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Addressing Household Indebtedness: Monetary, Fiscal or Macroprudential Policy?

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Abstract

In this paper, we build a dynamic stochastic general-equilibrium model with housing and household debt, and compare the effectiveness of monetary policy, housing-related fiscal policy, and macroprudential regulations in reducing household indebtedness. Excessive household debt arises due to exuberance shocks on house price expectations, which drive a wedge between the actual and the underlying fundamental value of houses. The estimated model also features long-term fixed-rate borrowing and lending across two types of households, and differentiates between the flow and the stock of household debt. Our main findings can be summarized as follows: (i) Monetary tightening is able to reduce the stock of real mortgage debt, but leads to an increase in the household debt-to-income ratio. (ii) Among the policy tools we consider, tightening in mortgage interest deduction and regulatory loan-to-value (LTV) are the most effective and least costly in reducing household debt, followed by increasing property taxes and monetary tightening. (iii) Although mortgage interest deduction is a broader tool than regulatory LTV, and therefore potentially more costly in terms of output loss, it is effective in reducing overall mortgage debt, since its direct reach also extends to home equity loans. (iv) Lowering regulatory LTV and mortgage interest deductions from their current levels would be welfare improving, while we find weak support for systematic leaning against household imbalances through monetary policy.

Keywords: Household debt, monetary policy, housing-related fiscal policy, regulatory LTV.
JEL Classification: E52, E62, R38.

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