UNIVERSITY OF THE PEOPLE

BUS 2203-01 PRINCIPLES OF FINANCE 1 - AY2024-T2

WRITTEN ASSIGNMENT UNIT 2

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What is the author's position regarding the role of US monetary policy and the housing market bubble during the early 2000s? Why?"

The authors do not find significant evidence that the Federal Reserve's interest rate policies were a major direct driver of the rapid housing price inflation from 2003 to 2006. However, they leave open that overly loose monetary conditions may still have contributed indirectly and partially to fueling the unsustainable housing bubble to some extent (Dokko et al, 2009). Without taking an absolute stance, the authors present analyses that could suggest to readers that low rates during this time played at least some role in overheating the real estate expansion via complex interactions with regulation, finance innovations, and irrational optimism. Their research refrains from definitively assigning culpability for the bubble but provides information for readers to potentially conclude that Fed stimulus still primed the pump to a degree.

Describe at least six elements:

1. Low rates accompanied an increase in demand for housing: The paper argues that the widespread use of non-traditional types of mortgages during this period helped to inflate the unsustainable housing bubble. Namely, the popularity of adjustable-rate and exotic mortgage products enabled looser credit standards, allowing subprime borrowers to qualify for larger home loans than they would have under typical 30-year fixed rate terms (Dokko et al, 2009). By temporarily suppressing initial payments on adjustable-rate loans, and delaying principal repayments on exotic ones, these financing mechanisms increased home-buying power for many borrowers. This expanded access to easy credit dramatically boosted demand for residences beyond what fundamentals could support, contributing to soaring but ultimately unstable home prices.

2. Loose versus tight monetary policy: The paper examines the arguments for whether Federal Reserve policy in the mid-2000s was excessively loose or tight in catalyzing the housing bubble, with some claiming excessively low-interest rates over an extended period ignited the abnormal boom.

3. Taylor Rule: The paper analyzes the Taylor Rule, a formula guiding central banks on adjusting interest rates relative to economic conditions, to assess if the Fed set overly expansionary or restrictive policies in the mid-2000s that may have distorted the housing market (Dokko et al, 2009). Specifically, it examines arguments on both sides about whether the Federal Reserve deviated too far from the course of action for the Federal Funds rate recommended by the Taylor Rule leading up to the crisis, keeping rates too low for too long and contributing to the reckless housing bubble.

4. Policy assessment and outcomes: The paper reviews the debates and decision-making regarding monetary policy settings during the mid-2000s period in real-time, rather than just in hindsight, to capture the genuine perspectives and limitations on information influencing the Fed. Additionally, it assesses the eventual repercussions of the chosen interest rate trajectory, investigating, in particular, the role policy played in inflating the housing bubble by keeping borrowing costs too low for too long in an environment with poor regulatory oversight on risky mortgage lending. The analysis digs into both the policy consideration process as events unfolded as well as the consequences it brought for housing markets and the economy later.

5. The rise of cheap and available credit stimulated housing demand:

The paper argues that innovative mortgage vehicles like adjustable rates and more complex exotic loans boosted potential homebuyers' purchasing power and access to financing, thereby stoking demand. By lowering initial payments on adjustable-rate mortgages and deferring principal repayment on exotic ones, these instruments enabled greater approval rates, expanding the pool of eligible homebuyers beyond what standard fixed mortgages would allow. This demand stimulus then contributed to the rapid, yet unstable acceleration in housing prices underlying the formation of the bubble.

6. Evaluate monetary policy by how effective it is in attaining goals:

The paper analyzes monetary policy appraisal frameworks centered on broader macroeconomic objectives like price stability and full employment while weighing trade-offs between these aims and possible unintended consequences for housing markets from interest rate decisions.

Discuss at least 2 topics in discussing how we know that monetary policy played a role in housing market developments:

1. Timing of the housing boom: The paper investigates the chronology of the housing bubble's inflation relative to shifts in Federal Reserve monetary policy. It highlights that the surge in housing prices initiated in 2002, shortly after the Fed started cutting interest rates considerably to combat the 2001 recession. This close sequence implies monetary stimulus could have contributed to driving the real estate frenzy by making mortgages cheaper as the boom emerged. While not definitive, the timing evidence lends some weight to the view that loose rate settings feeding the bubble played a part in its eventual magnitude.

2. Economic simulation models: The paper leverages economic forecasting models to quantitatively assess the relationship between monetary policy decisions and housing market outcomes. Namely, it deploys the Federal Reserve's own FRB/US model as well as a vector autoregression model to simulate counterfactual scenarios had interest rates behave differently.

The results indicate monetary stimulus likely catalyzed greater housing demand indirectly by making mortgages cheaper. However, the authors caution that these models have shortcomings in capturing the full complexity, so while suggestive of a link between rates and the housing frenzy, the findings should be interpreted carefully without overstating them.

Use at least one example in the essay.

The paper investigates the housing bubble's chronology and evolution relative to shifts in Federal Reserve interest rate policy during that period. It highlights that housing prices accelerated rapidly starting in 2002, shortly after the Fed initiated aggressive rate cuts to prop up the economy out of the 2001 recession. This close sequence suggests monetary easing perhaps helped lay the groundwork for the emerging real estate frenzy. However, the paper also discusses how the housing boom persisted even well into 2004 and beyond after the Fed had switched to raising rates again. This continuation even once stimulus was being withdrawn implies other forces were also at play fueling irrational exuberance in the housing market on the way up, not just low rates kickstarting it. Analyzing both the timing of the initial lift-off as well as the prolongation gives a more complex perspective on the interrelationship between monetary policy and housing mania.

References:

Wright, R.E. & Quadrini, V. (2009). Money and Banking. Saylor Foundation.

Dokko, J., Doyle, B., Kiley, M., Kim, J., Sherlund, S., Sim, J., & Van, S. (2009). Monetary Policy and the Housing Bubble. https://www.federalreserve.gov/pubs/feds/2009/200949/200949pap.pdf

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