Betting the House

Ò scar Jordà

Federal Reserve Bank of San Francisco

University of California, Davis

and

Moritz Schularick

University of Bonn

Centre for Economic Policy Research

Hong Kong Institute for Monetary Research

and

Alan M. Taylor

University of California, Davis

National Bureau of Economic Research

Centre for Economic Policy Research

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Summary

Is there a link between loose monetary conditions, credit growth, house price booms, and financial instability? This paper analyzes the role of interest rates and credit in driving house price booms and busts with data spanning 140 years of modern economic history in the advanced economies. We exploit the implications of the macroeconomic policy trilemma to identify exogenous variation in monetary conditions: countries with fixed exchange regimes often see fluctuations in short-term interest rates unrelated to home economic conditions. We use novel instrumental variable local projection methods to demonstrate that loose monetary conditions lead to booms in real estate lending and house prices bubbles; these, in turn, materially heighten the risk of financial crises. Both effects have become stronger in the postwar era.