

General Discussion: Housing *is* the Business Cycle

Chair: Otmar Issing

Mr. Issing: I think Ed Leamer's paper is so rich with data that, even on a very long flight, it is almost impossible to digest all the information. The data—the evidence, which you take for your conclusions—are one of the issues on which the discussion here should properly concentrate. In this context on conclusions you were cautious yourself. The predictive power of your model might be an interesting topic to discuss, and, notwithstanding the fact that on tomorrow's agenda is Rick Mishkin's paper, we should discuss house prices and monetary policy, as you draw such strong conclusions. Frank Smets has already commented on that. We should also discuss your propositions for targeting housing.

Mr. Makin: I really like Ed's paper, and I am going to ask a question. I felt like we were getting a striptease, but when it came time to really take everything off, you backed away and said, "But I don't see a recession in sight, although we have satisfied the necessary conditions for a recession."

Maybe I am overstating your case, but I'd like you to comment on that.

In the previous session, briefly we heard two people say that house prices are going down, and I think they both said the declines in prices were going to continue. I am curious to be able to find what

empirical evidence would distinguish between those two stories. If that is true, if the drop in house prices is going to persist, we have a serious problem that Ed may want to address, and that is the issue that Frank Smets brought up about financial channels. That is, in the run-up, especially in the last three years of the housing boom, many contracts were written and securitized, conditional on the idea that house prices would continue to rise. A sufficient condition to invalidate some of those contracts has simply been that house prices stopped rising.

A sufficient condition to further devalue those contracts is that house prices go down and go down for a long time. I am thinking in particular here of the market for derivative securities in which we are struggling today to price those securities because the models that price those securities are conditional on a low level of volatility. If you ask the model what those securities are worth today, it would probably say zero. So, we don't want to hear that, and probably the model would be wrong.

But what I am saying is that the housing boom, the run-up in prices, and the expectation that those price increases would continue have been embodied in a large quantity of securities that now credit markets are struggling to price. Maybe that is the link from Ed's story about housing to the potential for a recession.

Mr. Dugger: A word on perhaps a sufficient condition for John Makin's comment and a return to an earlier paper to talk about the set of financial instruments that we are concerned about in the present liquidity circumstances: Much in the discussion so far has been about how the supply side of credit shaped the set of mortgage-backed securities, collateralized mortgage obligations, and credit default swaps that enhance those obligations.

I would like to emphasize, at least from the perspective of a company like mine, much of the reason those instruments took the shape they did was the demand side of the equation—that is, they were shaped by what investors needed. Here's why. The current account deficit—returning to a subject that has occupied this conference extensively in past years—is a story about the demand side being mainly

from non-U.S. investors needing dollar assets. These investors did not particularly want mortgage instruments from specific areas. They wanted nationwide diversification. So, agency and private-label mortgage-backed securities answered that need.

As the current account deficit investor class became more complex, they wanted different risk gradations.

Accordingly, collateralized mortgage obligations with different risk tranches were delivered to meet those needs. To provide the liquidity these investors ultimately needed, whole classes of credit default swap instruments were created to enable a BBB to become an AAA if it needed to be sold or adjusted by the investors. This is all to say that, to a considerable degree, the demand side of what investors needed—both domestic and foreign (but mainly foreign)—is what shaped the set of instruments we are now talking about.

Additionally, the reputations of the gatekeepers of those instruments—the rating agencies, the appraisers, the providers of credit enhancements—have been compromised significantly. Accordingly, it is much more difficult to get the foreign community, which sees this U.S. market in a far less transparent way, to come back to the market. So, to a considerable degree, the work of restoring liquidity will have to involve getting those gatekeeper institutions operating again.

All of this is to come back and say Ed's paper, and Frank's comments, are right on point. But, Ed, isn't it the case that you are suggesting that we stay with the kind of gross domestic product (GDP) mix we have had for the last 20 or 30 years in which the GDP of the United States is highly dependent on housing and consumer consumption? Isn't that, in a sense, what the last few decades or last decade of current account adjustment discussion has been all about, to reduce the reliance of U.S. GDP on these components and more on a higher savings rate and a set of GDP components that are not so current account-dependent?

Mr. Blinder: This is a “methinks the gentleman doth protest too much” comment. Ed starts his paper, deliberately provocatively, by saying that both the bad news and the good news is that he is not a macroeconomist. And the following sentence says, “On the good

news, that frees me from the heavy conceptual burdens that most macroeconomists seem to carry.”

First, a word on what I think almost everyone in this room thinks was the conventional wisdom *before* we picked up Ed’s paper—which is that every postwar recession in the United States was caused either by a monetary tightening or by an oil shock, often both.

That is point one of the conventional wisdom, and it leads to the next question: “Well, why all these monetary tightenings?” The main reason, of course, was that the Federal Reserve was tightening to fight inflation, which might have been caused by an oil shock or something else. So, the Fed wasn’t doing it whimsically, but rather to fight inflation—as it saw the problem (if not always perfectly).

