

Discussion of Arslan, Guler and Taskin (2013) Joint Dynamics of House Prices and Foreclosures

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Dallas Fed Housing and Macro Conference
November 14, 2013

Disclaimer

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- not as a representative of:
 - The Boston Fed
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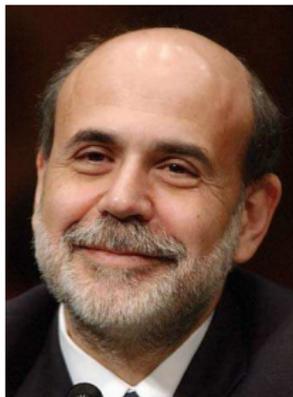
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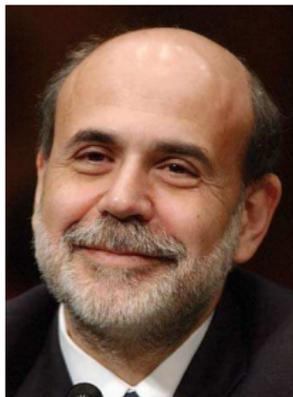
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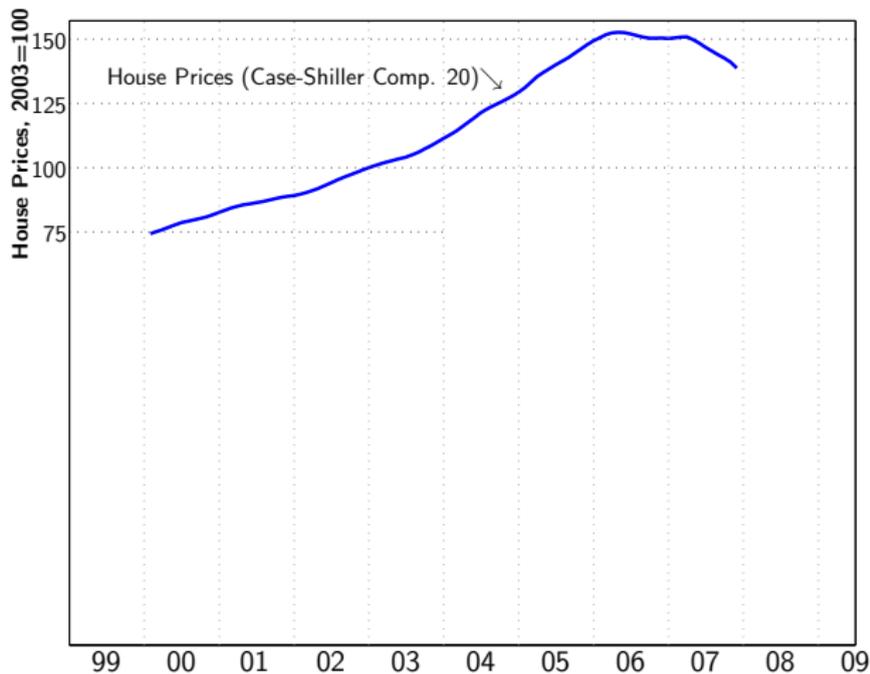
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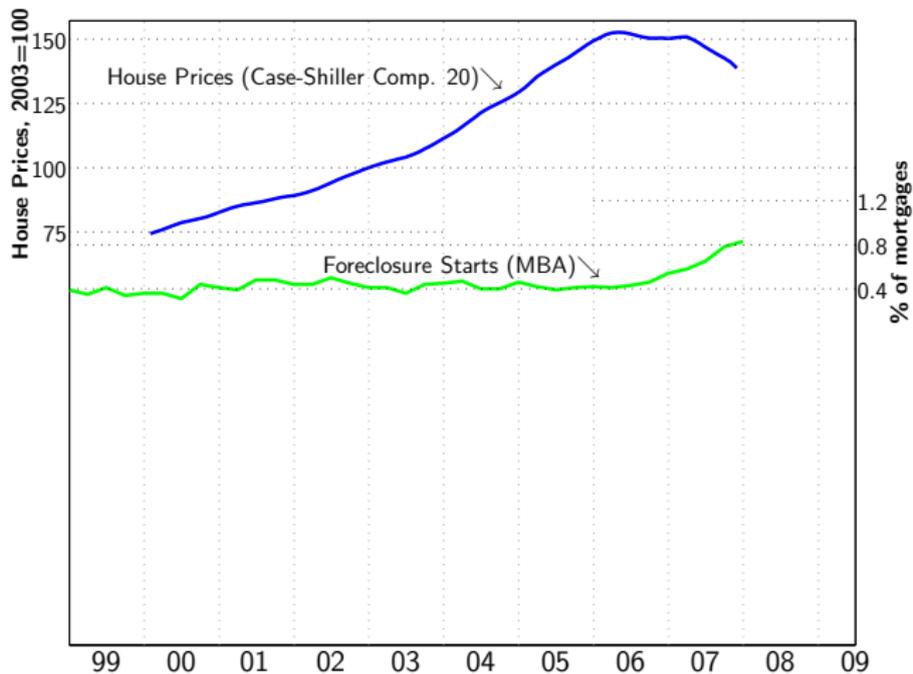


