How can we prevent house price bubbles?

Workshop at Danmarks Nationalbank, September 20, 2016

LARS JONUNG

KNUT WICKSELL CENTRE FOR FINANCIAL STUDIES, LUND UNIVERSITY

How can we prevent hours price bubbles?

My answer: Let us look upon the historical record.

Sweden is an interesting case. An exceptional long and persistent rise in real house prices 1995-2015. One of the highest in the world in recent years.

Main reference (in English): Fredrik NG Andersson and Lars Jonung:

The credit and housing boom in Sweden, 1995-2015: Forewarned is forearmed

http://voxeu.org/article/credit-and-housing-boom-sweden-1995-2015

Figure 1. Real house prices in Sweden, the UK and the US 1995Q1–2015Q3

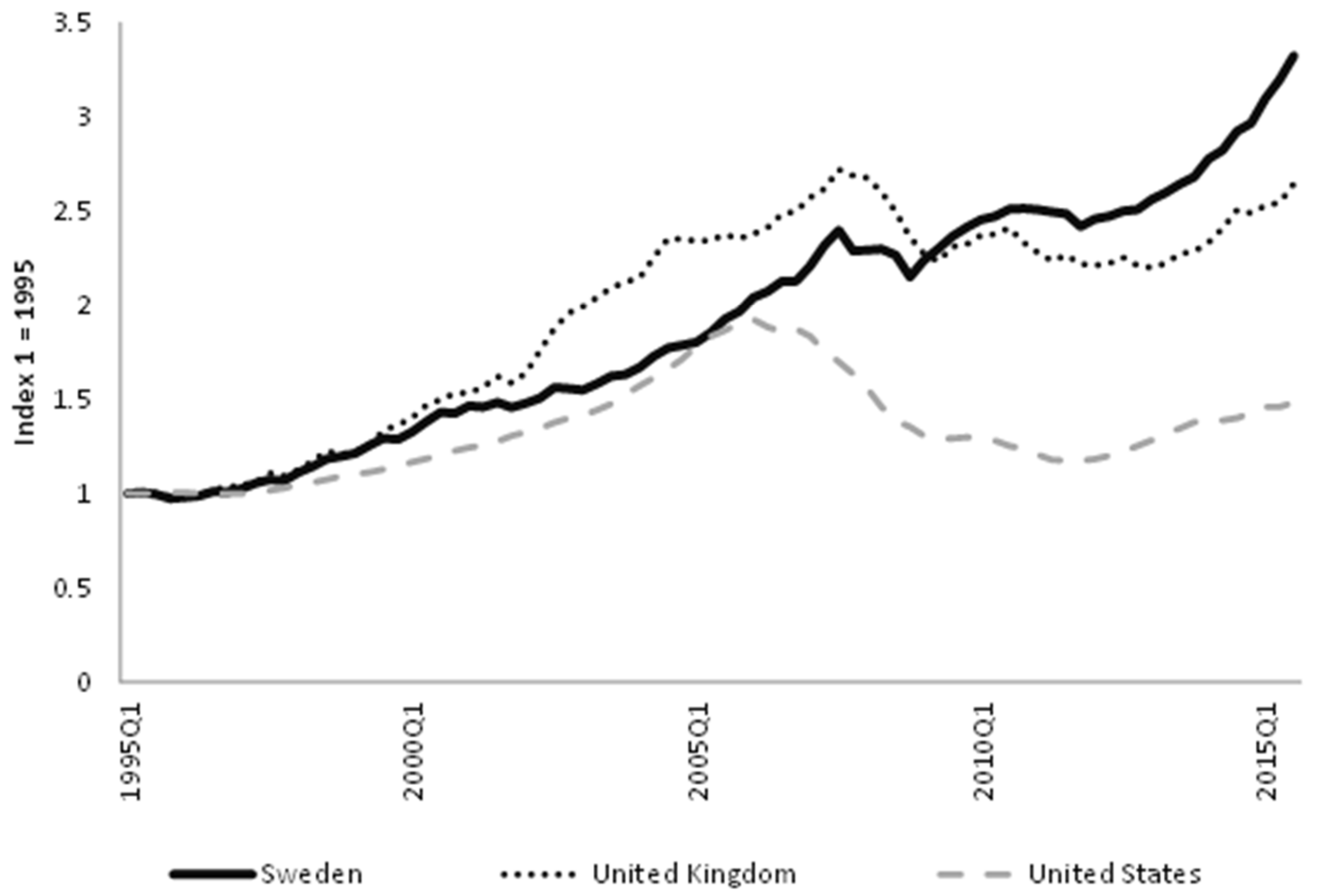


Figure 2. Total private non-financial sector debt and household debt, 1961Q1–2015Q3

