

# General Discussion: Housing and the Monetary Transmission Mechanism

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*Chair: Martin Feldstein*

**Mr. Feldstein:** Let me say Jim Hamilton has said some challenging things about capital requirements for Federal Reserve-regulated institutions and accounting standards. Maybe somebody from the Federal Reserve System who understands what the current practice is would like to comment on that. I think that would be helpful so we understand what gap there is—if any—between what is recommended and what is currently being practiced.

**Mr. Fischer:** I want to talk about an issue which comes up repeatedly, which is asset bubbles and monetary policy. I didn't expect to hear it here, but Rick Mishkin introduced it. There is a fairly subtle point to be made, which is that if you read what is actually said, that is fine. But then I wonder why we keep saying things that sound different. Now, what I am talking about?

Rick says the issue of how central banks might respond to house prices is not whether they respond at all, but whether they respond over and above the response called for in terms of objectives to stabilize inflation and employment. I don't think you would ever know whether they have responded over and above. If I took what he said literally, he and I agree.

But then I wonder why we keep hearing this: “We shouldn’t respond to asset prices. We should wait until the bubble collapses. We should deal with it ex post, etc.,” which seems to indicate there is a problem there. I have gotten used to that rhetoric. I don’t think there are any Chinese colleagues here today, but they tend to make policy in terms of metaphors. If they were here, they might tell us that a stitch in time saves nine.

I can’t understand why you wait for a bubble to explode and possibly get into major crises. I don’t know whether we are in a major crisis, but we are in an awkward situation at the moment as a result of having watched something happen and having decided not to do anything about it.

We are willing to accept open-mouth policy. I know some central bankers. I think Jacob Frenkel is one and Lucas Papademos is another who did pop bubbles with an open-mouth policy successfully. That’s fine, but if you are looking at this and you are worried about the consequences, what exactly is the problem with edging monetary policy in the direction of responding to something that might be ugly? You never know until it’s over whether it is going to be ugly or not. Why the strong insistence that we won’t do anything about it until it’s over? I don’t understand that, and we have heard it repeatedly and repeatedly.

I think we are in a sense in which people are protesting too much. I know a famous central banker who said to me, “I know I am the lender of last resort, but you will never hear me say that in public.” Central banks probably on more occasions than they would like to admit should respond to asset price bubbles but don’t want to say they will for fear of the consequences.

**Mr. White:** I am a little confused. I am looking at Rick’s paper, and Rick says, “The standard lifecycle view has equal effects from housing and financial wealth.”

Then, I look at John Muellbauer’s paper, and John’s paper says, “The classical lifecycle theory suggests that the housing wealth effect on aggregate consumption is small or negative.”

Now, maybe the standard lifecycle view is different from the classical lifecycle theory, but, to me, it seems like these two statements are contradictory. I would like to hear the two of them speak to this. Maybe Charlie Bean wants to come in as well. I don't know.

I must say that I side with John. I have never really understood how, particularly for an aggregate nation as a whole—an increase in house prices—which constitutes not only a form of implicit revenue for the owner but also an explicit cost looking forward for the consumer of housing services, increases wealth. Now, this is an enormously important issue because if John is right that we are picking up in the econometrics just the credit aspect of it, then we are back to the conclusion that this spending “must be repaid.” Intertemporal optimization implies you spend more up front but at the price of having to pay back later. Put otherwise, if John is right, we have an issue looking forward here in terms of higher personal savings rates, which will slow growth. If Rick is right, well, then perhaps we don't. But I do want to underline this is an enormously important issue.

Secondly, I would make the point that I agree with Stan Fischer in responding to the question of whether we lean against the bubble or clean up the mess afterward. Rick is basically saying that we can't lean, but we can clean up. I believe you can make equally strong arguments for the conclusion that you can lean and that you might not be able to clean up. So, I am with Stan.

**Mr. Svensson:** I would like to make a comment on Rick's discussion of the implications of housing and house prices for monetary policy and, in particular, on the appropriate monetary policy response to house price developments. A good way to summarize this discussion is by reference to standard flexible inflation targeting. Flexible inflation targeting means that the central bank wants to stabilize not only inflation around the inflation target, but also resource utilization. In practice, it boils down to choosing an interest rate path such that the resulting forecast of inflation and resource utilization looks good relative to the inflation target and the relative weight on resource stabilization.

The reason you need to consider the whole interest rate path and not just the current interest rate is that it is really expectations about future interest rates and not the current interest rate that matter for the response of the economy to policy. The reason you need to use a forecast of inflation and resource utilization is because of the lags in the response to policy.

