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RESEARCH SUMMARY

Housing Policy, Monetary Policy, and the Great Recession: Challenging the Standard Narrative, Preventing Future Crises?

The conventional narrative of the early 2000s is that low interest rates and banking deregulation contributed to an excess of demand in the US housing market, with growing lending and speculation creating a bubble. The bursting of the bubble, so the narrative goes, led to the Great Recession. If the problem was excess housing demand, the policy solution was tightening lending standards.

In "Housing Policy, Monetary Policy and the Great Recession," Scott Sumner and Kevin Erdmann question this narrative, rejecting the claim that excessive demand caused the financial crisis. They argue that a constrained supply of new housing in a few key urban centers was the primary trigger for high home prices before the crisis. Tightening lending standards across the board, therefore, served to depress housing markets for years after the crisis.

MISDIAGNOSING THE PROBLEM LED TO IMPROPER TREATMENT

Policymakers should not slow the economy in an attempt to prevent bubbles, which are not easy to identify in real time. Such efforts to reduce demand in 2007–08 were not only unnecessary but were also responsible for the recession and financial crisis.

Instead, US policymakers should adopt regulatory, credit, and monetary policies that can help stabilize the economy, allowing the creation of an environment for healthy growth in living standards. Such an approach involves three components:

1) *Reform zoning regulations in urban areas*. This would allow for more construction of new housing, especially in closed-access cities such as Boston, Los Angeles, New York City, and San Francisco, where constrained growth is currently resulting in high housing prices. The United States could sustainably employ many more workers in home construction if restrictions on building were removed.

2) *Avoid a situation where lending regulations are most lax during booms and tightest during recessions*. It was this sort of regulatory pattern that almost certainly exacerbated the severity of the Great Recession.

3) *Monetary policy should seek stable growth in nominal gross domestic product (NGDP)*. Rather than targeting inflation and unemployment, policymakers should aim for a relatively stable rate of growth in NGDP, the dollar value of all goods and services produced within a nation's borders. Attempts to use monetary policy to pop bubbles in individual asset markets such as real estate often end up destabilizing the overall economy. A stable NGDP growth rate, however, will provide an environment that is conducive to a stable labor market and a stable financial system.

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