Monthly Labor Review

June 2019

When one door opens: the housing boom and monetary policy

Maya B. Brandon

The housing industry is largely used by consumers and policymakers as a signal of how well the economy is doing. Often, especially in real estate circles, the housing boom is known as a time of mass prosperity and economic gain. Although people still view the housing boom with “rose-colored” glasses, the conditions that fostered the housing boom and the subsequent housing bubble burst are being studied as possible guides for future monetary policy.

The housing boom occurred between 2003 and 2006 when the Federal Reserve (the Fed) raised rates by 4.25 percent, access to mortgages was high, and lending standards were lax. In “How monetary policy shaped the housing boom” (National Bureau of Economic Research, Working Paper 25649, March 2019), Itamar Drechsler, Alexi Savov, and Philipp Schnabl seek to determine the evidentiary support that monetary policy may have had in nurturing the boom, which led to the bubble bursting.

The Fed raised rates and, naturally, the banks contracted because their deposits were not enough to cover previous levels of loan production and origination. This contraction enabled nonbank entities to swoop in and expand the market of private-label securitization loans, counteracting the banks contraction and increasing the fragility of the mortgage market. Private loans have less stringent standards than government-backed (government-insured) mortgages and most people who applied were granted access to these loans. Ultimately, the authors find that the Fed’s tightening led banks to increase their deposit spreads and contract their mortgage lending portfolio, in turn influencing private lenders to increase the availability of private loans to offset the government-sponsored enterprises mortgage-lending contraction.

The Fed’s tightening had little effect on total mortgage lending but opened the doors for substitutions between government-sponsored lending and private lending. The expansion of private loan availability allowed nonbanks to gain footing in the market, which, in turn, increased market instability leading to the housing boom and the housing bubble burst. Although monetary policy contributed to the housing boom, the investors were the principle participants and their willingness to fund capital markets and subprime loans invited and enabled the housing boom.

Some researchers suggest that had the Fed tightened rates more aggressively, the housing boom could have been better managed to not cause such a catastrophic burst. Unstable funding sources may cause the market to fluctuate more widely. Maintaining balance and acquiring stable funding, such as government insured loans and deposits, are favored by consumers, lenders, and policymakers as effective agents of lending and monetary policy. Markets are unpredictable, and policy can only deliver so much direction.

The housing boom and housing bubble burst presented an interesting case study as such a high level of expansion and contraction had not been presented before in such a short period. The housing boom and housing burst ushered in an era of the housing industry, acting as a signal for how well the general economy was doing. The economy was considered to be strong and healthy during the housing boom to then turn around and be considered weak and fickle during the housing burst. Examining past signals and comparing them with the current status is a clever way to track economic patterns and consumer spending while increasing the validity of predictions. Itamar Drechsler, Alexi Savov, and Philipp Schnabl effectively provided evidentiary support to back how monetary policy nurtured the housing boom and housing bubble burst. The authors were also effective in describing how the housing industry became a signal for the health of the general economy.