Housing, Stochastic Liquidity Preference, and Monetary Policy*

Robert R. Reed  
University of Alabama

Ejindu S. Ume  
Miami University

October 2015

Abstract

In recent years, the connection between housing market activity and monetary policy has received a large amount of attention. For example, what role does housing play in overall macroeconomic activity? To address the importance of housing for wealth accumulation, we study a model in which housing is traded across generations of individuals. Following Diamond and Dybvig (1983), individuals face stochastic liquidity preference shocks which impede housing accumulation. Intermediaries arise to help insure individuals against such idiosyncratic risk. However, inflation limits the extent of risk-sharing. In this manner, the model follows recent contributions which emphasize that shocks to discount rates contribute to wealth inequality. Moreover, in contrast to one-sector monetary growth models, we demonstrate that it is important to disaggregate fixed investment between the residential and non-residential sectors to determine the effects of money growth. In particular, monetary policy will have asymmetric effects across the components of the overall capital stock.

Keywords: Monetary Policy, Housing, Residential Capital

JEL Code: E52