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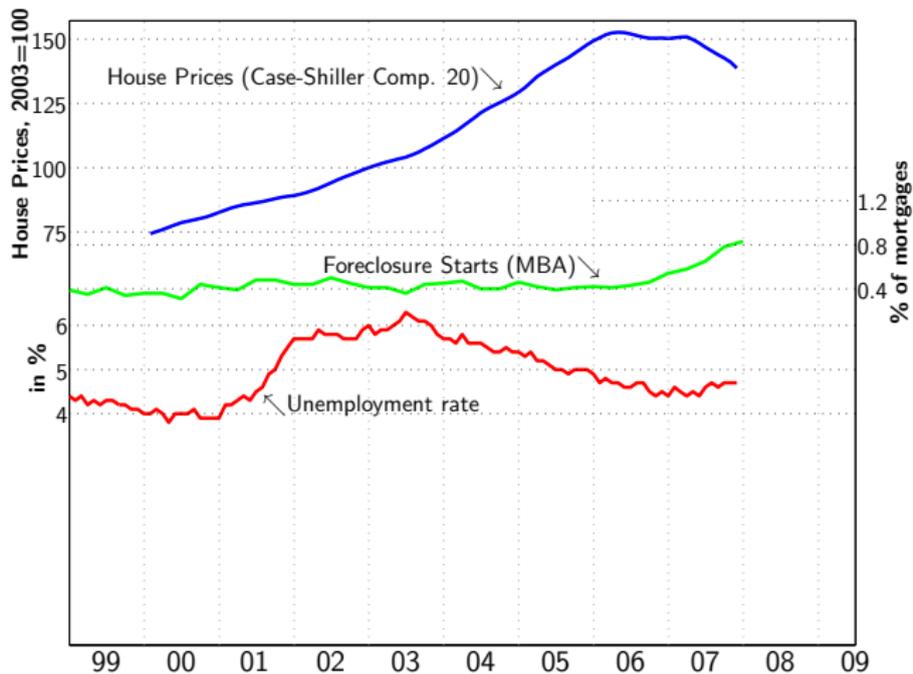
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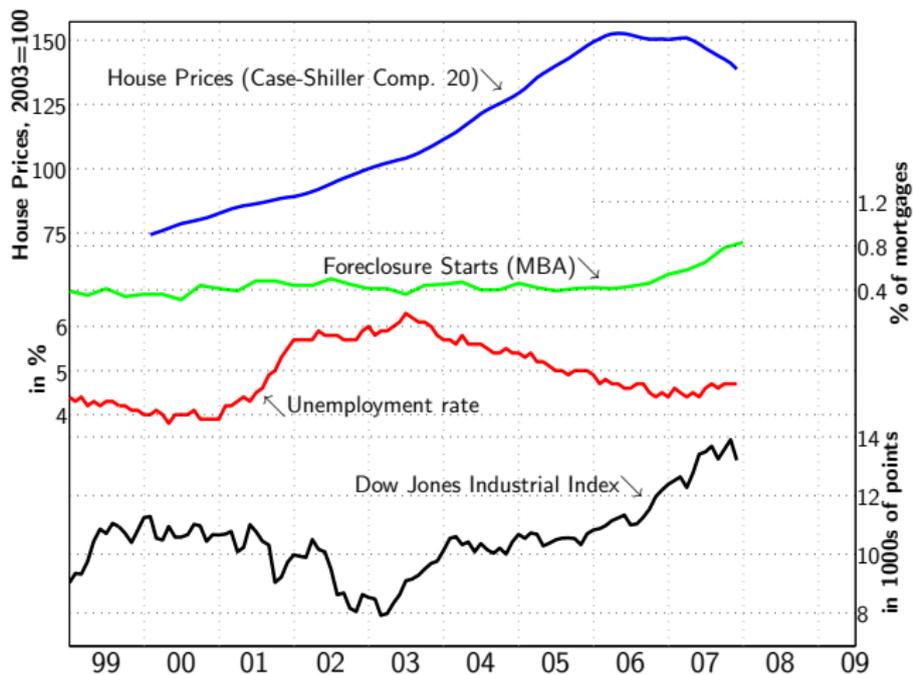
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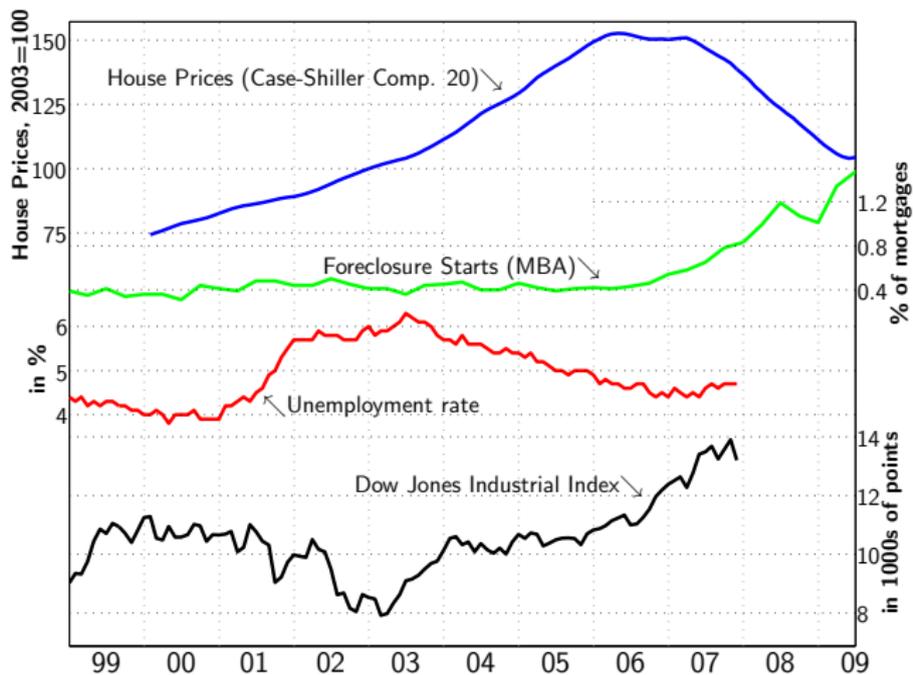