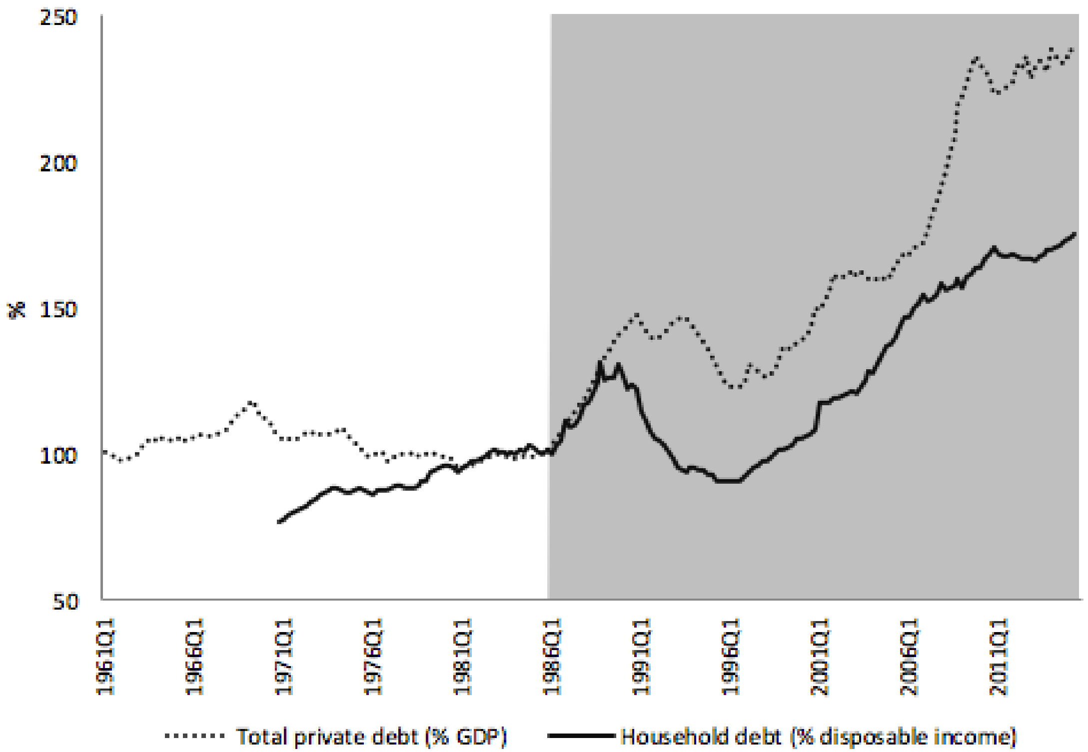


Figure 3. Household debt in relation to disposable income in Sweden, the UK and the US, 1995–2014, with the Riksbank's forecast for Sweden until 2019