Furthermore, the interest rate path and forecast of inflation and resource utilization need to be communicated to the market and general public in order to affect private sector expectations—“managing expectations,” as Mike Woodford has expressed it. Therefore, a few central banks, including the Riksbank, have started to publish their own interest rate path.

This way of thinking has implications for the appropriate monetary policy response to house prices. Whether you should respond to those or not depends only on whether the developments in house prices affect the forecast of inflation or resource utilization. Suppose that house price developments, for an unchanged interest rate path, shift up the forecast of inflation or resource utilization so it no longer looks good. Then you need to shift up the interest rate path, so as to counter the effect of house price developments and again make the resulting forecast of inflation and resource utilization look good.

The same goes for asset prices, bubbles, or any new information. You should filter any new information through the forecast of inflation and resource utilization. That filtering tells you whether you should respond to the new information or not. This is very easy to say. The principles are simple and can be summarized in a few words, as I have done. The difficulty is to judge in practice when and when not asset prices, potential bubbles, and house prices affect the forecast of future inflation and resource utilization. The principles are simple, but the practice is difficult.

**Mr. Feldstein:** To me, the issue of bubbles is very much tied up with the risk of the bursting of the bubble, and that is a very probabilistic issue. It's not what the basic forecast is, but what the probability is that the developments that you see in asset prices could lead to a very unwelcome outcome later on.

In a probabilistic way of thinking about policy, you may do a little bit of leaning, even though you know it is going to have collateral effects.

The mean forecast is all you need in a world in which you can ignore uncertainty because you have a linear model and a quadratic loss function.

**Mr. Harris:** I hate to pile on to Rick here on this bubble question. Is it really true that central banks can't identify bubbles? It seems to me from sitting on Wall Street through the last decade—particularly if you look at the housing bubble—by 2004, at least probabilistically, you are pretty convinced there was a bubble going on. It wasn't just that real prices of homes were rising rapidly, but you also had a surge in hybrid mortgages, you had self-identified investors popping up all over the place, you had an experience where hot markets were getting hotter—a sign that people were moving from cool markets into the markets where you could actually make money. Bob Shiller by 2004 had a lot of company around the issue of housing bubbles.

Even Alan Greenspan admitted there was froth in the housing market, which, in checking Roget's Thesaurus, I found that was the benign way to describe a possible bubble. So, isn't bubble identification just another kind of tough forecast for a central bank?

**Mr. Mishkin:** Let me talk about this issue about identifying bubbles first. In fact, I would like to take a behavioral-type view along the lines Bob Shiller has talked about. One thing that is true is when people see something *ex post* (after the fact), they think they knew what was going on *ex ante* (before the fact). It is a very common thing. You think you are smarter than you actually were. To give an example in this context, it is true that *ex post* we knew there was by 1999-2000 a bubble in the stock market.

But a lot of people were talking about bubbles in 1995 and 1996. In fact, a friend of mine told me he was talking to a bunch of economists at the University of Chicago at the time. They all pulled out of the market in 1995 and so missed out on a lot of price appreciation. The key point here is it is always easy *ex post* to identify a bubble. And you also not only have to identify the bubble, but you also have to know what to do if a bubble actually exists in order to get policy

right. The theoretical literature that thinks hard about what is the appropriate response is incredibly mixed.

Clearly, the position that Lars Svensson is taking is a little more technical way of describing the position that I have advocated. I know this is controversial. I do have to say that I disagree with Stan and Bill White on this. The issue here is that there are a lot of costs trying to anticipate bubbles when we don't have the stock of knowledge to know what to do if there is a bubble or the stock of knowledge to know that a bubble exists. In fact, the other problem is that when we in central banks get into trying to respond to potential bubbles, we start to lose our basic mission. That can be extremely high-cost, both in terms of what we do and what the public thinks we are doing.

**Mr. Hamilton:** This term "bubbles" gets used by different people in different ways. One of the ways it is commonly used would imply profitable personal investment strategies. I don't think we can agree that everybody knew there were profitable personal investment strategies. That is why I am inclined to focus on the issues that I raised of whether there are some kind of institutional incentives or something going on that is part of this broader phenomenon.

**Mr. Mishkin:** There are some Nordic examples that are classic in terms of what Jim talked about, which was that there was poor prudential supervision, excessive risk-taking, which led to a huge boom in asset prices. The issues he is raising are, in fact, serious ones.

**Mr. Rosengren:** My question is to Jim, and the observation is that if you look at a lot of the things that Rick Mishkin described in terms of where we missed, it seems to be tied to the subprime market, and a lot of that market is being financed outside of depository institutions.

