

Discussion of:
**The Seeds of the 2007-2009 Crisis: the
Housing Market and the Business Cycle**
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A good paper

- ▶ Focus on a very relevant problem
- ▶ Using advanced modeling framework
- ▶ Interesting results
- ▶ Paper is short and precise and easy to read
- ▶ I learned a lot from reading the paper

Aim of Paper

- ▶ In the last decade, the movement of U.S. housing prices departed dramatically from historically patterns
- ▶ This paper: Investigate the interrelationship between U.S. housing cycle and the business cycle in the last decades
- ▶ Aim of paper: To shed light on possible origin of the recent boom and bust in the housing market, the linkages with the broad economy, and assessment of future prospects
- ▶ Is the recent boom and bust in the housing sector unique?
- ▶ If yes, what has changed?

Modeling framework

- ▶ Nonlinear dynamic factor model to represent the phases of the housing market cycle and the business cycle
- ▶ The factors are assumed to follow two distinct Markov-switching processes
 - ▶ No restrictions on the relationship between S_t^H and S_t^{BC}
- ▶ Linkages between the two factors are modeled by their
 - ▶ Covariance
 - ▶ Markov processes
 - ▶ VAR specification for factors
- ▶ The measurement and transition equations are estimated simultaneously as a state space model

Results

- ▶ The relationship between the housing cycle and business cycle changed remarkably in the last decade
 - ▶ Missed link between these two cycles in the early 2000s
- ▶ The authors show that interest rates are an important factor in the relationship between the business cycle and the housing cycle
- ▶ Extend model to allow for changes in the housing cycle, business cycle and interest rate
 - ▶ Linkage between business cycle and the interest rate weaken during the 2002-2004 recovery
 - ▶ The association between lagged interest rate and the housing factor became much stronger since the 2001 recession
- ▶ Results suggest that the run up of housing prices since the 2001 is associated with the low level of interest rate

Comment 1

- ▶ The results in the paper indicates that too “loose” monetary policy played a central role for the recent housing and economic crisis
- ▶ What are the policy implications of your results?
- ▶ This paper and also others (see for instance Iacoviello (2005) and Bjørnland and Jacobsen (2008)) have found that there is a strong effect from interest rates towards housing prices
- ▶ The recent crisis has shown that housing prices also are important for economic fluctuations
- ▶ Should monetary policy react to housing prices and asset prices?

Comment 2

- ▶ What is the implications of the change in the linkage between the business cycle factor and the interest rate?
 - ▶ A shift/break in monetary policy? If so, what kind of shift?
 - ▶ Change in transmission mechanism?
 - ▶ Deflationary pressure?

- ▶ The Federal Reserve Bank adopted a low interest rate
 - ▶ Due to “loose” policy
 - ▶ Due to large capital inflows from abroad. Especially, Asian countries bought U.S. securities both to peg the exchange rates at an export-friendly level and to hedge against a depreciation of their own currency
 - ▶ Due to fear of a deflationary period after the bursting of the Internet bubble.

Comment 3

- ▶ There are at least two candidate explanations for the current crisis, see Blanchard (2009) and Brunnermeier (2009)
 - ▶ Loose monetary policy vs. new transformation in the banking system
- ▶ The traditional banking model
 - ▶ Issuing banks hold loans until they are repaid
- ▶ “Originate and distribute” banking model
 - ▶ Loans are pooled, tranced, and then resold via securitization
- ▶ This (may) have affected banks' lending standards and can be viewed as a shift in supply of credit
 - ▶ This have fueled the housing price boom
- ▶ The empirical analysis do not control for this