



9TH JACQUES POLAK ANNUAL RESEARCH CONFERENCE
NOVEMBER 13-14, 2008

Policy Response to Asset and Housing Price Booms and Busts

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Panel discussion presented at the 9th Jacques Polak Annual Research Conference
Hosted by the International Monetary Fund
Washington, DC—November 13-14, 2008

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Panel Discussion

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Three Issues

- Ex ante policy issues.
- Ex post policy issues.

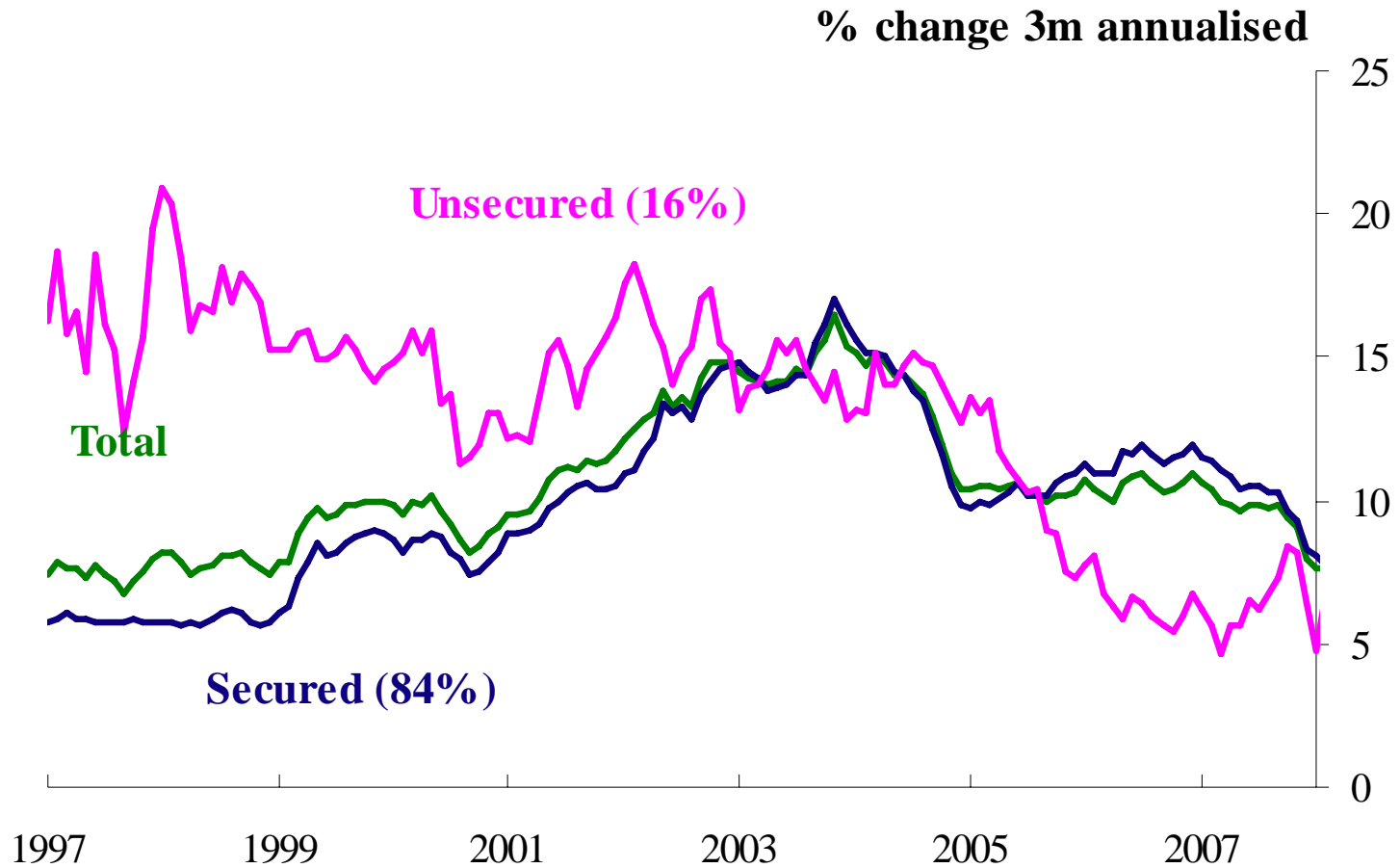
Background

- Given my comparative advantage, I will discuss these issues from a U.K. perspective.
- But given the global issues, there is some general relevance.
- What is striking about current events is how far they transcend the specific institutional features of particular countries.