The third point of the conventional wisdom, which is in the textbooks if you look but might not be in the index under “real estate,” is that when the Fed decides to fight inflation, it does it with the only instrument it has—raising interest rates. And the principal responses to rate hikes come in the most interest-sensitive pieces of the GDP, which are a) housing and b) automobiles. That is what I thought was the conventional wisdom.

So, I think, Ed, that the discovery that housing is important downplays too much the role of monetary policy, which you come to at the end. This is very consistent with what Frank said in his comments. And it echoes, by the way, the discussion we were having in the last session, which was around whether housing is an autonomous source of shocks that emerge from the housing sector and then, via multipliers and other mechanisms, affect the rest of economy, or whether housing is the transmission mechanism via which the Fed works its way. Obviously, the weights on those two possibilities are not 100 percent and zero. I believe the conventional wisdom before the second page of this paper was weighted heavily toward the view that it was the Fed working its way. It just so happens that housing is the instrumentality because it is so much more interest-sensitive than anything else.

Mr. Leamer: I heard a lot of very good comments. I thank Frank Smets for his interesting comments on my paper. I have several reactions to it.

First of all, with regard to multivariate analysis, I have done some econometric work on the 10 components of leading indicators to determine which of those 10 really work well for predicting recessions and which combinations work well. It certainly is the case that an inverted yield curve by itself predicts recessions, but housing starts, together with the interest rate spread, does better than either by itself. However, I am trying to build a causal story, and I don't want to have the causal story through housing compete with a policy variable without associating that policy variable with a causal mechanism. So, inside the context of my paper, I am thinking the interest rate spread has its impact through housing, though it surely operates through other channels.

That raises the second question, which regards spillovers. There is no question: You cannot have recession if you just have a problem with residential investment. Is it inventories? Is it business investment? Well, my view is that we should think of the inventories and business investment as the passenger, not the driver. They respond to opportunities on the consumer side—that is, the statement temporal orderings. The first things to move are the consumer components. Later on come the business components. I am giving that a causal interpretation, even though I am very careful in this paper to talk about how it is very dangerous to draw causal conclusions from temporal orderings.

My view, then, is if you want to look for the next recession soon, worry about the linkages between housing and other consumer spending items, especially consumer durables. The paper tomorrow by John Muellbauer on consumer spending is therefore extremely material for thinking about whether we are going to have a recession this year. Within consumer durables, it is automobiles and not furniture that is the cyclically volatile component. Is spending on autos going to weaken? Is that somehow linked with the housing market?

I did take a stance on this spillover issue in my paper, but not a stance that is backed up with any hard work. My view was that the wealth effect is not going to operate with enough speed to account

for the fact that consumer durables tend to decline about a quarter after you get a problem with housing. You may tell us otherwise, but I don't think the mechanism is through the wealth effect. Therefore, I looked for some other causal variables that are affecting both of those, which are monetary policy and unemployment.

As far as the stability of the U.S. economy, I have done some of these correlation studies, too. I found that it is the external component that has helped stabilize the U.S. GDP. That is pertinent to the conversation we had last year at Jackson Hole about the extension of supply chains across borders. A drop in consumer spending may have little to do with U.S. operations if we are importing most of the product from foreign sources. In fact, we have a negative correlation now in the economy between the contribution that comes from consumer durables (and other components of GDP) and imports. That has been a stabilizing effect.

One more comment: I was very much looking forward to hearing Ned Gramlich talk at lunch. I don't think there is anything I have said that he would regard to be astounding. In the de Leeuw-Gramlich piece and the Maisel piece, there was a great deal of emphasis on housing as a channel through which monetary policy affects the economy.

With regard to Alan Blinder's comment on the received wisdom, it is best to understand that I am from the University of California, Los Angeles, so macroeconomics is the real business cycle and/or rational expectations. So, when I say "macro," I don't mean the received wisdom of epidemiological macro. It is the theoretically driven macro, rational expectations and/or the real business cycle. That seems to me to be the problem area, where it has completely lost track of the facts.

I recognize that the Fed model explicitly embodies the housing channel, as it should. So, that is not surprising. But I do wonder whether that Fed model adequately deals with the intertemporal aspects of the control problem, allowing monetary policy to affect the timing of the building but not the total. It is not enough merely to recognize that monetary policy works through housing. One needs to understand that if we stimulate housing in 2003 and 2004, we are inevitably going to have a weaker housing sector in 2007 and 2008.

It is this intertemporal control problem that I am trying to emphasize. If that is the received wisdom, I don't see it percolating up in the vast literature that I reviewed, nor did that wisdom seem to affect the deliberations regarding monetary policy in 2003 and 2004.

Mr. Smets: Just one comment. I didn't want to say much about the quantitative significance of the financial channels, as this will be the topic of the papers by John Muellbauer and Governor Mishkin. If there are going to be large spillovers, they will have to come through those financial channels rather than through the more traditional investment accelerator effect because residential investment is only a small part of the economy.

Probably the clearest example of the wealth/collateral channel working is the U.K. experience in the early 1990s when 2 million households had negative net equity in their houses and consumption was very depressed. But, of course, this was partly specific to the institutional framework of the mortgage market in the United Kingdom, and it is not clear at all whether this is a useful analogy for the United States.