

## The loose monetary policy and the housing bubble

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### Abstract

This research paper explores whether loose monetary policy has led to a real estate bubble. The background section of the study introduces the current impact of monetary policy on the real estate market and the importance of the formation and bursting of real estate bubbles. The significance of this research lies in understanding the mechanism by which monetary policy affects the formation of real estate bubbles and providing references for relevant policy formulation.

**Keywords:** loose monetary, housing bubble

### Introduction

In their article ‘Monetary Policy and the Housing Bubble,’ Dokko’s team (2009) states that these questions naturally occur with a casual glance at the data. Indeed, researchers are increasingly suggesting that loose monetary policy was a primary cause of the bubble in house prices and activity. John Taylor (2007, cited in Dokko 2009) provides an early example of a study ascribing a large role to “too loose” monetary policy in spurring housing activity after the 2001 recession. Although not universally held, this view has gained acceptance from many observers.

Before deeply discussing the generation and bursting of real estate foam, we must first define and identify it. Real estate foam usually refers to the situation that the house price in the real estate market is too high and does not conform to the actual economic fundamentals. The emergence of foam is closely related to investor sentiment, market expectations, monetary policy, and other factors.

To accurately judge the existence of real estate foam, various methods can be used to identify them. Firstly, we can start with the level of housing prices and compare whether there is a significant deviation between the long-term average level and the current housing prices. There may be a foam when the house price is much higher than the normal level. Secondly, we can observe the proportional relationship between housing purchase investment and residential demand. If the investment demand dominates and the enthusiasm for investment and real estate speculation rises, it may also be a sign of a foam. In addition, monitoring the trading activities of the real estate market is also very important, including indicators such as trading volume and trading cycle. The foam is likely driven by speculation if the market transaction is extremely active, frequent, and rapid.

When identifying the real estate foam, we should also

consider the impact of loose monetary policy on foam formation. The loose monetary policy encourages market investment activities by lowering interest rates and relaxing credit restrictions. However, if the loose policy is excessive, investors may borrow and invest excessively and push up the house price excessively, thus forming a foam. Therefore, for the definition and identification of the real estate foam, we cannot ignore the role of monetary policy in the overheated real estate market.

In practical application, it is necessary to comprehensively consider a variety of indicators and factors to accurately judge the existence and extent of the real estate foam. In addition to the indicators above, such as housing prices, the ratio of investment demand to residential demand, and trading activities, factors such as investor confidence index and the effectiveness of regulatory policies can also be considered. Only through comprehensive and objective observation and analysis can we judge whether there is a foam in the real estate market more accurately.

Traditional monetary policy typically adopts countercyclical regulation strategies during economic downturns to stimulate investment and consumption and promote economic recovery. This includes lowering interest rates and reserve requirement ratios and increasing the money supply. However, whether loose monetary policy will lead to excessive investment and increased risk-taking by real estate companies and what role monetary authorities play in real estate regulation remains a question that needs to be discussed.

### Arguments

As a macroeconomic regulation tool, monetary policy mainly affects economic activities by adjusting the money supply and interest rate levels. The types of monetary policy include both tightening and easing policies. Tight policy refers to controlling the speed of economic growth

by raising interest rates, tightening the money supply, and other means to avoid inflation. On the contrary, loose policies mainly stimulate economic growth, employment, and consumption by lowering interest rates and expanding the money supply.

The definition and types of monetary policy profoundly impact the real estate market. Firstly, the type of monetary policy determines the cost and supply of funds, directly affecting homebuyers' purchasing power and willingness. When monetary policy is loose, low-interest rates and abundant money supply will reduce the cost of funds for purchasing houses, promoting increased purchasing activities. On the contrary, when monetary policy is tightened, high-interest rates and a tight money supply will increase the cost of funds for buying houses and suppress demand for houses.

Secondly, the type of monetary policy will also impact the investment environment and real estate market expectations. The loose monetary policy usually causes capital to flow into the real estate market, driving up prices and forming a real estate foam. Due to low-interest rates and abundant money supply, home-buying investment has become a relatively feasible high-yield investment option. However, once monetary policy tightens, interest rates rise, and funding supply tightens, investor expectations change, which may lead to a reversal of the supply and demand relationship in the real estate market, a drop in prices, and ultimately trigger adjustments or even crashes in the real estate market.

After understanding the definition and type of monetary policy, we can see that loose monetary policy tends to positively impact the real estate market and induce the risk of a real estate foam. Therefore, it is necessary to choose and implement monetary policies reasonably based on the actual situation and economic development stage to provide solid support for the healthy and stable development of the real estate market.