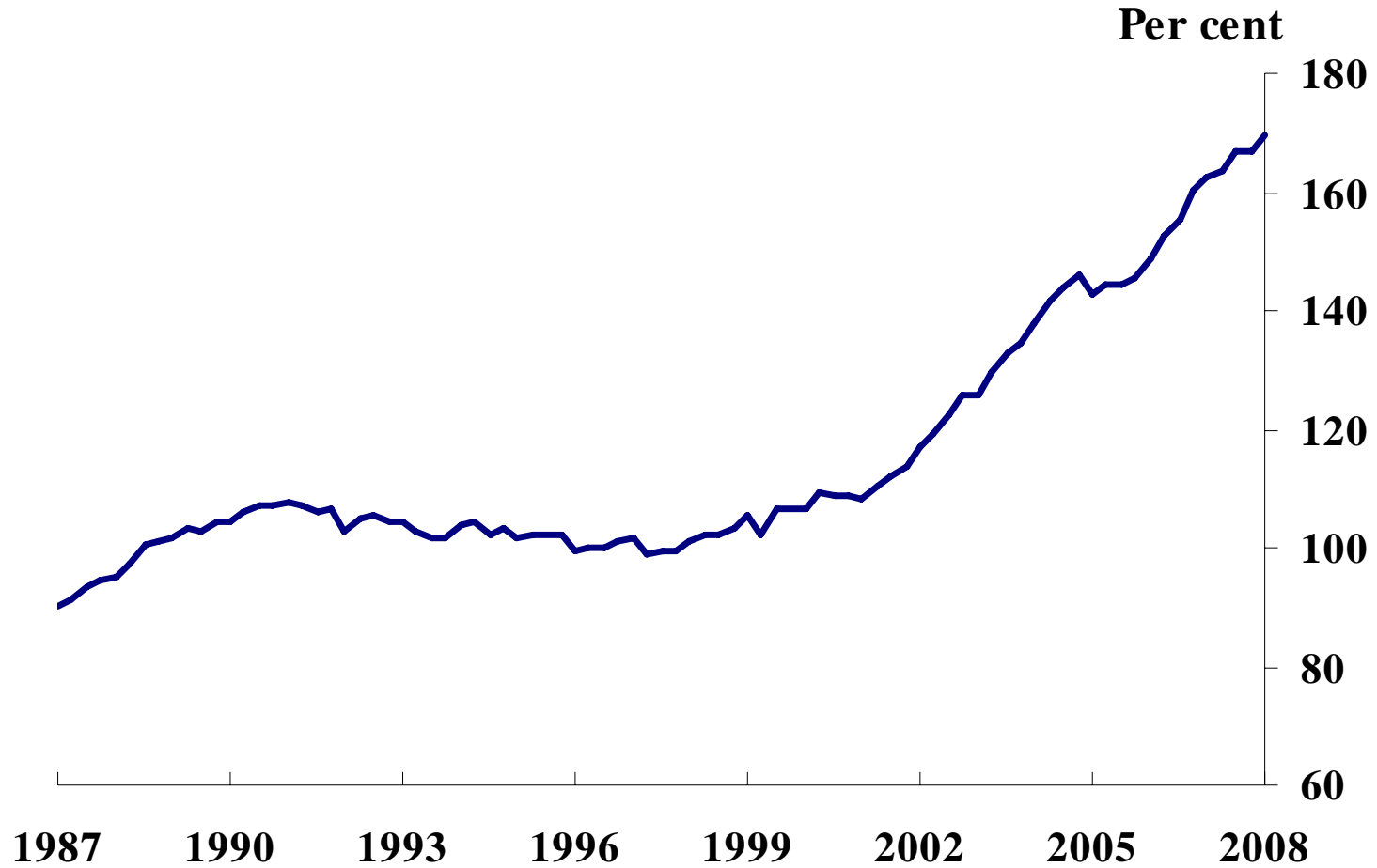
Household indebtedness

- The growth of household indebtedness has been a much-debated issue in the U.K.