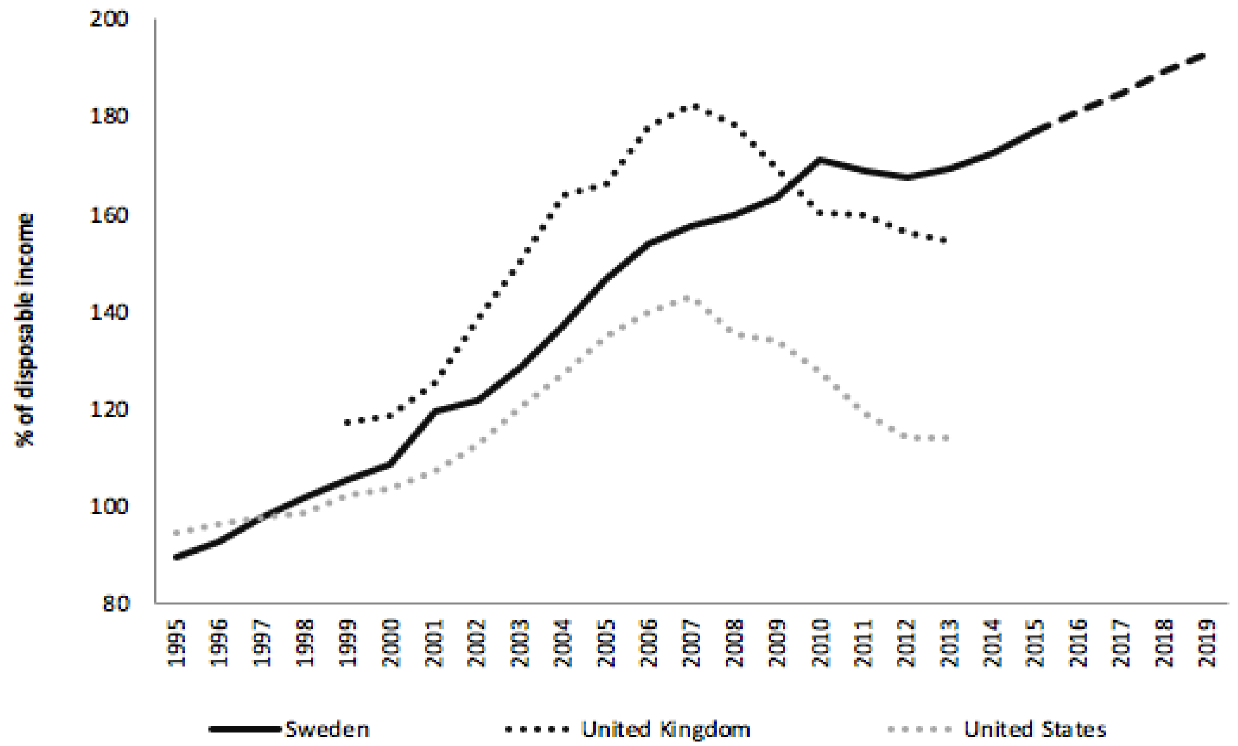


Table 1. Growth of credit relative to growth of real income

	Sweden	United Kingdom	USA	Germany
2001-2005	**2.2**	**2.7**	**2.1**	0.5
2006-2010	**3.7**	**2.7**	**2.3**	0.3
2011-2015	**1.9**	0.6	1.0	0.4

Source: Eurostat, OECD, St. Louis Federal Reserve

The causes of house price bubbles

A sharp growth of credit is a necessary condition for any financial crisis.

We do not observe a financial crisis without a previous credit (financial) expansion.

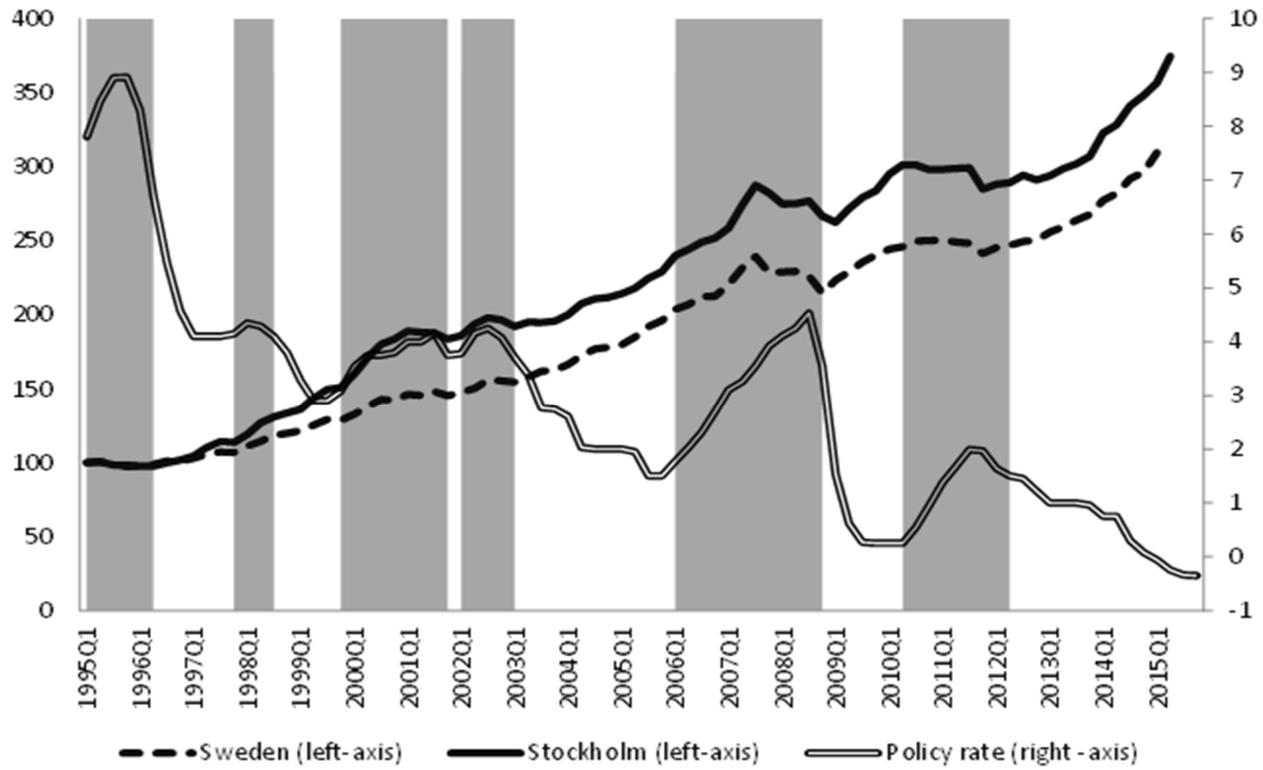
In addition, a ”***trigger***” is needed that sets of the crisis. For example a policy change that unexpectedly and sharply increases the price of credit (the real rate of interest).

