Comment on "Consumption and House Prices in the Great Recession"

March 10, 2017

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- This comes at the expense of some detail in other directions.

Thin parts of the model

- Exogenous endowments of labor income; inelastically supplied labor.

- Financial intermediaries that are risk-neutral and not subject to default risk.

- Fixed real rates, so the lenders who lose when borrowers default are in some other country.

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- Then the collapse arises as people shift their beliefs about future demand.

- Financial frictions and their relaxation have a role to play in understanding the boom and bust, but are not in themselves the main source of what went on

Policy implications

- Rational expectations are not necessarily ex post accurate.

- In this economy *no one* knows that their beliefs in a future rise in housing demand are inaccurate. Presumably this includes potential policy makers.

- Beliefs about future returns will sometimes be overoptimistic. If they are rational, they will not *always* err in the direction of overoptimism.

- This paper reminds us that the existence of investment booms and busts, even big ones, does not imply we need to prevent booms.

Missing pieces (unfair criticisms)

- Differing beliefs

- Land price volatility from beliefs about future technology growth

Belief differences

- Agents who have different beliefs will see each other as opportunities to increase expected returns by taking on risk: betting with each other.

- With incomplete asset markets so they can't bet directly, they may use lending, borrowing, investment and short sales (if these are possible) to replicate simple bets.

- When uncertainty is resolved, there are large wealth redistributions. If they are mediated by leverage, this can stress the financial system.

- In this model house value declines and mortgage defaults have consequences for homeowners, but there are no consumers in the model who directly or indirectly are affected by valuation of the mortgages.

Land price volatility from growth risk

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- If technological growth rates vary persistently, an upward shift in beliefs about growth rates raises the value of both land and reproducible capital.

- The value of reproducible capital comes back to a steady state, because of its reproducibility.

- Land in fixed supply rises in value as soon as beliefs about future growth have risen, and the land values stay up.

- Most of house price volatility is in the price of land.

Qualifications to policy implications from these omissions

- The relative importance of financial frictions is likely to be greater once the model has consumer agents who borrow and lend to each other via financial intermediaries who can default. So the paper's implication that the main story is overoptimistic common beliefs, not intermediary balance sheets, might need qualificaiton.

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- This model focuses tightly on beliefs about housing market. It could be that much of the model's dynamics would work without the dramatic shifts in beliefs about demand for housing itself. Policy that attempted to increase public understanding about the housing market might not hit the main source of fluctuations in house prices.