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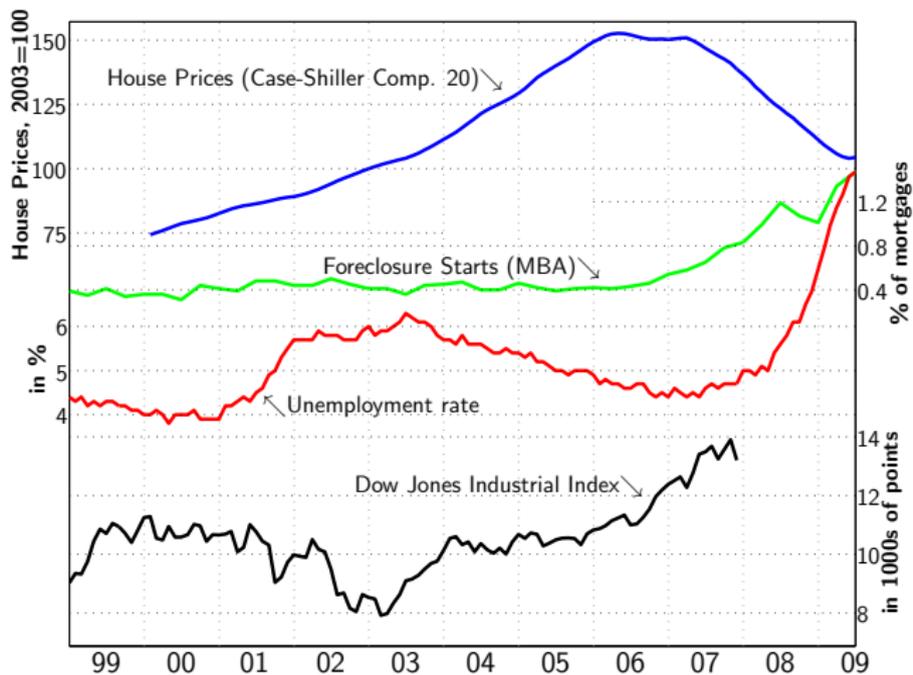
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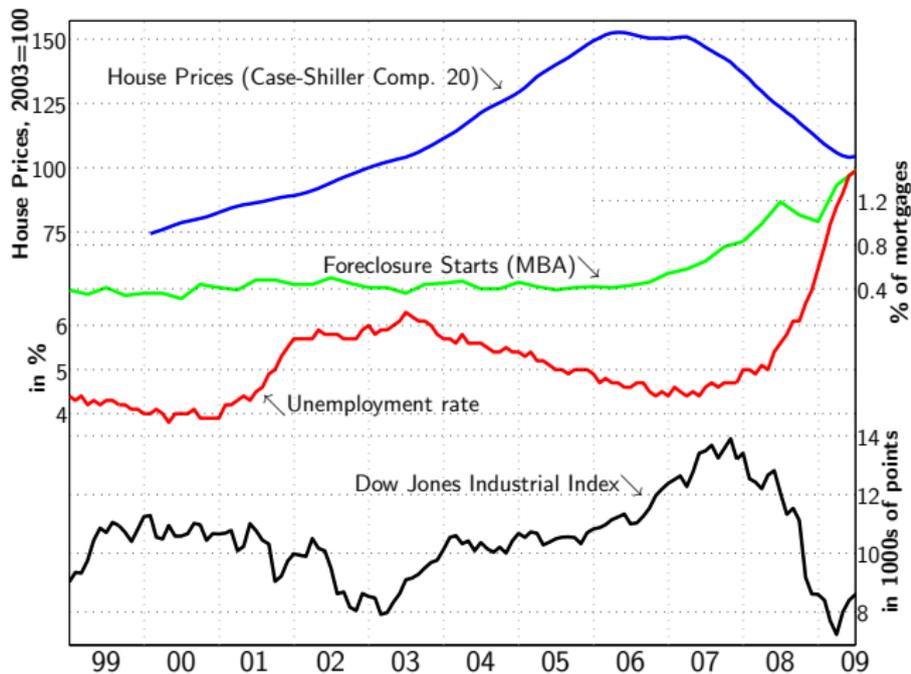
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This paper

