THEMATIC GLOBAL VIEWS

Housing boom: what are the consequences for monetary policy?

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Despite the Covid economic shock, house prices have continued to rise in most advanced economies, and are also increasing rapidly in some emerging economies. This is not (yet) a global housing boom. Indeed, indicators of overvaluation remain below those observed before the Great Financial Crisis (GFC) and are still very contrasted across regions. However, the simultaneity of price increases in very different countries raises the question of a possible "common factor". All eyes are naturally on the expansion of central banks' balance sheets. Here, we ask what role house prices can play in determining monetary policy in general, as well as in advanced economies (mostly the US and Europe) in the current situation.

Globally, house prices rose by 7.3% YoY in Q1 2021 (the average across 56 countries), their fastest pace since 2006. Thirteen countries recorded double-digit price growth. Several countries have seen a deceleration in house prices since Q1 2020 (Italy) or even declines (Spain and India) due to the restrictive measures and the economic crisis. Among the national price indices available at the end of Q1 2021, the increases since Q4 2019 were 14.8% in the US, 10.0% in the UK and 7.8% in France (i.e., in these three cases, higher rates of increase than in the previous five quarters). This is the continuation of an upward trend that has been observed almost everywhere since at least the mid-2010s. Since January 2021, the authorities have intervened in several countries (China, New Zealand and Ireland) with a series of measures to tighten lending rules.

What should or can CBs do about a housing boom?

House price booms fuelled by a credit boom have proved particularly pernicious in the past. Reinhart and Rogoff (2009) have shown that the collapse of real estate prices (residential and/or commercial) is one of the main causes of financial crises. In many cases, these collapses occur after real estate bubbles, which often seem to be associated with excessive credit availability. When bubbles burst, the financial sector and the real economy are hit hard.

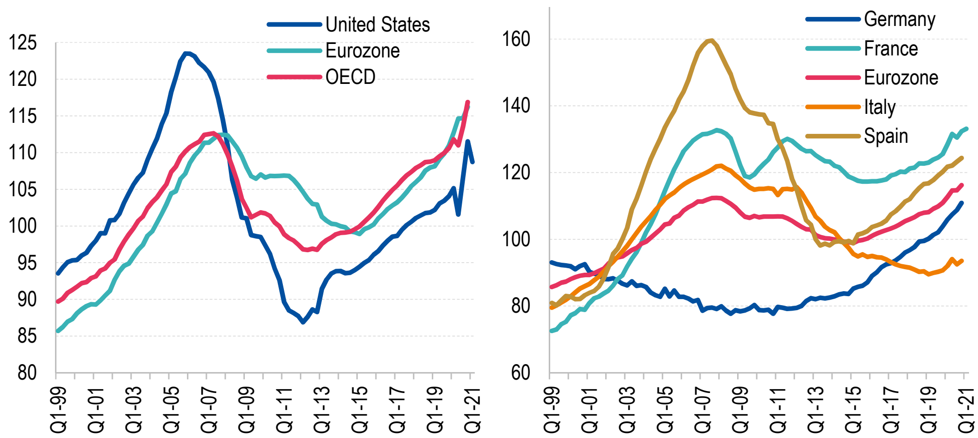
The question of whether monetary policy should play a role in preventing housing bubbles is controversial. In theory, an appropriate macroprudential regulatory policy relieves monetary policy from reacting to house price developments. Discretionary macroprudential policies, which selectively tighten lending conditions, play an important role in preventing or mitigating housing bubbles.

At the same time, however, CBs must ensure that their monetary policy does not exacerbate household debt. Monitoring house prices is therefore an important element of the *risk management* approach. Indeed, low short-term interest rates often lead to an easing of lending conditions and increased risk-taking by banks. This effect is amplified when interest rates are kept low for a prolonged period. The easing of credit conditions may be exacerbated by the use of securitisation.

In economies where a large proportion of consumers are credit-dependent, a sharp rise in house prices can have pronounced effects on consumption (wealth effect). Leverage tends to be very high in the real estate sector, and for many households, residential property is both the main asset and the main liability (which is not the case for equities).