The consequences of major financial crisis are costly for society and for public finances. The political consequences are usually quite substantial as well. Look at the 1930s.

Crisis should thus be avoided.

Figure 4. The policy rate (%) of the Riksbank (right-hand axis) and real house prices (index=100 for 1995), (left-hand axis), 1995-2015

Source: Statistics Sweden.



How can we prevent house price bubbles?

Policy-makers should focus on monetary policy – that is on central bank policy in order to prevent house price bubbles.

The close association between rising house prices and a rising volume of credit raises the ***question of causality.*** Our econometric tests suggest that the expansion of credit has contributed to higher real house prices. There is also a feedback from rising house prices, increasing demand for credit. Other factors have impacted on house prices as well, such as restrictions on the supply of housing, rent controls, mortgage interest deductibility, population growth, and a strong rise in household income.

Bottom line: without a credit expansion there will not be a high and long house price inflation.

How can we prevent house price bubbles?

We can calculate the size of a likely correction in Sweden by estimating a long run sustainable debt level for households.

Such a simple calculation suggests a reduction by 60 percentage points.

This is more than the correction in the house price bubbles that have occurred in many countries in recent years.

How can we prevent house price bubbles?

Interest rates should be set by the central bank such that the risk of house price bubbles is minimized. This implies that the growth of credit should be roughly in line with the growth of real income.

Here we may find a clash between monetary stability (price level stability or inflation targeting) and financial stability.

How do we resolve this clash?

Let us go back into history again.

KNUT WICKSELL (1856-1926)

Professor in Lund 1901-1916

Father of inflation targeting.

His model of the cumulative process did not involve asset markets. Thus financial crisis and house price bubbles were not observed and analyzed by Wicksell in ***Interest and Prices***.

How can we prevent house price bubbles?

Solution: Financial stability should be made the prime task of monetary policy.

Central banks have the power to determine the volume of credit as providers of the legal tender.

Inflation targeting should come second to financial stability.

A dual mandate with a clear order of priorities between financial and monetary stability.

How can we prevent house price bubbles?

The task of combining financial stability with monetary stability is facilitated by adopting a *broad tolerance interval.*

In the case of Sweden, an explicit 2 per cent around a target of 2 per cent would be a step in the right direction.

This gives more flexibility for the Riksbank to pursue financial and monetary stability simultaneously.

How can we prevent house price bubbles?

Macroprudential policies?

Such policies represent a round-about - selective (not general) - way of raising the price of credit.

The pendulum of financial regulation is now swinging back to re-regulation. Macroprudential policies run the risk of repeating the mistakes of the financial regulations of the Bretton Woods area. (New wine in old bottles.)

Instead a general approach should be adopted. Higher interest rates and keeping the growth of credit at bay eliminate the use macroprudential policies.

The credit multiplier could be reduced by introducing higher reserve requirements for commercial banks.

How can we prevent house price bubbles?

Monetary policy *cannot* do it all alone.

Fiscal policy, tax policy, regulatory policies have a role to play as well.

What happens to central bank independence in case of a new financial crisis?

A new major financial crisis will force about a change in the monetary regime. This is a major lesson from history.

Perhaps it is better to make the change in the monetary policy regime now before the next financial crisis rather than after the crisis?

To save inflation targeting, financial stability should be the main goal of central banks.

How can we prevent house price bubbles?

Workshop at Danmarks Nationalbank, September 20, 2016

LARS JONUNG

KNUT WICKSELL CENTRE FOR FINANCIAL STUDIES, LUND UNIVERSITY