- Authors construct a dynamic general equilibrium model with exogenous:
 - 1 risk free rate (2% versus 3%)
 - 2 minimum down payment requirement (0% versus 20%)
 - 3 unemployment rate (5% versus 6.5%)
- 1. Solve for steady state equilibrium under different scenarios
 - constant unemployment rate:
 - unemployment = 6.5% forever
- 2. Consider transition from one steady state to another.
 - Equilibrium 1: $u = 5%$ forever.
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General Equilibrium

- The value of general equilibrium analysis is that
 - General equilibrium effects often confound partial equilibrium.
- Financial innovation (like relaxing borrowing constraints) allows two agents to share risk (PE insight). How can that reduce welfare?
 - If households do less precautionary savings, then asset prices fall and interest rates go up.
 - Borrowers are worse off.
 - and all households do less consumption smoothing.
- This paper asks what happens to default when the hazard of unemployment goes up.
 - for a given borrower, given loan, the \uparrow hazard of unemployment \Rightarrow \uparrow hazard of default. (PE insight)
- GE insight: \uparrow hazard of unemployment \Rightarrow \downarrow hazard of default.
 - Lenders demand higher interest rates because of the conditional probability of default for loans goes up.
 - leads to less borrowing and less default!

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Rational Expectations

- Consider the down payment requirement.
- Equilibrium 1: Down Payment requirement = 0%
 - All market participants believe that down payment is 0%
 - And will be forever.
- Transition to Equilibrium 2: Down Payment requirement = 20%