Lending to individuals



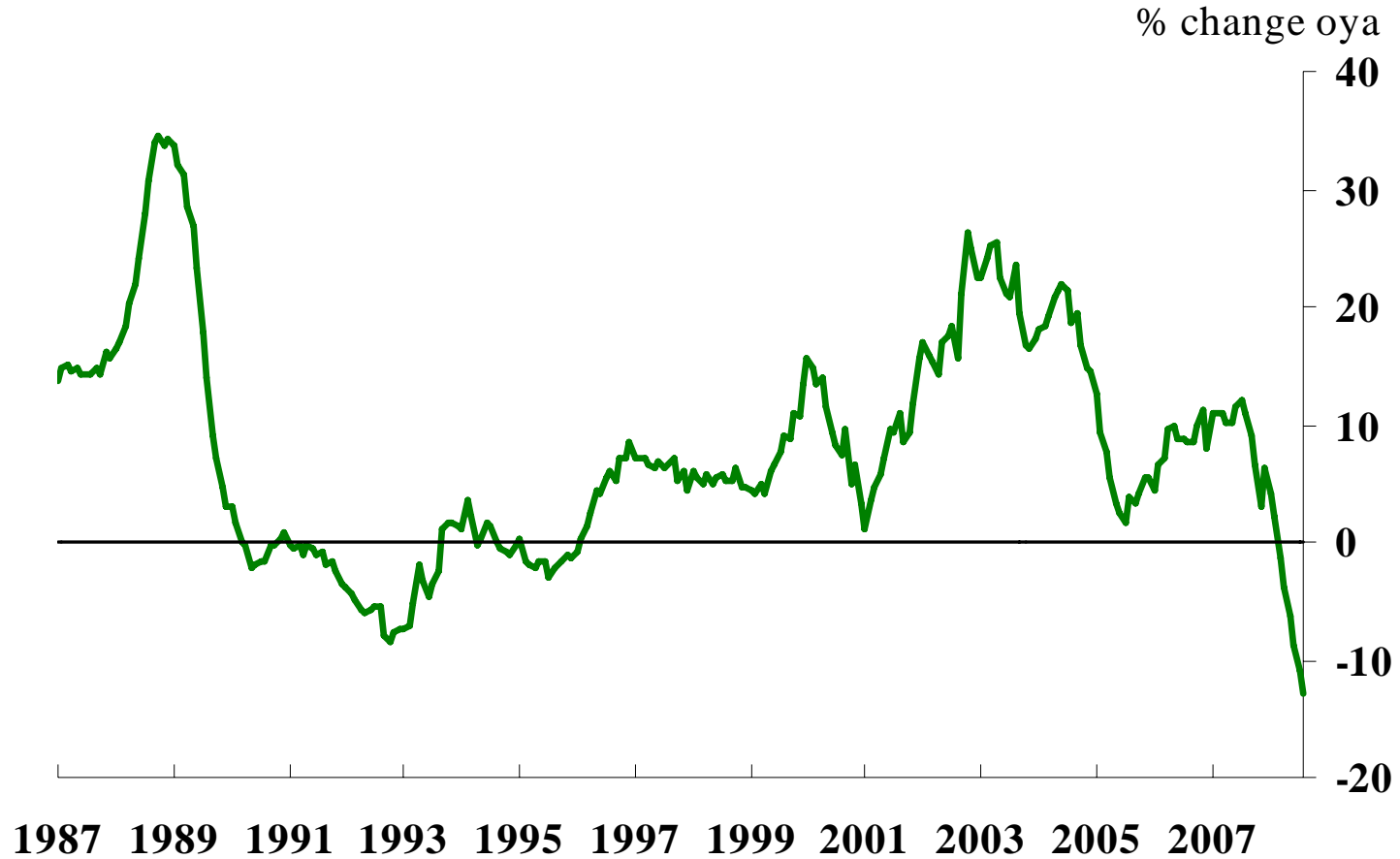
Household debt to income



Household indebtedness

- The growth of household indebtedness has been a much-debated issue in the U.K.
- It was accompanied by significant increases in house prices – which are now falling.

Annual house price inflation



Source: Halifax

Key Issues

- What are the market failures?
- How should monetary policy respond to these developments?

