THE HOUSING MARKET AND FINANCIAL STABILITY

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David Miles
Imperial College
London

Housing, mortgages and financial stability

The combination of rapid and simultaneous increases in mortgage debt and house prices have been a source of financial instability in the past.

This has happened in the relatively recent past (Ireland, USA, Spain in the period after 2007) but also further back (UK and Nordic countries in the early 1990's).

It has often happened after a period when interest rates on mortgages have some down as well as a rise in mortgage availability.

QUESTION: What policy tools are best suited to control risks of such instability happening? What is the cost of using such tools?

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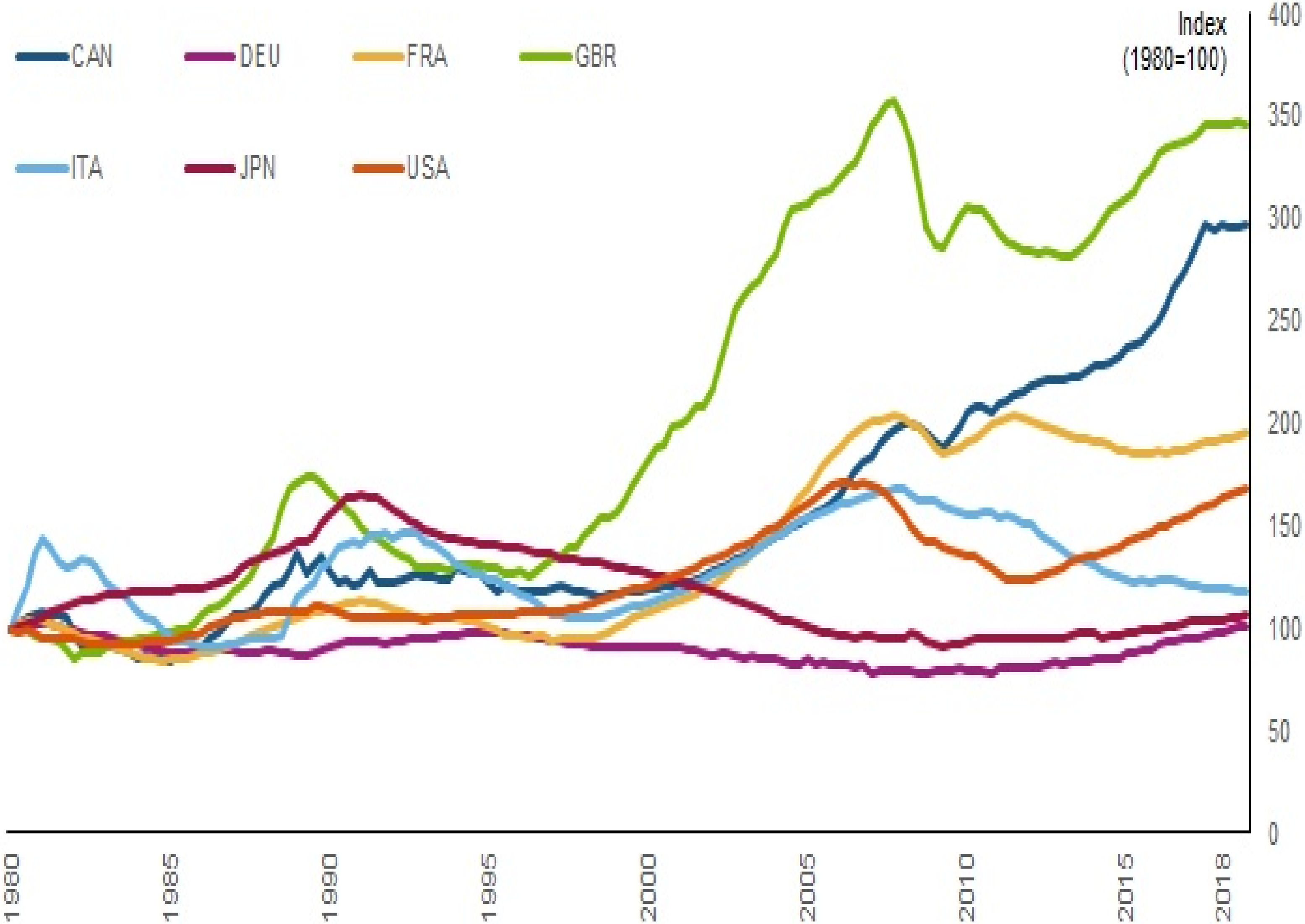
Two types of policy tool:

- The blunt instrument of interest rates – monetary policy
- The more targeted instruments of limits on lending size (eg LTI, LTV, DSI limits) or on lending price (e.g. capital requirement weights on mortgages).

Interest rates and the housing market

The real cost of mortgages is a very powerful driver of housing values and of lending.

