The Economic and Social Review, Vol. 21, No. 3, April, 1990, pp. 333-334

Interest and Non-Interest Terms in the Process of Mortgage Market Clearing: A Reply

F.X. BROWNE
OECD, Paris

Thom (1990) argues that, in a situation of excess mortgage demand, loan applicants "with relatively low LV ratios (high DR ratios) have their demands satisfied while those with relatively high LV ratios are placed in a 'mortgage queue'. Hence successful applicants are on their desired demand curves *but the aggregate demand curve does not shift* and excess demand remains a feature of the market" (my italics). The key to Thom's argument is that, in the circumstances indicated, the aggregate demand curve does not shift. This, however, is no more than a mere hypothesis which does not, I think, possess much *a priori* appeal. If, after searching the market, an applicant finds that, because of generalised excess demand, there still remains a large discrepancy between what he/she can afford or is willing to pay (including all non-price terms of which the DR is one) and what is required by the building society, that person will clearly cease to actively search for a mortgage. Just like the discouraged job seeker will leave the labour market, the discouraged "mortgage seeker" will leave the mortgage market.

The fact that building society managers may follow a convention of enlisting applicants in a "mortgage queue" after having refused their demands is largely irrelevant to the issue of whether the aggregate demand curve shifts or not. It is the behaviour of mortgage applicants in such circumstances, rather than any rule that building societies may follow, which is relevant.

Therefore, I continue to maintain plausibly that endogenous changes in the downpayment ratio will shift the mortgage demand schedule. This, however, as Thom correctly points out, does create a problem with my analysis. With one particular qualification, I accept the analysis in paragraph three of his note. The best way around this problem is to relax the assumption that endogenous changes in DR shifts the demand schedule *contemporaneously*.

Thus, when a change in DR occurs, because of excess demand in period t, it is probably more reasonable to assume (because of the time-consuming nature of search activity) that this will not cause a shift in the demand schedule until period t+1. Given the stickiness of the loan rate of interest mortage excess demand is probably autocorrelated in time and thus endogenous changes in DR still contribute to clearing the mortgage market.

The qualification mentioned above is potentially a major one and relates to Thom's interpretation of the LV ratio as real mortgage demand. It could alternatively be interpreted as the ratio of *nominal* mortgage demand to nominal house demand where L is the value of the mortgage and Ph the value of the (average) house. Both of these demands are functions of the mortgage rate of interest. Thus, this ratio may indeed be independent of the mortgage rate of interest. This would clearly undermine Thom's main criticism of my paper. An increase in the mortgage rate of interest not only reduces the demand for mortgages but also the demand for housing and thus its impact on LV and DR is, short of deeper analysis, uncertain.