given that they are calculated largely for the same variables (mainly private consumption, residential investment).
  - Especially the *hump-shapes* of the VAR vs. the almost *linear shapes* of the DSGE should be explained.
- Monetary policy consists of inflation targetting (φ_π) with sluggish policy shocks (ρ_r).
  - Are the parameters of monetary policy ($\varphi_\pi = 1.5$, $\rho_r = 0.7$) based on *empirical* values, or are they *normative*?
  - Parameter values are not discussed in the paper. How much influence do these parameters have on the impact of a policy rate shock?
  - Paper refers to the monetary policy rule as *Taylor rule*, but it does not contain output. Why not?
  - Policy rule targets inflation in consumption good. Why not use the CPI?

General Remarks

- Element missing from both VAR and DSGE models is *tax deductibility* of mortgage interest payments. Interesting to include explicitly, since:
  - Considerable heterogeneity in euro area countries.
  - Pushes up loan-to-value ratio (e.g. 90% in NL), so affects transmission.
  - Considerable political debate, central bank perspective relevant.
- Paper analyses how *institutional characteristics of mortgage market* influences transmission, but makes no recommendation for reform.
  - Do authors think that further "development" is beneficial? If so, across the board (equity release, loan-to-value, rate adjustment) or selectively?
  - Potential risk is another financial crisis, since the most developed mortgage markets (e.g. US, UK) were hit hardest.