 - All market participants believe that down payment is 20%
 - And will be forever.
- What's the problem?
 - People believe that probability of change is 0
 - But it obviously isn't!
 - "Failure of Rational Expectations"
- This is not just a technical problem.
 - All the transition dynamics result from the fact that the change is completely unanticipated.

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Fundamental Problems with GE Asset Pricing

- To get big changes in asset prices in GE models
- You need changes in fundamentals that are
 - Big
 - Unanticipated
- Macroeconomic variables change very slowly
 - Worst Recession in 75 years: C falls 3%.
- So to explain wild swings in asset prices we need big changes
- Policy?
- Problem is that large, unanticipated changes in policy are very, very rare.

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Fundamental Problems with GE Asset Pricing

- To get big changes in asset prices in GE models
- You need changes in fundamentals that are
 - Big
 - Unanticipated
- Macroeconomic variables change very slowly
 - Worst Recession in 75 years: C falls 3%.
- So to explain wild swings in asset prices we need big changes
- Policy?
- Problem is that large, unanticipated changes in policy are very, very rare.

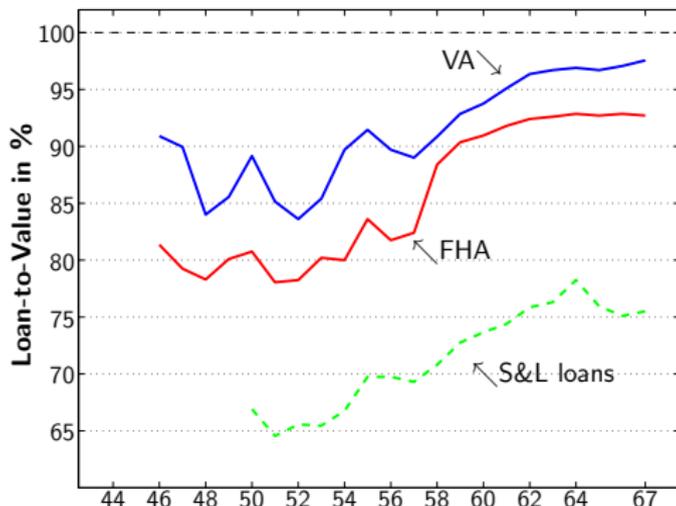
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 - Practitioners.
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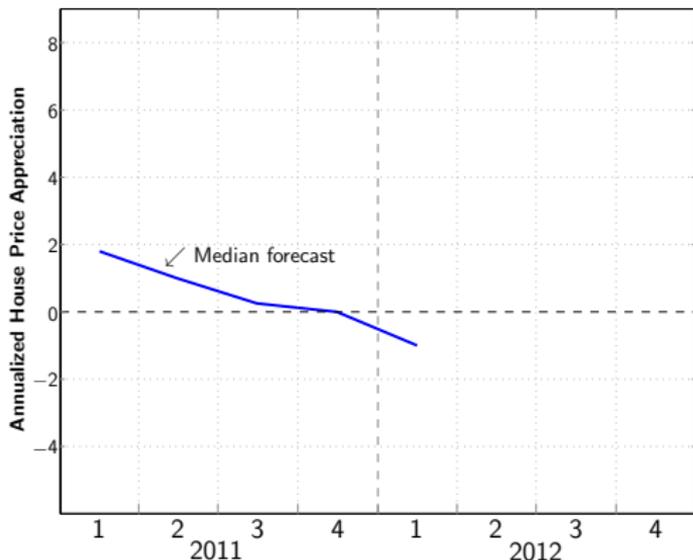
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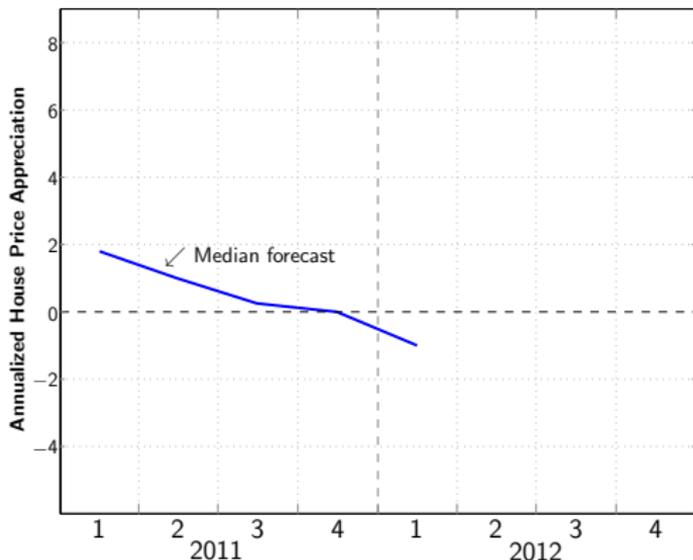
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Forecasts of 2012 House Prices



