CENTRE FOR MACROECONOMICS

Economic and Social Research Council

Optimal Credit Market Policy

CFM-DP2025-13

Matteo Iacoviello[1,4], Ricardo Nunes[2,3,5] and Andrea Prestipino[4]

[1]Centre for Economic Policy Research, [2]Centre for International Macroeconomic Studies, [3]Centre for Macroeconomics, [4]Federal Reserve Board of Governors, [5]University of Surrey

In the wake of the global financial crisis, there has been considerable debate about the best way to manage financial instability. Policymakers often rely on macroprudential measures—policies that prevent financial imbalances by restricting lending in good times—or they resort to policies that intervene after a crisis has already occurred to minimize damage.

This paper investigates optimal policies in credit markets using a comprehensive economic model that considers how housing serves as collateral for borrowing. The study specifically analyzes whether and how governments can improve welfare by implementing taxes or subsidies on housing and borrowing depending on economic conditions.

The analysis is built around a dynamic economic model with two types of agents: borrowers and savers. Borrowers are more inclined to spend today rather than in the future, and they typically borrow against their housing wealth. Savers, in contrast, are more patient, save more, and lend to borrowers. Economic downturns can drastically reduce housing prices, tightening the collateral constraints of borrowers. Such tightening exacerbates economic downturns because it forces borrowers to sell houses, further depressing house prices and amplifying economic instability.

The paper finds that introducing a housing tax during economic booms and subsidizing housing during recessions significantly improves welfare for both borrowers and savers. This policy effectively reduces sharp fluctuations in housing prices, softening the severity of downturns. Interestingly, the gains from this policy largely stem from the subsidies provided during recessions, which help stabilize the economy after a crisis rather than from the preventive measures during economic booms. This finding underscores the effectiveness of reactive policies, which assist the economy in recovering from crises, compared to purely preventive macroprudential measures.

Overall, the paper demonstrates that simple, conditionally varying taxes or subsidies on housing or borrowing can achieve substantial economic stability and welfare improvements, helping both borrowers and savers.