When you look at a lot of these structured investment vehicles, many of them are not sponsored by banks. Furthermore, many securitizations and structured products are done outside the banking system but with liquidity provisions provided by banks. These securitizations could include loans from receivables that could include loans for cars, that could be home equity loans, or that could be mortgages. When you look at those kinds of vehicles, I am a little puzzled how

to stop structured investment vehicles from financing highly risky assets. If that is where a lot of the problems were, I would like to have a better idea of how you see broker markets being supervised.

If what you want to stop is high-risk lending, which I am not sure should be the goal, but if that is what you wanted to do, I am not sure whom you want to put the capital ratios on. I am not sure bank supervision is going to be equipped to deal with many organizations that are completely outside of depository organizations.

**Mr. Barnes:** I don't really want to belabor the point, but Rick Mishkin said that central banks don't have any informational advantage over markets, yet he also said that central banks with supervisory powers can take action if they see excessive risk-taking. It seems to me there might be an inconsistency there between being able to identify asset bubbles and being unable to identify excessive risk-taking. If you can do one, you should be able to do the other.

**Mr. Hale:** In the last eight weeks, the challenge confronting the Federal Reserve has changed quite profoundly. We have gone from a housing recession to what I would now describe as a crisis of information in the financial markets. There has been a total loss of confidence in the credit rating agencies. As a result, investors are very unsure how to price various asset classes.

Therefore, the commercial paper market has shrunk by \$200 billion in the last three weeks. In the next six weeks, \$1.3 trillion of commercial paper will mature in conduits operated by European and American banks.

We had some major accidents in Germany in July. The odds are very high there will be more accidents because of this crisis of information.

How can the Federal Reserve in these new circumstances address the problem of a crisis of information?

**Mr. Lindsey:** I would like to add to Jim Hamilton's list of reasons why the response mechanism may be slower, and that has to do with the nature of model-based decision-making. We certainly saw it quite explicitly with regard to the way the credit rating agencies scored

credits in this cycle. It is abundantly clear in the appraisal standards. It was clear in the late 1990s with regard to bottom-up appraisal of future profit growth. There are plenty of reasons why there are institutional lags in the system. I am not sure that is the reason why we might go to your solution, but it does highlight your problem.

One final example of linear extrapolation from model-based decision-making is—I don't know how to say this politely—if one reads the policy statements following Federal Open Market Committee meetings, nearly all of them in the last year have pointed out that housing conditions have deteriorated more than we expected.

**Mr. Mishkin:** Let me respond to Martin Barnes. I think there is a huge difference—you can actually have bubbles that are fundamentally driven by bad fundamentals, bad policies. Take the savings and loan crisis as a classic example. As economists, we knew exactly there was excessive risk-taking going on because of poor prudential supervision and regulation. In fact, it was pointed out continually by economists, and it then took a while before the political will was there to fix the problem.

So, I think they are completely different. No inconsistency between the two.

**Mr. Hamilton:** Obviously, we don't regulate all institutions, but if an institution is too big to fail, we ought to be worrying about it, not with the fed funds rate as the instrument, but we should seek regulatory supervision of it. So, that is how we would draw that line.

**Mr. Fraga:** Just a quick vote siding with Stan. It seems to me that everything we do when we run monetary policy is uncertain. On the side of perhaps being a bit more proactive, I would list a couple of points. One is the fact that things that affect the plumbing of the monetary system—the banks, in particular—do have more dangerous consequences than things that don't. To the extent we see contamination of the plumbing, as I believe we do now, with risks appearing in the banks' balance sheets that we didn't think were there (very much in this spirit of Kindleberger's story of how crises unravel), I think monetary policy should be proactive.

The second point is that bankruptcy matters. In a textbook world, where bankruptcy has no costs, forced liquidations are not a problem. But in actual proceedings, the costs are tremendous. So, I'll vote with Stan on this one too.

**Mr. Gurria:** We come to these meetings for some answers and for best practices—what to do. If we don't like what is happening, we agree that it should not have happened, then, first, how do we fix it, but then how do we avoid it from happening again? Ned Gramlich in his paper said something very much along the lines of Mr. Hamilton's comments right now. Half of the originators were not federally supervised, and many of the originators were not even controlled by normal regulatory structures. Therefore, Mr. Rosengren says, "Don't overdo it. Let's not go too far."

But obviously there is a need to go further, if not too far, in terms of supervising. The old methods of quality and the old methods of capital and the old methods of maybe "too big to fail" because it has other impacts on people who have nothing to do with the problem are just as good as any other criterion. But it does seem like we should ask ourselves these questions, but also have some answers that are in the regulatory environment because we were a little complacent in the beginning of the process, thinking it was going to sort itself out.