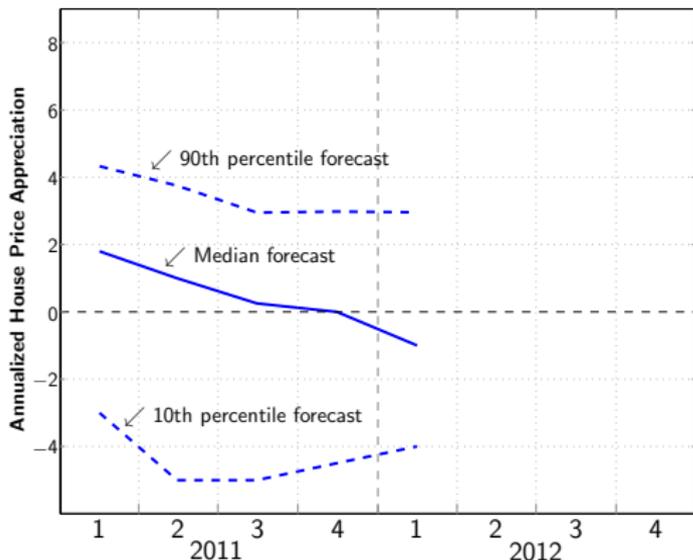
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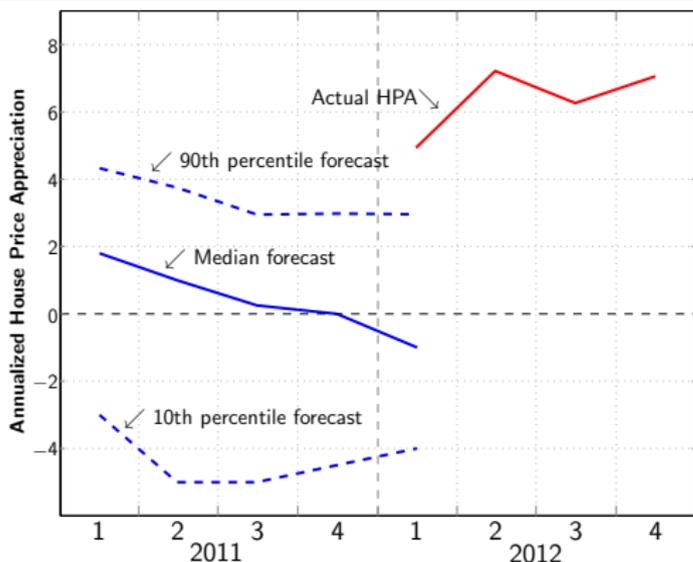
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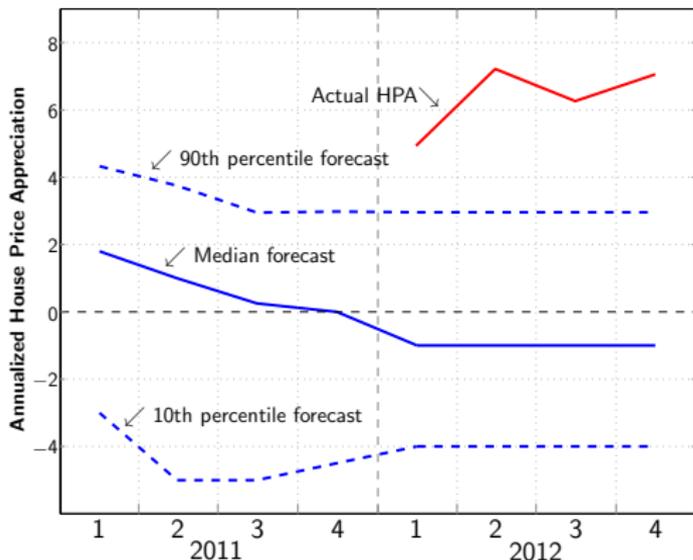
