How Monetary Policy Shaped the Housing Boom

by Drechsler, Savov, and Schnabl

Discussion by Christopher Palmer
MIT Sloan & NBER

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Contributions

• Address debate about monetary policy vs. lending standards and the mortgage boom
• Argue timing doesn’t line up for low rates to be problem
• Provide explanation for rising rates => PLS growth

Two major contributions:

1. Unifying explanation for boom: combining monetary policy and rise in private-label securitization
2. Cross-sectional exposure for identification
Fed raises rates

Banks with market power don't pass through 1-1

Deposits (relatively) decrease

Banks (relatively) contract portfolio lending

PLS lending increases in exposed areas

DSS (QJE, 2017)

Banks fund portfolio lending with deposits

\( Q^{\text{monopoly}} < Q^* \)

vacuum
Findings

1. Avg bank passed through only 60% of Fed tightening
2. Banks with most market power passed through least
3. Banks w/ most market power had lower deposit growth
4. Banks w/ most market power increased lending least
5. PLS increased most where bank market power highest
6. Basically all of 2003-2006 increase in PLS share explainable by cross-sectional exposure to deposit channel
Fed raises rates → Banks with market power don't pass through 1-1 → Deposits (relatively) decrease → PLS lending increases in exposed areas → Banks (relatively) contract portfolio lending

What’s the difference?

Key possibility raised: Reverse causality

Banks choose to not pass through 100% of FFR hike when return to portfolio lending goes down
Stupidity or Endogeneity?

Implication of paper: Banks either

a) failed to anticipate PLS market coming and thought could retain more lending market share than did
   • Why don’t banks compete more?
   • “Shucks, guess we’ve been disrupted.”
   • Could have replicated non-bank securitized lending more.

b) made a calculation that increasing spread was worth losing lending market share
   • Could have held spreads and kept up portfolio lending
Alternative, also-consistent story

Key step: did deposit market power explain PLS geography?

Key question: did deposit channel drive increase in PLS share? Or vice-versa?

Low rates, savings glut
Reach for yield
Demand for PLS
PLS supply crowds out portfolio lending
Banks price deposits less competitively where PLS grows most

See Countrywide opening up, decide to just take profits on deposit side

Bernanke (2010)
Becker and Ivashina (JF, 2014)
Merrill, Nadauld, Strahan (MS, 2017)

Nadauld and Sherlund (JFE, 2013)
Mian and Sufi (2018)
Consistent with Taylor (2007)?

- Authors point out time inconsistency of Taylor’s claim that too-low rates caused lending standards decline.
- But Taylor’s point isn’t about nominal changes.
- All about levels relative to Taylor rule.

**Figure 1**

Counterfactual Federal Funds Rate

Actual Federal Funds Rate

Figure 1
Counter: Bernanke (2010)

Figure 12: Monetary Policy and House Prices in the Advanced Economies

The correlation between Taylor rule residuals and house prices is stronger if the sample is restricted to only countries in the euro area (marked in red), with the simple correlation rising from -0.22 to (a still statistically insignificant) -0.48. However the direction of causation is complex. For example, within the euro area the policy interest rate is common to all countries, thus variation in Taylor rule residuals is driven purely by differences in local inflation and output. Countries with higher output growth and inflation than the euro area as a whole will likely have negative Taylor rule residuals (or positive residuals in the opposite case), as policy is set for the entire economy. Countries with stronger growth will also likely have more demand for housing and if the supply of houses is at least somewhat inelastic in the short run, more house price appreciation. Thus the observed negative correlation could result in this case, even if monetary policy was not loose relative to a Taylor rule in the aggregate or if monetary policy has little or no effect on house prices.

The observation that the correlation between Taylor rule residuals and house prices is more pronounced in a case in which there is no variation in the policy interest rate and that the correlation may be spuriously driven by other factors.

...but we’re generally skeptical of cross-country growth regressions.

Should deposits channel -> PLS be operant everywhere? Or only where PLS in play?

Source: IMF (2009)
What could rule this out?

• Estimate deposit effects within-bank since lending and deposits needn’t be co-located?
  • No, since lending effects are at the bank/county level, doesn’t rule out reverse causality

• Controls for future return on lending?
  • No, low $R^2$. Still lots of scope for omitted variables.

• Measuring beta in pre-period?
  • Helps rule out contemporaneous shocks to local PLS supply, but measure conflates deposit market power with lower return on activities funded by deposits
What could rule this out? (2)

• Show effects on house prices?
  • No, doesn’t rule out reverse causality

• 2SLS of lending on deposit changes with mkt power IV?
  • No, first-stage correlated with lending demand shocks

• Placebo tests? 2000-2002 reverse causality story: exposed banks slow lending growth even when MP loose

• Identifying cross-sectional magnitude of other local supply shock channels (e.g., final demand) and show they are identified but near zero effect on PLS share
Conclusion

• Banks with market power find it profitable to not pass through 100% of rate hikes even though lose non-GSE lending market share
• Creates local vacuums for PLS market, shown to contribute to housing boom
• Find this explains *all* of PLS growth from 2003-2006
• No room for other cross-sectional reasons for some areas to increase PLS share more than others
• Important to better address that deposit spreads are a choice influenced by anticipated local PLS boom