In summary, the definition and type of monetary policy significantly impact the real estate market. The loose monetary policy will promote the development of the real estate market to a certain extent, but it also brings the risk of a real estate foam. Therefore, when formulating and implementing monetary policy, it is necessary to comprehensively consider various factors to ensure mutual coordination between monetary policy and the real estate market to achieve sustainable economic development.

Loose monetary policy refers to a policy measure taken by the central bank to stimulate economic growth by lowering interest rates and increasing the money supply. It has a series of characteristics and significantly impacts the real estate market.

Firstly, one of the characteristics of loose monetary policy

is the reduction of interest rates. The central bank encourages borrowing and investment by lowering interest rates to stimulate economic activity. In the real estate market, low-interest rates reduce the cost of home loans, thereby stimulating an increase in demand for home purchases. In this situation, people are more willing to purchase real estate, which promotes the prosperity of the real estate market.

Secondly, loose monetary policy will also increase the money supply. The central bank increases the amount of money in circulation by purchasing bonds, lending, and other means, increasing the money supply in the market. In this way, there are relatively abundant funds in the market, making it more convenient to finance real estate projects. Project developers can easily obtain financial support, thereby promoting the development of the real estate market.

Thirdly, loose monetary policy usually leads to an increase in investors' risk appetite. Lowering interest rates and increasing the money supply will encourage investors to seek higher returns. The real estate market is usually seen as a relatively stable and high-return investment area; therefore, under loose monetary policy, investors are more inclined to invest their funds in the real estate market. In this way, the demand in the real estate market will become stronger, and housing prices will correspondingly rise.

However, the impact of loose monetary policy on the real estate market is not entirely positive. Excessive loose monetary policy may form a foam in the real estate market. When housing prices rise rapidly, investors may develop a speculative mentality, further pushing up housing prices. Under such circumstances, the real estate market is in the foam stage. Once the foam bursts, it may cause financial risks and economic instability.

The emergence of the real estate foam is a complex and multifactorial process. In the past few decades, we can observe that loose monetary policy has, to some extent, driven the rapid growth of the real estate market. However, the loose monetary policy is not the only reason for the foam in real estate. There are other factors.

First, the imbalance between supply and demand is one of the important reasons for the emergence of the real estate foam. The real estate market's supply is limited, but demand has been maintaining a rapid growth trend. With the growth of population, the acceleration of the urbanization process, and the increase of residents' income, people's demand for housing continues to increase. However, due to limited land supply and long development cycles, the growth of the real estate market supply is relatively lagging, and the imbalance between supply and demand is gradually intensifying, creating conditions for the formation of the real estate foam.

Secondly, the proliferation of financial innovation and leveraged debt is also an important driving factor for the emergence of the real estate foam. Financial innovation has led to the emergence of various financial products, including loans and investment tools related to real estate. Due to the promotion of financial innovation, the financing channels in the real estate market have become more relaxed, and the government and financial institutions have provided more loans and financial support for homebuyers. In this case, it is generally easy for buyers to obtain low-cost loans, which has prompted the real estate market to rise, forming a price foam.

In addition, short-term speculation and market sentiment also played a certain role in forming the real estate foam. When the real estate market starts to rise, investors generally have a speculative mentality, believing real estate is a quick way to obtain capital returns. The spread of market sentiment and the increase in speculative behavior have further driven the price increase in the real estate market. However, once the market sentiment reverses, investors begin to worry about the foam of the market and the continuous decline of prices, which will lead to the bursting of the real estate foam.

### Conclusion

To sum up, the real estate foam results from multiple factors. The loose monetary policy has promoted the rapid growth of the real estate market to a certain extent. The imbalance between supply and demand, the overflow of financial innovation and leveraged debt, short-term speculation, and market sentiment are also important reasons for the emergence of the real estate foam. To avoid the

emergence of future real estate foam, the government and regulatory agencies should strengthen the supervision of the real estate market, reasonably regulate monetary policy, and avoid excessive easing. At the same time, corresponding measures need to be taken in areas such as land supply, financial innovation, and market sentiment to ensure the stability and sustainable development of the real estate market.

Taylor's (2009) article 'The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong' indicates that the classic explanation of financial crises, going back hundreds of years, is that excesses cause them—frequently monetary excesses—which leads to a boom and an inevitable bust. In the recent crisis, we had a housing boom and bust, which in turn led to financial turmoil in the United States and other countries. I begin by showing that monetary excesses were the main cause of that boom and the resulting bust.

To sum up, the loose monetary policy has promoted the emergence of the real estate foam to a certain extent. The imbalance between supply and demand, the flood of financial innovation and leveraged debt, short-term speculation, and market sentiment are also important reasons for the emergence of the real estate foam.

### References

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