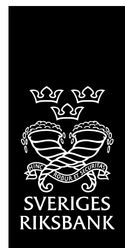

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"Avoiding collective amnesia"

Keynote speech at the conference "Should macroprudential policy target real estate prices?"

11-12 May 2017, Vilnius, Lithuania

Introduction

"Those who fail to learn from history are condemned to repeat it" is a famous saying by Sir Winston Churchill in a speech made to the House of Commons in 1948. Learning from history and previous mistakes is of course important in every walk of life, but perhaps even more important to us who work with financial stability and macroprudential policy. With my background as a central banker and many years of experience in handling banking and financial crises, I believe that Churchill's saying is as true today as ever before. The only way we can address, and perhaps even prevent, economic crises is by understanding their causes.

What history has shown, again and again, is that financial crises follow predictable patterns. We are all familiar with the origin of the last financial crisis, and we all know what prominent role the residential real estate market and mortgage market played in the severity and the persistency of the crisis, not only in the US but all around the world. Increasing empirical literature has also shown that leverage, excessive risk-taking, and misaligned incentives in residential and commercial real estate often lead to externalities with implications for both financial stability and the real economy. Because of the systemic importance of the residential real estate sector, I strongly believe that macroprudential policy has a key role to play in order to preserve macroeconomic and financial stability. This policy area offers many tools targeted specifically at addressing risks in the residential real estate sector.

The interaction between macroprudential policy and housing prices is by no means a new subject to me, neither in my role as Governor of the Riksbank, in

which I have tried to deal with these issues for many years now, nor in my role as Chair of the ESRB's Advisory Technical Committee, where this topic has gained increased attention in the last few years. There are many aspects and challenges to bear in mind when discussing this topic. I therefore welcome the discussion at this conference and thank you for the invitation to speak. The topic for my speech, to a large degree, covers the theme for the first session of today, namely whether macroprudential policy should have explicit goals for house price growth. Hopefully, my remarks will illustrate some of the challenges – analytical and pedagogical – that policy makers face when deciding on the appropriate way of bringing house price developments into macroprudential policy decision making.

But in order for me to adequately address this theme, I think it is important to take a step back and remember why macroprudential policy exists and recall the main purpose of this still rather new policy area.

What is the purpose of macroprudential policy and how do we measure its effectiveness?

Put simply, macroprudential policy has two main tasks. First, it should strengthen the resilience of the financial system as a whole. Second, it should counteract the build-up of financial imbalances that could later lead to costly adjustments.[1] In the context of risks and vulnerabilities related to the residential real estate sector, macroprudential policy measures not only can reinforce the resilience of banks and households, but also counteract the build-up of financial imbalances by influencing the supply of or demand for credit. It is, however, rather tricky to measure the effectiveness of macroprudential policy. This is because it is difficult, if not impossible, to measure the scale of reduction in systemic risk. One consequence of this is that the empirical evidence on the effectiveness of macroprudential policies is still fairly limited, although it is increasing at a rapid pace. Nevertheless, some studies exist and they seem to suggest that borrower-based (demand-side) policies such as limits on loan-to-value and debt-to-income ratios, are more effective in managing credit flow and housing prices, than lender-based (supply-side) policies such as capital and liquidity buffers. Borrower-based policies seem more effective when growth rates of housing prices and credit are very high.[2]

Hence, ideally, macroprudential policy should serve to mitigate pro-cyclicality in the behavior of households and financial institutions. In other words, it should be countercyclical, i.e. macroprudential policy should be tighter when there is a high risk of imbalances building up. This may imply a need to quantify the macroprudential policy objective and to set a quantitative target, i.e. introduce macroprudential policy rules. Yet, there are many challenges associated with this. Let me discuss some of the aspects that I think need to be considered before introducing such rules.

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[1] See Nordh Berntsson, C. and Molin, J. (2012), Creating a Swedish toolkit for macroprudential policy, *Riksbank Studies*, November 2012, Sveriges Riksbank.

[2] See Guibourg, G., Jonsson, M., Lagerwall, B. and Nilsson, C. (2015), Macroprudential policy – effects on the economy and the interaction with monetary policy, article in *Economic Review* 2015:2, Sveriges Riksbank.

There are certain benefits to be derived from setting specific macroprudential policy rules

Overall, I think there is a broad agreement that there are many advantages in setting specific targets and rules for macroprudential policy. As a central banker, I think there is a certain degree of analogy to be made here with monetary policy. For example, having an inflation target will help stabilize inflation expectations and therefore make it easier to influence actual inflation. Having an explicit numerical inflation target will also constitute the benchmark against which the effectiveness of monetary policy is measured. Setting a specific target will consequently help increase transparency and accountability, which are essential.

