The Effect of Mortgage Interest Deduction and Mortgage Product Innovation on House Prices

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Abstract:
In many countries, house prices are overvalued according to price-to-income ratios. These ratios ignore the fact that nominal interest rates have decreased since the 1980s. Models that try to explain house prices based on a standard annuity mortgage can incorporate the role of the interest rate. We extend these models to incorporate mortgage interest deduction and the recent innovation in mortgage products. Our results indicate that there exists a long-run relationship between house prices and borrowing limits adjusted for mortgage interest deduction and mortgage characteristics. We show that this measure Granger causes house prices while evidence in the other direction is almost nonexistent. The model allows a better interpretation of housing markets and is useful for scenario analysis to improve decision-making.