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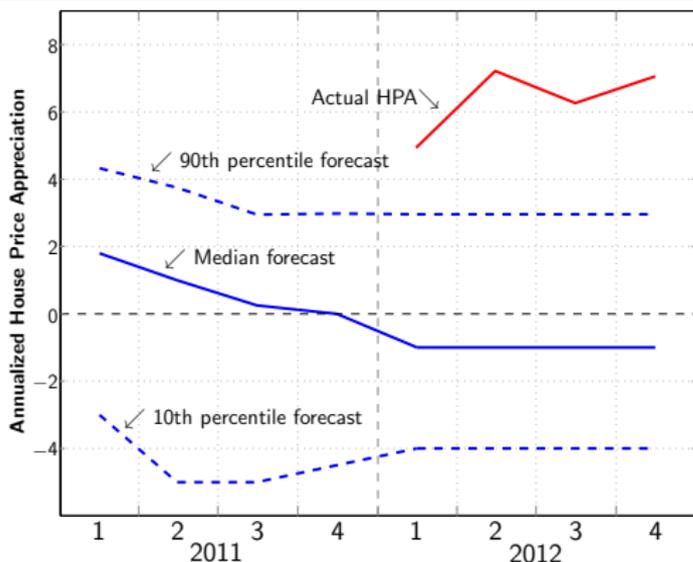
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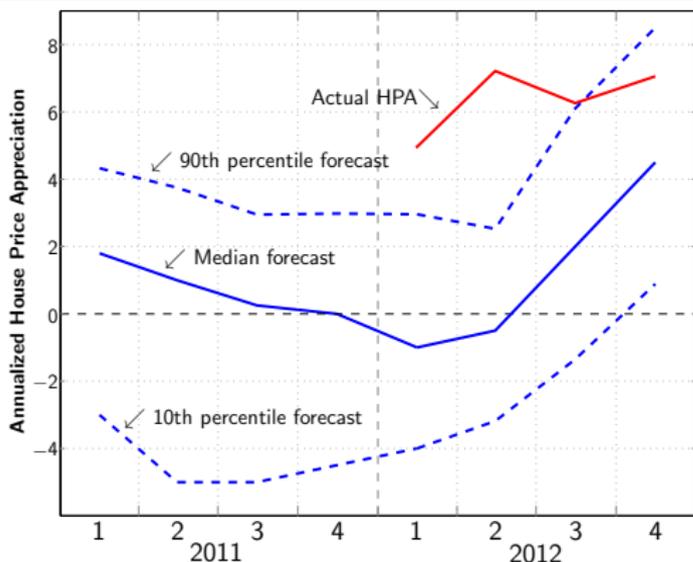
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