All these benefits are of course also applicable when setting rule s for macroprudential policy. There might even be a case to be made that rules are even more appropriate in this policy area. For instance, setting specific rules might be particularly useful when models and instruments are not fully developed, much like macroprudential policy is today.

Explicit rules can contribute to increased transparency and better communication of macroprudential policy decisions. It may reduce the risk of inaction bias and relieve the pressure on policy makers to abstain from policy adjustments during economic expansions, when any discretionary tightening might be challenged by public myopia. Undoubtedly, there are also some obvious problems relating to setting specific rules for complex policy issues. Let me discuss some of them in relation to residential real estate, and try to give you my view of the question of today's first session, i.e. if macroprudential policy should have explicit goals for house price growth.

Setting a numerical target for house price growth would be very challenging…

There are important challenges regarding setting a specific numerical target for house price growth, like for inflation in monetary policy. For the macroprudential authority, or any other policy maker for that matter, it is hard to know what constitutes the correct price growth rate at a given time. We have to acknowledge that housing prices are determined by a range of different factors that are both cyclical and structural in nature. For example, a low interest rate environment and expansionary monetary policy may entail a higher price growth rate than what is expected in steady-state. The same can be said about expansionary fiscal policy, which could lead to rising incomes and wealth in the household sector. There are also supply-side factors, like low residential housing construction and rent controls, which may influence the prevailing price growth rate. These are supply-side and demand-side factors that macroprudential policy might find hard to counteract.

There would also be some practical problems if we were to start targeting a single house price index. For instance, aggregate house price data could mask trends that exist at the regional level. Correspondingly, prices might increase differently depending on housing tenure, i.e. for single-family houses and apartments. Let me take housing prices in Sweden as an example to illustrate my points. Since 1987,

the average annual house price increase in Sweden in real terms has been more than 4 per cent. In Stockholm, the corresponding figure is almost 6 per cent. In certain periods, house prices in Stockholm have been increasing by more than 25 per cent. And looking only at apartments, the price increase has been even larger. In contrast, in many cities in the north of Sweden, prices have increased only moderately.

…but we need indicators for when to take action, and house prices are very important in this context

Since the range of price increases is so wide, setting an explicit goal for house price growth is incredibly hard and it would be extremely difficult to create a satisfactory index that captures the dynamics of all regional markets. That said, aggregate price indices might still guide the policy maker and signal the build-up of risks. For instance, the work on identifying early warning indicators and setting different thresholds for these indicators will certainly help the policy maker decide when to act and avoid risks linked to inaction bias.[3]

The Basel Committee's reference guide for the countercyclical capital buffer, relating the buffer to the credit-to-GDP gap, can be seen in this context. Of course, one can always discuss the pros and cons of individual indicators, as has certainly been the case with the credit-to-GDP gap. One virtue of guidelines like this is that they put some limit on the amount of discretion given to the macroprudential policy maker. But relying on a purely mechanical relationship between indicators and macroprudential policy might be too crude. I think an element of judgment is still going to be required. Charles Goodhart has referred to presumptive indicators: When, for instance, house price growth is deemed to be excessively high, the macroprucential policy maker has to take a stand and comply or explain the lack of measures taken.

The "policy stance" of macroprudential policy is hard to assess, but important progress is being made

One concept related to this topic, and that has been discussed for example within the ESRB, is the "policy stance" of macroprudential policy. How do we know if macroprudential policy is expansionary or contractionary, and in which dimensions do we measure this? This was one main topic on the first annual ESRB conference held last year.

For me, it's obvious to compare this with monetary policy. The task of assessing the monetary policy stance is easier, but developments after the global financial crisis, and the downward trend in the long-run real interest rate, have made it hard to know exactly how expansionary monetary policy is. As I mentioned in the beginning, the goals of macroprudential policy are diverse and complex: both providing a resilient financial system and mitigating financial imbalances. Needless

[3] See, for example, Giordani, P., Spector, E. and Zhang, X. (2017), A new early warning indicator of financial fragility in Sweden, *Economic Commentaries* No. 1 2017. Sveriges Riksbank.

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to say, taking a stand on the stance of macroprudential policy is challenging, to say the least.

Hence, the work on intermediate policy objectives and indicators, going on at the ESRB and elsewhere, is very important. Hopefully, we will be able to be more specific on the assessment of the macroprudential policy stance in the not-so-distant future.

Another interesting comparison with monetary policy is that, regarding the policy interest rate, decisions are normally being made with fixed time intervals. Once again referring to the countercyclical capital buffer, regardless of what indicators the designated authority chooses to look at, the legislation prescribes reviewing the appropriate buffer with fixed time intervals, i.e. every quarter. This is another way in which inaction bias can be reduced, since it forces the policy maker to regularly take a stand on the appropriate action.

