Referee's report on MS383:

The contribution of the paper is significant for the following reasons:

a. A key contribution, as the Abstract indicates, is to show that in a stylized OLG model, 'there is no pure wealth effect on consumption from a change in house prices if this represents a change in their fundamental value.'

b. It is also shown , however, that 'where there is no invisible hand to impose the transversality condition,' there can also be a bubble term b (t)K which affects consumption, as shown by writing the consumption function as:

$$C = (\frac{1}{1-\eta})\xi(F + bK - \Lambda + H)$$

,

where bK represents the bubble.

c. It follows that, in the model under consideration, a change in housing wealth affects consumption if and only if it is due to a change in the speculative bubble component of house prices.

The first of these contributions, (a) seems to make sense of the bold statement 'Housing wealth isn't wealth' attributed to Mervyn King, (now Governor of Bank of England), used as the title of the paper. The second contribution, (b), on the other hand, makes sense of recent papers such as Laibson (2009) on 'Bubble Economics' and Khandani et al. on 'Refinancing Ratchet Effect' which stress the contribution of inflated house prices to consumer demand in the US. The third, (c), amounts to a critique of econometric studies which fail to separate fundamental values from speculative bubbles. Take them together, they suggest that it may be a serious error to impose rational expectations in the housing market: and the author is, of course, famous for an earlier critique of RE as a pre-requisite for macroeconomic modelling, see 'The Macroeconomics of Doctor Pangloss', The Economic Journal, 1980.

For these reasons, I strongly recommend the paper for publication. As it stands, however, the paper seems to give undue emphasis to contribution (a). It could, ideally, be improved if more emphasis was given to the proposition (b), with reference to papers such as those cited for example, and if the specification error made by econometricians was clarified, see (c). But this could, I believe, be done by stylistic revision and adding references - with no revision of substance.

2) However, the weakness of the paper is on failing to stress on this major result in point (c) above.

3) In p.3, for instance, it was made clear that: "The message of this paper is that the benchmark model should instead be one in which there is no pure

wealth effect from a change in house prices and in which therefore the collateral effect is instead of, not in addition to, the normal wealth effect. By overestimating the effect on consumer demand of a change in house prices, the monetary authority may be led to move its rates too aggressively."

Khandani, A; Lo, A; Merton, R (2009): 'Systemic risk and the Refinancing Ratchet Effect', NBER working paper No. 15362.

Laibson, D (2009), 'Bubble Economics', Hahn lecture, Royal Economic Society meeting, University of Surrey (April).