



Contents lists available at ScienceDirect

## Journal of Economics and Business



# The U.S. housing price bubble: Bernanke versus Taylor



Abrar M. Fitwi<sup>a</sup>, Scott E. Hein<sup>b,\*</sup>, Jeffrey M. Mercer<sup>b</sup>

<sup>a</sup> Department of Business Administration and Economics, Saint Mary's College, United States

<sup>b</sup> Rawls College of Business, Texas Tech University, United States

### ARTICLE INFO

#### Article history:

Received 14 January 2014

Received in revised form 6 April 2015

Accepted 10 May 2015

Available online 18 May 2015

#### Keywords:

Monetary policy

Taylor rule deviations

Bernanke

International capital inflows

U.S. housing prices

Financial crisis

Macro-economic forces

#### JEL classification:

E00

E39

E58

F00

F21

F39

G12

G15

R00

### ABSTRACT

This paper examines the effects of two major macro-economic forces argued by opposing renowned U.S. economists to have contributed most significantly to the U.S. housing price bubble that preceded the recent global financial crisis. The first force examined, as argued by John Taylor, is the Federal Reserve's loose monetary policy stance from 2002 to 2005. The second force examined, as argued by Ben Bernanke, is the substantial global inflow of capital to the U.S. over the same time period. We develop and estimate a reduced form model for U.S. housing prices, and find evidence consistent with both factors' contributing significantly to the recent macro-housing price behavior in the U.S.

© 2015 Elsevier Inc. All rights reserved.

\* Corresponding author. Tel.: +1 806 834 3433; fax: +1 806 742 3197.

E-mail addresses: [afitwi@saintmarys.edu](mailto:afitwi@saintmarys.edu) (A.M. Fitwi), [scott.hein@ttu.edu](mailto:scott.hein@ttu.edu) (S.E. Hein), [jeffrey.mercer@ttu.edu](mailto:jeffrey.mercer@ttu.edu) (J.M. Mercer).

## 1. Introduction

The U.S. housing price run-up and its subsequent collapse are considered by many to be central elements in causing the recent global financial crisis. To this day, the primary cause of the bubble remains hotly debated.<sup>1</sup> Numerous explanations of the bubble have been offered by academics, finance professionals, and policymakers alike. The list of possible causal links is indeed quite long and exhaustive, including the growth of mortgage securitization and the related “originate-to-distribute” development related to efforts to enhance “affordable housing,” biased ratings by credit rating agencies, the creation of non-traditional mortgages, the naïve expectation that housing prices can only rise, and many other possibilities.

Among these possibilities, two explanations in particular have garnered substantial attention in the press and from policymakers and legislators partly because of the stature of their key proponents. The first proponent, Taylor (2009a, 2009b), argues that the monetary policy actions of the Federal Reserve in the 2002–2005 period played a significant role in causing the substantial rise in housing prices by keeping the target fed funds rate “too low.” In Taylor’s framework, the actual level of the funds rate is compared to the level given by “the Taylor Rule” (Taylor, 1993). Taylor points out that the Fed’s earlier policy toward the level of the funds rate had been consistent with the Taylor Rule, but that it deviated substantially in the run-up to the bubble period, suggesting excessively easing monetary policy in the U.S. was a key motivating factor.

The second proponent, former Federal Reserve Chairman Ben Bernanke, disagrees that the Fed had a role to play in the housing bubble. Bernanke (2010) responded to the claims of Taylor and others by noting that monetary policy from 2002 to 2005 appears to have been reasonably consistent with the Federal Reserve’s mandated goals of maximum sustainable employment and price stability. Moreover, he finds no support for a monetary explanation outside of the U.S. when he looks at international evidence linking Taylor Rule deviations to housing prices. He further argues that the policy was appropriate, given the state of the economy at that time and the information that was available to policymakers. Bernanke concluded that the low target fed funds rate from 2002 to 2005 had only a small impact on housing prices. Bernanke instead attributes the housing market boom to the global inflow of capital to the U.S., which in turn kept long-term interest rates low. He finds international evidence that he views as being consistent with his argument (Bernanke, 2010). In a speech that reviewed monetary policy in the aftermath of the 2001 recession, Bernanke also pointed to international evidence on the relationship between monetary policy and housing prices (Bernanke, 2010).

These counter claims are interesting *prima facie*, but even more so given the professional stature of each of these two proponents. To date, there is no unanimous agreement on either claim; it is an issue that has been rigorously debated, with strong opinions on both sides of the matter, but little direct evidence. Additionally, there is an obvious policy perspective to knowing more about the factors that led to one of the worst financial crises of modern time.

The existing literature finds indirect support for each of the two opposing views. The first view is supported by Taylor himself (2009a), Jarocinski and Smets (2008), Ahrend (2010), and Ahrend, Courneade and Price (2008). Taylor finds support for his claims that Federal Reserve policymakers are at least partially responsible for the housing price increase by maintaining low interest rates for too long. Taylor finds evidence that the Fed deviated from historical precedent and principles for setting interest rates in the 2002 to 2005 period. His rule (known widely as the Taylor Rule), showing how the Fed traditionally sets the target for the federal funds rate by trying to achieve its dual mandate, is shown to have worked well for 20 years, before the 2002–2005 period. Taylor provides evidence, however, that the Fed chose to keep interest rates lower than usual, given economic conditions at the time, beginning in 2002. In his view this was a primary cause of the subsequent housing price increases in the U.S. Interestingly, Taylor does not provide direct support for his claim, but provides

<sup>1</sup> On December 11, 2013 CNBC ran a one-hour special of “The Kudlow Report” with Alan Greenspan and John Taylor debating live the specific issues addressed in this paper.

Download English Version:

<https://daneshyari.com/en/article/957933>

Download Persian Version:

<https://daneshyari.com/article/957933>

[Daneshyari.com](https://daneshyari.com)