Effects of monetary policy on housing bubbles

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Introduction

Monetary policy is one of the important policies which is used by the government of any country to manage the economic parameters (Caspi, 2015). This is an important tool to manage the amount of money supply in the economy and thus have effect price stability. These policies require changes in the short term borrowing rates in an economy which is generally the interest rates. The government and the monetary authority of the country can control the economic parameters like the exchange rate, unemployment rate, and Gross domestic through the changes in the interest rates.

One of the important monetary policy which has made history is the one in United States during the time of subprime crisis. The year 2008 was a remarkable year in global economic history as most of the countries of the world was facing a situation of slowdown or depression. The origin of such an economic situation was identified in the housing bubble. Such incident require deeper understanding of the related factors. Though the economists have identified that the housing bubble can be due to four main reasons: monetary and fiscal policies, inflow of capital from foreign, financial sector and bubble expansion.

The essay below would provide an account of the relationship between the monetary policy followed in United States at that time and how the contributed to the housing bubbles. We would critically evaluate the relation by evaluating the theories as established by the researchers in this area (Phiri, 2018). Also the final segment of this essay would make recommendations for the central banks of the countries to use monetary policies for various macroeconomic parameters.

Arguments supporting the idea that monetary policy have significant effects on housing bubble.

The incident in United States of low levels of interest rates and the rising prices of the real estate sector provide a real case example of how monetary policy can create housing bubbles. The prices of United States real estate has been stable during most of the period in history. It was from the year 1996 that the prices started to rise. From the period between 1997 and 2007, the prices rose by eleven percent. There were many factors which led to the housing bubble, but monetary policy during that period was also one of the important factor. Federal bank kept very low interest rates during that period which increased the amount of money circulating in the economy.

In one of the research, it indicates that the monetary policy of a country have direct effect on the prices in the housing sector (Dokko et al., 2011).

The interest rate as established by the banks and financial institutions of a country impact the housing prices. The researchers indicate that the monetary policy of Federal Bank to control the macroeconomic environment was not appropriate. The nominal interest rate of the bank reached to a level of zero. These were aggressive policy measures which were previously never used in the history of United States. Federal bank used methods of quantitative easing which improved the availability of credit and the housing market.

Some of the eminent economists like White, Stokes, and Taylor show important link between low interest rates and high prices of real estate. They argue that the low interest level creates a situation of inflation, where people are ready to pay higher price for same goods. As the purchasing power of the people increases, they are ready to shell out more for the same piece of land. The low interest rate also encourages people borrow more than what they can pay back. This led to escalation effect and led to the housing bubble of 2008.

Some of the economists also indicate about the monetary policy transmission mechanism. The act of reducing the long term interest rate, have known to increase the capital inflow in countries like Asia, Middle East and United states. According to the transmission mechanism, when the interest rate are low, the demand for loan increases. Various adjustable rate mortgages become cheap relative to the 30 year fixed rates.

In some of the theories developed by the economists indicate that long term mortgage interest rate is highly sensitive to any changes in the short terms interest rate in the economy. Thus it would not be wrong to say that Fed's loose policies was one of the important contributing factor to the housing bubble. An expansive monetary policy, creates an asset boom by inducing the borrowings which is beyond the limits to acquire the asset.

A similar case has been indicated by Austrian Economists which indicate that in a capitalist's economy, when the markets work well, it will bring down the overall interest rates as people would save more for the future. But in the situation when the interest rate has been engineered by the monetary policy, it may lead to stretching of the economy in various directions. It can lead to unsustainable economic situations and give rise to bubbles ready to explode. This idea was also supported by one of the eminent economists Milton Friedman. In some his important studies conducted for years indicate that there would be a situation of larger boom after a period of larger contraction. These studies were based on asset bubbles in various parts of the globe like ' tech boom' and Japanese ' lost decade'.

The relationship has also been supported by the important economists Taylor. According to his rule, the changes in the financial market infuses money in various sectors of the economy. The high rates of inflation is the direct effect on more money in the hands of the consumers. As their purchasing power increases, they compete for the same goods and pay a price which is much higher than the original price (Kiss and Vadas, 2007). Thus monetary policy is crucial for any economy and may create repercussions which can take the form of a bubble.