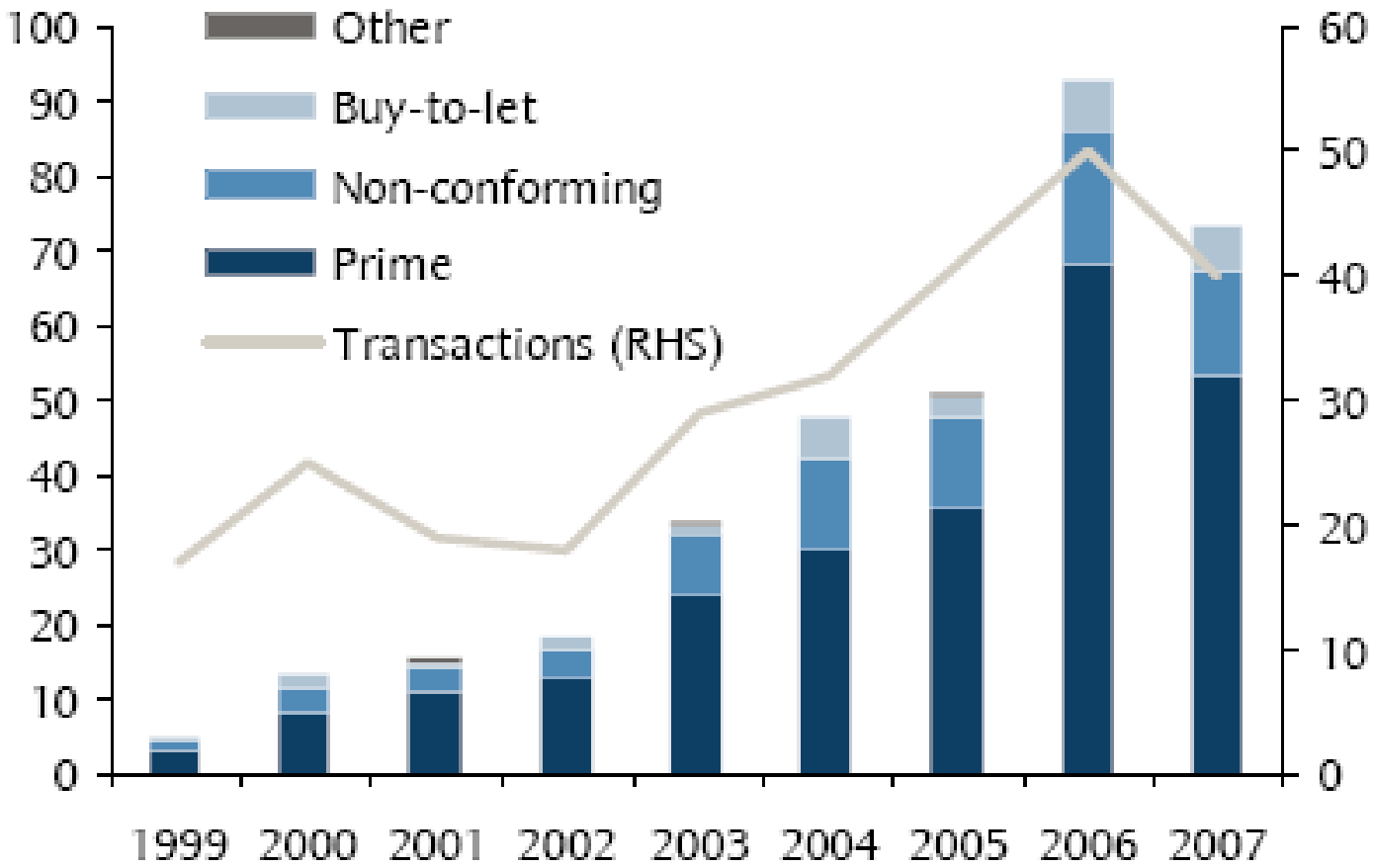
Issue I

- behavioural issues in understanding household indebtedness
 - what assumptions should we make about the level of expertise that households have.
 - how do we think about differences between secured and unsecured credit?
the literature to date on credit markets has mainly focused on credit rationing and how to reduce not how to reduce indebtedness.

Issue II

- Originate and distribute model was a key innovation
 - this has implications for financial regulation
 - but there are also issues about risk pricing and whether macro risk is appropriately priced.