In theory, an appropriate macroprudential regulatory policy relieves monetary policy from reacting to house price developments

1/ **Price-to-income and price-to-rent ratios (average)**



Source: OECD, Amundi Research - Data as of June 2021 | Source: OECD, Amundi Research - Data as of June 2021

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The global house price boom that preceded the GFC was driven by many factors (disposable income, interest rates, bank lending and a number of factors related to supply). However, **the downward trend in long-term global real interest rates was one of the main drivers of the rise in global house prices during the 2000s**. There is always a risk that in the medium to long term, real interest rates will rise again, creating problems in countries where housing purchases have been financed by credit. In addition, increased liquidity may also lead to higher house prices.

However, raising short-term interest rates is not a panacea. It may be desirable in economies with a high degree of homogeneity (e.g., small countries like Sweden or medium-sized countries like the UK). On the other hand, in regions with very heterogeneous housing markets (such as the Eurozone or the US), tightening monetary policy to contain house price pressures is often considered inappropriate and possibly counterproductive, given its potentially severe consequences on the rest of the economy.

Could the current rise in house prices despite the Covid crisis precipitate monetary tightening?

The Covid crisis has led the CBs to reintroduce asset purchase programmes (QEs). For the moment, tightening is therefore less a question of raising (key) interest rates than of tapering.

Ultra-low mortgage rates on the back of non-conventional CB measures are widely seen as a major cause of the continuation of the rise in house prices during the Covid crisis, even though a number of other factors have also played a role (notably public support for household income, specific protection measures for borrowers and renters and, possibly, behavioural factors such as a more pronounced search for living space and security).

For the moment it is true that, despite this continued rise, most valuation indicators remain below pre-Lehman levels. While nominal average prices often exceed those of 2006-2008 (this is the case, among others, in the United States, the United Kingdom and France), the same is not generally true of valuation and affordability metrics that adjust prices for household income and mortgage rates (at least in the US, EU and UK, while some smaller DMs do show these metrics at or close to their peaks).

Moreover, in terms of fragility, in the specific case of the United States, the average profile of borrowers was (at least before the Covid crisis), much more solid than before the GCF. The massive distribution of credit to fragile households, seen as a major cause of the Lehman crisis, was not repeated during the 2010s.

Delayed shockwaves from the Covid crisis may still hit real estate markets

Nonetheless, even though the threat of another Lehman-like crisis looks distant, the current rise in prices and debt raises at least two threats:

- **Delayed shockwaves from the Covid crisis may still hit the now more stretched real estate markets.** These deferred effects could come, first of all, from the withdrawal of public protections and guarantees relating to the real estate itself. On this topic, the US Federal Reserve notes, in its May Financial Stability Report, the dependence of many borrowers on temporary Covid-related protective measures, many of which have been extended until the summer. Other delayed effects could come from a fall (or at least a deceleration) in household income via the labour market. This particularly concerns Europe, where unemployment could still rise when the very protective short-hour work (and other income support) measures are withdrawn. The ECB mentions this risk, along with its perception of “signs of overvaluation” in the residential real estate market, in its May Financial Stability Review.
- Even absent a delayed Covid-related shock, the sustainability of current prices and debt levels relies more than ever on ultra-low rates. Over time, this can only make any tightening of monetary conditions at the initiative of the CBs even more difficult than today (for fears of generating negative macro effects through price decreases or increased costs for borrowers), as well as increase the risks associated to any widening in risk premiums that would be unwanted by the CBs.

The desire to “calm the game” could end up winning out

Therefore, in the end, despite the virtuous effects of rising house prices during the current recovery (notably the wealth effects on confidence), the desire to “calm the game” could end up winning out. In our view, this is especially true in the US, where the Fed is buying $120bn of securities each month, of which $40bn of MBS. If house prices continue to rise in the US, the Fed may conclude that credit conditions are excessively accommodative and proceed to tapering, starting by reducing its MBS purchases.

Eurozone housing markets are less securitised and more heterogeneous than US markets. Moreover, the situation is very different with still moderate price dynamics in several countries. At this point, the evolution of real estate prices therefore has less reason to lead the ECB than the Fed to reduce securities purchases. Overall, we see housing market trends as a further element of divergence between the US and the Eurozone.

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