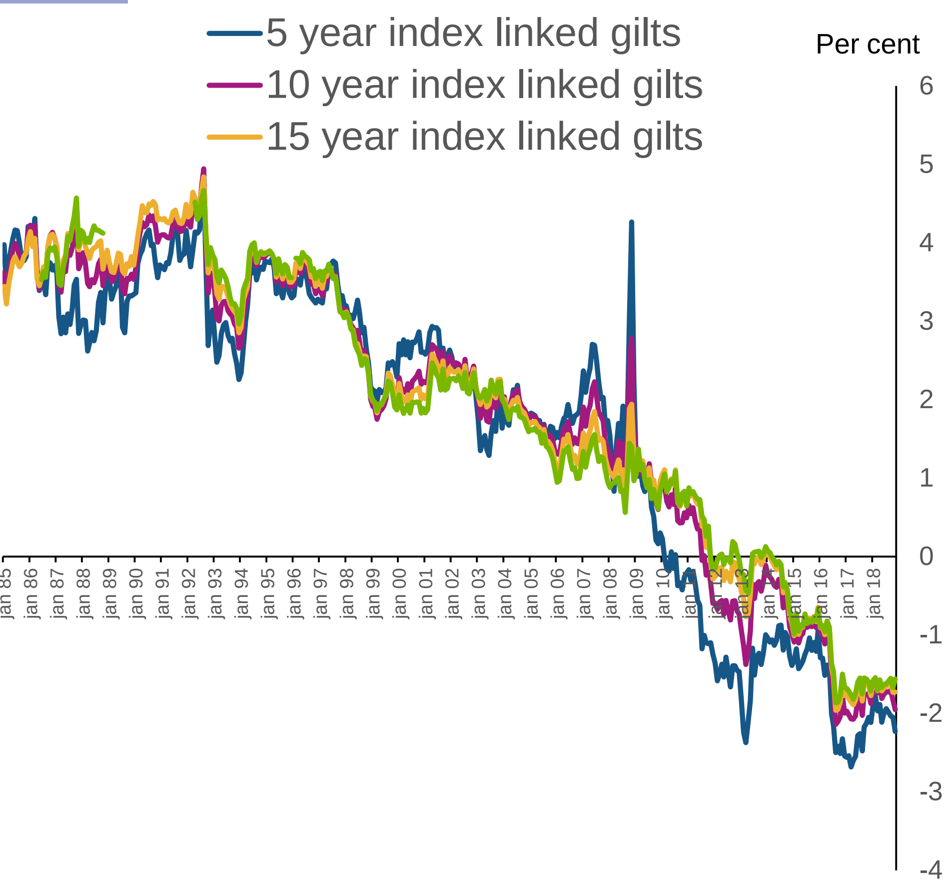
One powerful reason for the rise in house prices – and in the stock of mortgage debt relative to GDP – in many countries over the past 30-40 years is unusually low ***real*** interest rates.



Real house prices (relative to consumer prices, 1980-2018, 1980=100)

‘World’ interest rate – weighted average 10 year real yields for G7 countries (excl. Italy)

The decline in real yields in the UK



House prices in the UK might have been half their current level without the huge fall in real rates

Problems with using interest rates to control housing sector risks

- Central banks control short term nominal rates – not longer term real rates. Arguably the latter are more relevant to the value of a very long life real asset like a house.

- Conflict between using monetary policy for CPI target and to control housing sector risks.

- In Euro area there are huge differences between housing and mortgage markets across countries, but only one policy rate

- Germany has a relatively low owner occupation rate, predominantly fixed rate mortgages and no recent history of runaway housing markets. Italy and Spain do not look like this.

Macro prudential tools are more targeted at housing markets and can be different across countries – unlike monetary policy

- LTI / LTV / DSI ratio limits are designed to do similar things. It is about the quantity of debt to individual households - more reliable than shifting capital weights on mortgages which affect prices.
- We should be sceptical about the ability of regulators/central banks to fine tune these ratios so that they can be moved to offset cyclical shifts in housing.
- Working out where we are in a “housing cycle” is very hard.
- Housing markets do not have predictable cycles; telling the difference between a permanent shift in fundamentals and a temporary bout of excess optimism or pessimism is very difficult.

Predictable, consistent and easy to understand affordability tests may be the best.

- Where households cannot walk away from mortgage debt (unlike in parts of the US) then the trigger for mortgage and housing market problems is inability to pay the mortgage.

- A good question that mortgage lenders should have to ask is:

"If the cost of borrowing rises by X is it likely that this person can afford to continue paying the mortgage?"

- The regulator can set X – possibly in a way that varies over time. Though I am sceptical that frequent changes in X make sense.

- Affordability rule may be better than LTI / LTV rules.

But there is no way to avoid the tensions in using macro pru to control housing market threats to stability

- Potential conflict between control of solvency risks - which means limits on borrowing and gearing – and the widespread availability of debt to allow house purchase for younger people.

- The solvency risks are both for lending institutions (ie systemic risk) and also for individual households (a concern about people’s ability to assess and control their own risks of default).

- Various policy tools can be used to try to control these risks – eg capital requirements on lenders; affordability tests to be applied to individuals.

- But they can take home ownership away from many until what we used to think of as late in life – into the late 30’s.

Final pessimistic thought…..

- These tensions will get more difficult if house prices rise faster than other prices and maybe faster than incomes.
- Distortions in the market against private renting do not help.
- If very low real interest rates are here to stay – and we have been on a 35 year downward trend – these tensions between financial stability and widespread home ownership may not lessen.