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Macroprudential policy in a recovering property market: Too much too soon?

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Macroprudential policy in a recovering property market: Too much too soon[1]

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INTRODUCTION

The financial crisis of 2007/08 revealed the need for a greater array of policy options in tempering housing market activity. Across countries increasing evidence emerged of property market distortions proliferating to other sectors of the real economy, thus highlighting the need for policies which target excessive and destablishing movements in lending, house prices and output levels. While elements of both fiscal and monetary policy have been considered in this regard, a growing body of opinion views macroprudential policies as the optimal policy response, particularly, in property markets, because of the preciseness of their focus and the potential flexibility of their application. Accordingly, one such series of measures - limits on loan to value (LTV) and debt to income ratios (LTI), are increasingly under scrutiny. These measures have been adopted for some time by authorities in Hong Kong, China, Korea, Singapore, and other emerging market economies, with Canada and Denmark examples of advanced countries using such limits prior to the crisis. More recently, the Hungarian, Magyar Nemezeti Bank, the Norges Bank, the Swedish Financial Supervisory Authority and the Bank of Finland have signalled their adoption.

In international terms, the Irish property market presents as the extreme case in terms of negative spill-overs between the housing market, the general economy and the financial sector. With both prices and activity levels increasing substantially over the previous decade, the property sector had, by 2007, assumed a disproportionate significance both on the balance sheets of Irish financial institutions and in the general economy. For example, in terms of employment, the number of persons at work in the construction sector effectively trebled from 97,000 persons in 1995 to 269,000 in 2006 and, by 2008, the sector directly accounted for one in every eight jobs in the economy.

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In October 2014, the Central Bank of Ireland proposed the introduction of regulations which placed ceilings on the proportion of mortgage lending at high LTVs and LTIs by domestic financial institutions. The objective of these measures was to increase the resilience of the banking and household sectors to the property market and to try and reduce the risk of bank credit and housing price ``spirals'' from emerging in future.

In simulating the effects of the macroprudential measures our model suggests the following results: house prices fall and reach their largest decline after 4 years, approximately, 6 percent down relative to a baseline level and, approximately, 2 percent below the baseline in the long-run. The impact on housing completions mirrors that of house prices. Housing construction is a function of the profitability of building new units, given by the ratio of house prices to building costs. As building costs are assumed to remain unchanged in this scenario, the decline in house prices also leads to a decline in the construction of new housing units.

With a quarter of potential borrowers displaced under the introduction of the measures, housing completions fall by 4 percent relative to baseline after 5 years, thus lagging the largest decline in house prices by approximately 4 quarters. Finally, the long-run effect of the mortgage restrictions, given this level of displacement, is a housing stock that is almost 1 percent lower than in the baseline case of no change in policy. In the more extreme scenario of 50 percent displacement, this impact results in a 2 percent decline.

In this paper we present a structural model of the Irish mortgage and property market that allows us to assess the implications of these measures on the mortgage interest rate, the number of mortgages extended, house price levels and housing supply. The results in this paper indicate that, while the macroprudential measures proposed will more than likely result in house prices being lower than what they otherwise would be, they may also result in fewer houses being supplied to the market and fewer mortgage loans being issued than a “baseline” or no policy change scenario. As a result, the measures may well end up curbing house price inflation but at the cost of generating a sub-optimal equilibrium in the housing market, where the measures result in restricted demand for new houses, while the supply-side response in the housing market is impaired by credit and other regulatory restrictions.