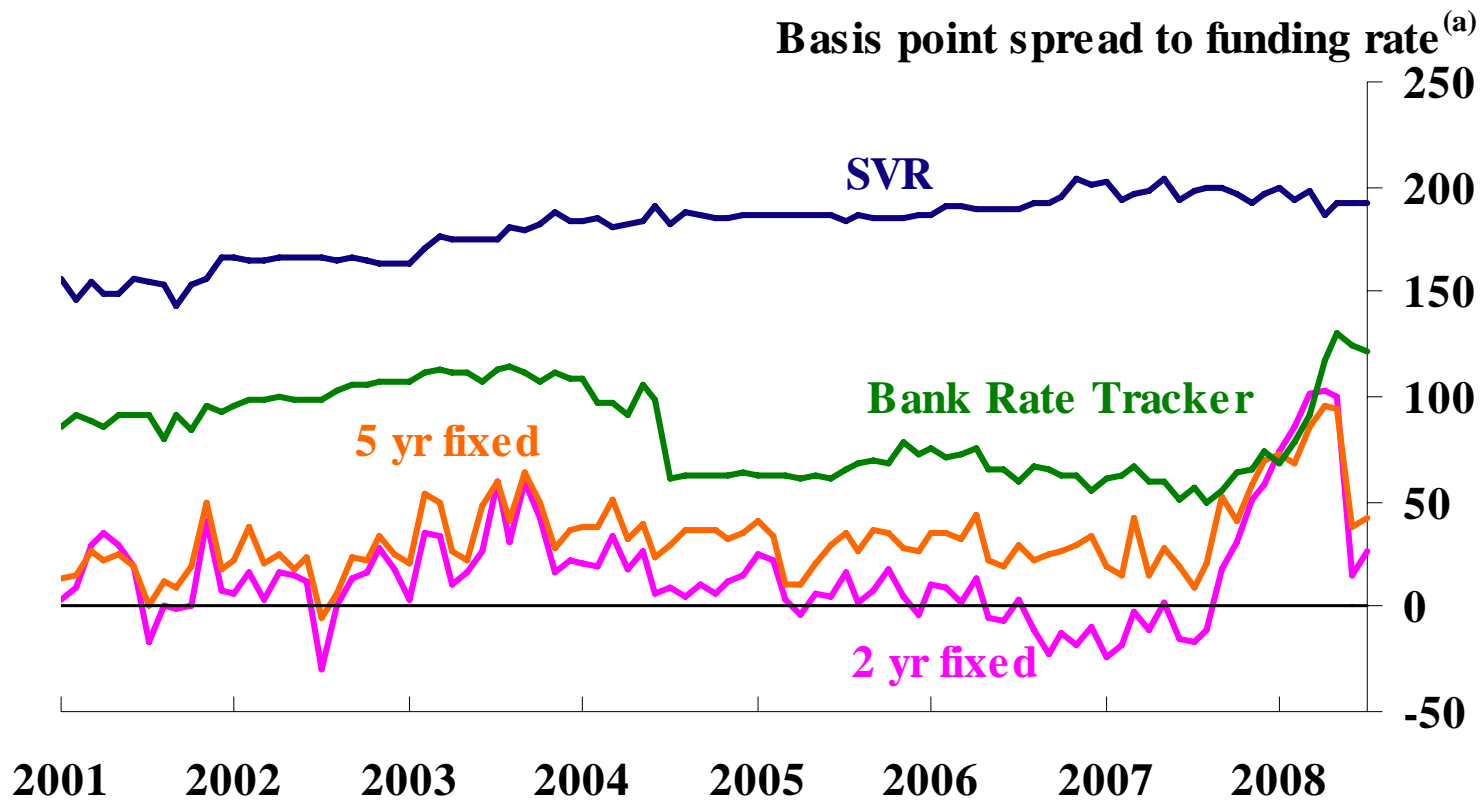
UK RMBS Issuance



Source: Barclays Capital



Mortgage lending spreads



(a) Tracker mortgages spread over Bank Rate; 2 yr, and 5 yr fixed rate mortgages spread over one month lag of 2 and 5 year swap rates

Ex Ante Policy Issues

- Is inflation targeting part of the problem?
 - A frequent claim is that post 2001 global monetary policy was too loose.
 - But there was little steer from indicators of inflation.
 - but did low interest rates encourage indebtedness?

- How should inflation targeting central banks respond to asset price developments including house prices?
 - the price of housing services is not well measured in price indices
 - the link between house prices and the price of housing services is not very direct.
 - nominal interest rates are important in models with downpayment effects

- The growth of leverage was however fairly clear and many institutions warned about it.
 - BIS and Bank of England's own Financial Stability report
- What was the optimal policy response?

