Policy Response to Asset and Housing Price Booms and Busts

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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 if 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.
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.
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

% loans in arrears


6-12 months
3-6 months
>12 months

Source: CML