Macroprudential policy is not the only game in town

While I have my doubts for setting explicit numerical goals for house price growth, we must not let data limitations get in the way of addressing the larger question at hand. Or to use a famous idiom; we still have to be able to see the forest for the trees. We must not forget that large upswings in housing prices and debt levels have often been followed by periods of financial instability and recessions. This is one of the reasons why I am a firm believer that macroprudential policy has a key role in reducing systemic risk stemming from the residential real estate sector. This is also why we at the Riksbank have for a long time now been urging the Swedish FSA, which is the responsible authority for macroprudential policy, to implement measures such as limits to loan-to-value ratios and debt-to-income ratios as well as requirements on amortization, in order to curb the developments on the Swedish housing and mortgage market.

But, regarding the situation in Sweden, other policies need to play their part as well, not least housing and tax policy. We cannot rely on macroprudential policy to handle the more structural problems on the housing market. At the Riksbank, we have therefore also been advocating policies influencing the structural characteristics of the housing market. Such policies could address the tax treatment of interest tax deductibility, the regulation of rental markets or regulatory constraints on developing new housing. There are certainly limits to the amount of "fine-tuning" that can be done with macroprudential policy alone. For me, measures such as LTV- and DTI-limits are a little bit like setting speed-limits for banks and households, and saying "up to here but no further".

Moreover, we cannot, of course, discard the role of monetary policy in tackling these issues. If monetary policy is very expansionary over a long period of time, this could contribute to distorted expectations of how high interest rates will be in the future and how the housing market will develop, and lead to increased risk taking in the economy. Personally, I think that macroeconomic stability, financial stability, and price stability are closely interlinked. One of the key challenges going forward is to try to find a proper combination of monetary policy on the one hand, and macroprudential policy on the other.

Also, we must not forget that it is essentially each individual household's and each individual bank's responsibility to ensure sound lending. This is a central principle in a market-based system, and something which we should not forget in the debate about macroprudential policy. This is also why I think it is important for banks and policy makers to increase public awareness about the risks stemming from high debt and house price levels. Here, communication is going to be key and I think we can all do better in educating the public about these issues.

For us policy makers, this also means that measures taken in one area must take into account what is being done in other areas. The left hand needs to know what the right hand is doing, even if they are not completely coordinated. In addition, policy makers need to be forward looking, since it often takes time for measures to have an impact. This is especially true for measures that affect the supply of housing, but also true for flow measures with a declared macroprudential intent. We have to acknowledge that many of these issues are like changing the direction of a large ocean liner. It will take time before we will see any results, and different policy areas must work together.

Someone needs to take away the punch bowl before things get out of hand

All in all, we, as policy makers and central bankers, can do a lot of things to mitigate risks stemming from the mortgage and housing market. Certainly, we cannot complain that there are no available tools at our disposal. So why are we in many countries still lagging behind in taking policy action despite our better judgment? In Sweden, for instance, it has proven exceedingly difficult to deal with issues surrounding the mortgage and housing market and there is a strong political reluctance to take action. Politicians and various authorities seem to agree about the diagnosis, but it appears to be extremely hard to agree on the right prescription.

I am fairly certain that the reason is inaction bias. When housing prices are high and going up, people are making money and do not want policy makers to take away the proverbial punch bowl. And the combination of certain short-term costs and uncertain long-term benefits creates incentives for politicians and macroprudential authorities to postpone policy actions.

For me, practical policy making entails making decisions under uncertainty. We will not always know what the counterfactual is going to be. It is therefore unavoidable that practical policy making in the coming years will consist, to a great extent, of "learning by doing" – with the emphasis on both 'learning' and 'doing'. And although it is one of the first concepts you learn in an introductory economics class, and goes to the core of economic thinking, policy makers must understand that there is no such thing as a "free lunch". There is no way around the fact that measures will have short term costs if they are going to be effective. There is no magic bullet.

At the end of the day, authorities are responsible for taking action if developments on the residential real estate market threaten macroeconomic and financial stability. There has to be somebody who takes away the punch bowl before the party gets out of hand.

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Concluding remarks

Let me conclude where I began by echoing the sentiment of Churchill's warnings about not learning from past mistakes. I have already highlighted the fact that understanding the causes of previous economic and financial crises is going to be essential in preventing future crisis. However, knowledge itself is no guarantee that we will be able to safeguard macroeconomic and financial stability. Hence, in order to avoid the risk of collective amnesia, it is crucial to create an institutional framework that stimulates macroprudential action. Setting specific macroprudential policy rules might be one way of doing this and it is certainly a question worth asking. I anticipate productive discussion to this issue and others in the next few hours. Thank you.