My own take

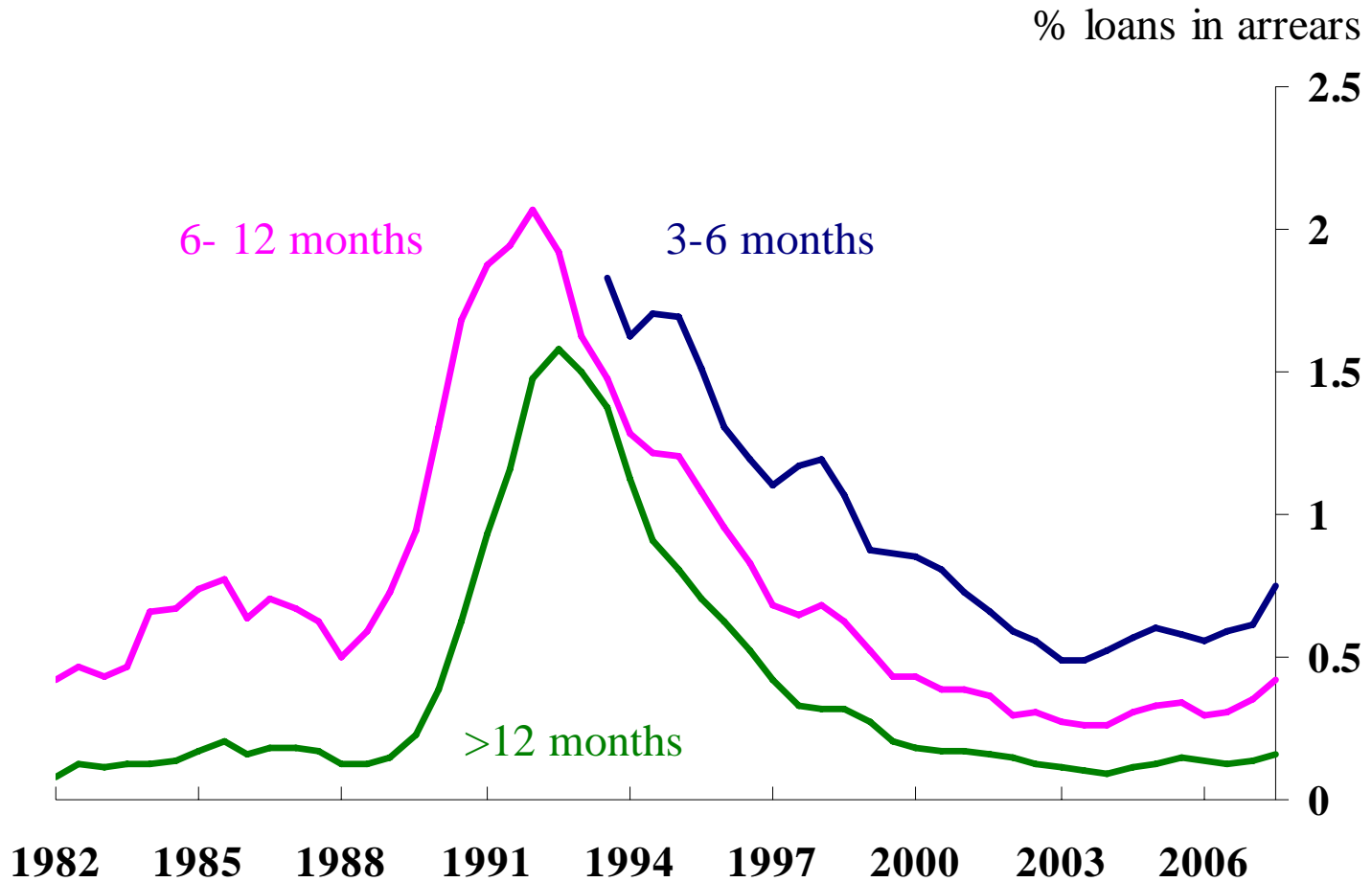
- This does not undermine the case for inflation targeting.

Ex Post Policy Issues

- First order business is to establish orderly deleveraging.
- Some economies (like the U.K. need to rebalance)
- But major issue is to prevent undershooting – Banks are now being extremely cautious.
- Need to look at both prices and quantities of credit.
- Monetary policy effectiveness is impaired.

- Even now, for the U.K. the current financial crisis has little to do with default of the real sector onto the financial sector

Mortgage Repossessions



Source: CML