Monetary Policy and Mortgage Problems

BY CHARLES GERENA

"Do People Understand Monetary Policy?" Carlos Carvalho and Fernanda Nechio, Federal Reserve Bank of San Francisco Working Paper 2012-01, January 2012.

Quick quiz: When inflation is rising and unemployment is low, what does the Fed usually do? The answer has long been to increase interest rates in order to make money more costly and keep the economy from overheating.

Targeting interest rates in response to changes in inflation and output — and, thus, following something like the "Taylor rule" — is a monetary policy approach that is much discussed among researchers and central bankers. But if individuals and businesses don't fully understand how the Fed meets its dual mandate of price stability and maximum employment, policymakers may have a harder time managing inflation expectations and, in turn, keeping prices stable.

Carlos Carvalho of the Pontifical Catholic University of Rio de Janeiro and Fernanda Nechio of the San Francisco Fed try to gauge the public's level of monetary policy literacy. Using the Thomson Reuters/University of Michigan Surveys of Consumers, they examine responses related to the future direction of price movements, interest rates for borrowing money, and unemployment to see if they are consistent with the Taylor rule. For example, if people who believe unemployment will decline are more likely to believe that interest rates will go up in the future than those who forecast rising unemployment, they are making a connection that is consistent with the Taylor rule.

Carvalho and Nechio find there is some awareness of how monetary policy happens. "The degree of awareness, however, does not appear to be uniform across income and education levels, and age groups," the economists note. "Higher income, more educated, and older households appear to be more aware of the Taylor rule than younger, less educated, and lower income households."

"Why Did So Many People Make So Many *Ex Post* Bad Decisions? The Causes of the Foreclosure Crisis." Christopher L. Foote, Kristopher S. Gerardi, and Paul S. Willen, Federal Reserve Bank of Boston Public Policy Discussion Paper 12-2, May 2012 (also published as Federal Reserve Bank of Atlanta Working Paper 2012-7, May 2012).

Here's a familiar storyline about the mortgage default crisis — brokers persuaded prospective homeowners to take out unconventional loans that they eventually couldn't afford, while investment bankers persuaded investors to buy hard-to-understand mortgage-backed securities that were far riskier than investors appreciated. In both cases, the "insiders" exploited information that the "outsiders" didn't have, motivated by their lack of exposure to the downside of the transaction.

In their May 2012 paper, Christopher Foote and Paul Willen of the Boston Fed and Kristopher Gerardi of the Atlanta Fed argue this "insider/outsider" depiction of the foreclosure crisis is inaccurate. Rather, the authors assert, people were simply "overly optimistic" about the future path of the housing market.

"Higher house price expectations rationalize the decisions of borrowers, investors, and intermediaries — their embrace of high leverage when purchasing homes or funding mortgage investments, their failure to require rigorous documentation of income or assets before making loans, and their extension of credit to borrowers with histories of not repaying debt," they note. "The bubble theory therefore explains the foreclosure crisis as a consequence of distorted beliefs rather than distorted incentives."

"Time-to-Plan Lags for Commercial Construction Projects." Jonathan N. Millar, Stephen D. Oliner, and Daniel E. Sichel, Federal Reserve Board of Governors Finance and Economics Discussion Series 2012-34, April 2012.

Following the last four recessions, commercial construction recovered more slowly than the economy as a whole. Part of the reason may be the time required to plan a project before a single shovelful of dirt is turned. Yet little is known about the typical length of this "time-to-plan" lag or the factors that influence it.

Jonathan Millar and Daniel Sichel at the Federal Reserve Board of Governors and Stephen Oliner at the American Enterprise Institute provide their best estimates of the time-to-plan lag based on an analysis of more than 80,000 commercial construction projects in the United States from 1999 to 2010. They find the lag was quite lengthy — averaging one year and five months — and was the longest for larger, more complex projects and those located in metropolitan areas in California and the Northeast.

Another key finding is that the regulatory environment faced by project planners contributes to some of the variation in time-to-plan lags across locations. Using results from a survey of land-use regulation in 6,900 municipalities, Millar, Sichel, and Oliner find a positive correlation between lags and the number of local agencies required to approve zoning changes. Also, "the planning period tends to be shorter in places (i) that require developers to help pay for infrastructure improvements, (ii) that restrict the density of development, (iii) that have greater political opposition to development activity, and (iv) whose land-use regulations tend to be upheld by the courts." **RF**