working paper

Mortgage Amortization and Amplification

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Mortgages characterized by negative or low early amortization schedules amplify the macroeconomic effects of a housing risk shock. We analyze the role of mortgage amortization in a two-sector DSGE model with housing risk and endogenous default. Mortgage loan contracts extend to two periods and have adjustable rates. The fraction of principal to be repaid in the first period can vary. As the fraction of principal to be paid in the first period falls, steady-state mortgages and leverage increase and the impact of a housing risk shock on consumption and output is amplified. Borrowers prefer negative amortization. If free to choose the amortization s
of the principal in the last period of the contract. Low early repayments of principal allow borrowers t
postpone default to the second period having incurred small sunk costs.

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