

# Discussion of “A Tale of Two Countries”

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1. Brief summary
2. What is the counterfactual?
3. How do we interpret sentiment?

# Summary

- Interesting and provocative paper, central message:
  - 1) Take your view on how real estate collapses lead to financial crises and output losses, and fix your numbers for these channels.
  - 2) There are important non-financial channels that have “**separate**” effects on consumption and investment and the consumption response is amplified by “**sentiment**”
- What does separate mean and what is sentiment capturing?

# Why is “separate” subtle?

- Suppose land prices fall, and so some borrowers default and lenders take loan losses. The loan losses lead lenders to tighten credit terms even for borrowers whose creditworthiness is unchanged. I define this to be a “credit crunch”.
- *Suppose* I can perfectly estimate the effect of the credit crunch, and there is some extra decline in output not accounted for. What do I call that? Can we be sure it is a non-financial channel (and do we care)?

# Traditional financial channel

- Suppose some lenders are completely immune from the change in land prices, so their lending terms are not changing. Should they offer the same loan terms to the borrowers who had their collateral values fall?  
**No!**
- Those borrowers are in fact less creditworthy, so their loan demand should fall and their spending should drop.
- This is completely standard (but hard to control for.)

# Are there other channels?

- What about borrowers, who did not own any land and hence had no direct change in their creditworthiness? Should they get the same loan terms from the unimpaired lenders and be unaffected? *Maybe!*
- The reduced spending of impaired borrowers reduces the return on investing for healthy borrowers, so they may cut their spending, even if their credit terms don't change.
- I call this an aggregate demand spillover ( $\neq$  credit crunch). **Is the distinction meaningful?**
- (I am skipping over behavioral effects in my written comments)

# Why care about the other channels?

- *Because policy responses likely depend on them!*
- Real estate example: many countries try to restrict leverage that can be used to make purchases.
- There are two leading tools:
- Loan to Value (LTV, which require minimum downpayments)
- Loan to Income (LTI, which cap total borrowing capacity)

# Are LTV and LTI equivalent?

- **No!** Let LTV can let you “ride the bubble”. When prices rise, you can borrow more.
- LTI will bind more tightly, unless incomes are growing as fast as prices.
- China uses LTV rules and actually has loosened to try to encourage more borrowing to support prices!
- Probably makes the aggregate demand externality worse.

# The UK LTI limits



# What about sentiment?

- The independent effects from “the emotional, psychological, or qualitative "tone" (optimism or pessimism) surrounding the housing market, which can influence households’ confidence about future economic conditions and shape their economic decisions”
- How do we identify channel this is we think that wealth is hard to measure, especially in China where market prices might be stale?

# Benchmark?

- Suppose Consumption  $\propto$  “True” Wealth ( $W^*$ )
- $W^*$  depends on accurate real estate prices, but we only see  $W$  (reported wealth) which uses current market prices.
- Then any proxies that capture the gap between  $W$  and  $W^*$  will predict consumption.
- This makes it hard to separate a “pure sentiment” effect from a statistical effect.

# Suggestion

- Try to do a filtering calculation that tries to calibrate the magnitude of the  $W-W^*$  mismeasurement effect.
- Find other proxies besides sentiment that might predict  $W-W^*$  and control for those variables too.
- Propose a benchmark for a plausible marginal propensity to consume out of  $W^*$ . Are the residual sentiment effects inconsistent with that benchmark?

# Summary

- New take on what happened in Japan and further evidence on China
- Needs some more work to confirm their preferred interpretation to distinguish it from other channels.
- Does convince me that some more pessimism about China's outlook is warranted.
- (I wonder if there are interactions with demographics.)