Many research has been done to establish the direct relationship between monetary policies and housing bubble. They have used VAR analysis to find the correlation between the two variable. Most of these statistical models have indicated direct correlation coefficient with higher values. These studies clearly establish the relationship and support the idea.

Arguments against the idea that monetary policy have any direct effect on the housing bubble

Some of the researchers view that the low level of interest rate policy followed by Federal Bank during the period of 2006-2009 was important to boost the economy from the recession of the internet bubble (Miles, 2012). They also argue that the monetary policy during that period had little or no role in the housing bubble as experienced by United States.

Thus there are varying views and approaches which indicate relationship between the monetary policy and housing bubble.

The findings from some of the researches by eminent economists indicate that interest rate had no role to play in the housing bubble as experienced by United States in 2008.

Some of the researchers suggest that macro prudential regulations have a higher role than the monetary policy for creation of housing bubble. They argue that factors such as Congress, Fannie Mae and Freddie Mac led to the high house ownerships and faulty financial innovations.

Finally the critics strongly indicate that the major reason of US housing bubble was other factors rather than low interest rates. The financial market innovations is considered as one of the important aspect (McDonald and Stokes, 2015). The financial companies in order to compete with each other adopted lending policies which were inadequate. The creditworthiness of the borrowers were not accessed and huge sum of money was given to them. Such financial innovative lending products created an escalating effect on all sector of the economy. The country was facing an overall high levels of inflation with the real estate sector being highly targeted. Consumers spending increased and people started investing in houses. This gradually led to the formation of bubble as it was not supported by other economic factors or real growth of the country.

The critics also argue that the loose monetary policy lead to other situations which creates a multiplicative effect on rise of the prices in housing sector. Thus they put forward the proposition that the monetary policy do not have any direct relationship with the housing bubble but lead to some of the situation which can lead to creation of bubble in real estate sector.

Some studies indicate that the timing of the monetary policy had effect on the housing sector. As the economy of United States was already in the phase of recovery from the internet boom, a slight money infusion into the economy led to the creation of bubble. Thus they argue had the situation been normal, such changes in the monetary policy might not have created any creation of asset bubble (Moons and Hellinckx, 2015).

One of the research was conducted to analyse whether monetary policy should be used to achieve financial stability even if leads changes in the macroeconomic factors like inflation and unemployment rate. One way of viewing such relationship is the growth of the real estate finance sector in various countries of the world. Thus any method used to bring financial stability would be at the expense of changes in the growing real estate financial sector. In that respect, we can say whether it is monetary policy or fiscal policy, the correction would create an inflationary situation leading to a bubble in this sector. Thus it would not be wrong to look into the benefits of the monetary policy for the real estate sector.

In one of the research it was found that there are various benefits of monetary policy for dealing with the risks of housing boom. Policy makers often face a trade-off situation where they need to choose between the macroeconomic goals and financial stability.

Conclusion

Finally based on the above viewpoints related with the strength of relationship of the monetary policy and the housing bubble, we can conclude that there is significant relationship between the two. However the monetary policy create effects on other contributing factors which lead to rise in the prices of the real estate sector (McDonald and Stokes, 2013). The money transmission mechanism plays a vital role in this regard. The higher level of money supply is invariably known to create an inflationary effect which can lead to cause of bubbles in various sectors.

Based on this understanding, some of the important recommendations can be made for the monetary policy setters of various countries. These are as follows:

- The monetary and fiscal policy are important policies of any economy and therefore should be used with much consideration of its effects on other sectors of the economy.
- Using aggressive monetary policy in order to maintain the macro-economic environment of a country may not always bear positive results. The economic parameters of any country is very sensitive to any changes in the interest rate and therefore should be handled gently.
- It is the responsibility of the central banks to adopt appropriate policies which support all sectors of an economy and bring an all-inclusive growth of the country.
- Finally the central banks of the country is required to use these tools in a manner which do not lead to future negative repercussions in other sectors of the economy.
- The policy makers are often faced with a dilemma situation where they have to choose between the changes in the macroeconomic factors and financial stability.

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