

Monetary policy and housing markets: interactions and side effects

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<https://www.oecd.org/housing/policy-toolkit/>

Monetary policy influences housing prices through the level of interest rates (cost of credit, discount rate, attractiveness vis-à-vis other investments). The housing market affects aggregate demand through construction activity and its influence on consumption (wealth and income effects). Housing booms and busts can threaten financial and macroeconomic stability, and thus ultimately also feed through to consumer price inflation. Central banks can thus not ignore housing market developments. But monetary policy is too crude an instrument to target house prices. A new class of instruments – macroprudential policies – has been created and fills this gap since the Global Financial Crisis. Moreover, housing prices are substantially driven by structural housing policies which affect housing supply and demand. At the same time, including owner-occupied housing in the consumer price basket helps to adequately feed this important part of households' expenditure into central banks' reaction functions. While monetary policies worldwide have undoubtedly played a central role in containing the economic fallout from COVID-19,

potential side effects, such as shooting up housing prices, and the proportionality of long-lasting unconventional monetary policy measures need to gain increasing attention as economies are bouncing back from the COVID crisis.

Why should central banks pay attention to a specific sector such as the housing market?

Central banks worldwide are mandated with ensuring price stability, subject to this (or in parallel with, as in the US Fed) also with supporting growth and employment. Their price stability objective is usually coined in terms of consumer price inflation. Monetary policy is a rather “crude” instrument, which affects aggregate demand broadly, and cannot usually be targeted towards developments in specific sectors. So, why should monetary policy care about developments in a specific sector such as the housing market?

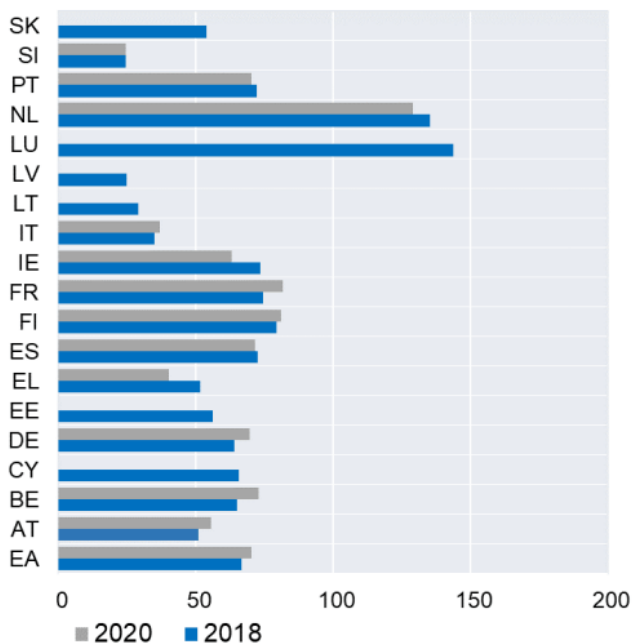
There are several channels in which housing is relevant for the transmission of monetary policy impulses such as changes in official interest rates or in bond market yields through QE. First, the level of short-term and long-term interest rates influences **mortgage credit rates**. So, it makes purchasing a home more (or less) affordable. Thus, demand for housing – and thus employment, aggregate demand and ultimately also consumer price inflation – rises (or falls). Mortgage loans make up 77% of euro area households’ total borrowing (ECB, 2021). The growth of euro area mortgage loans continued its upward trend observed since 2016 to reach around 5% in nominal terms most recently. In 2019, in the EU and euro area gross value added in the construction sector made up 5.4% and 5%, respectively, of GDP, with a wide range of 1.7% to 7.4% across EU countries, though. Construction projects are typically financed to a substantial extent through credit. So, financing costs exert a potentially strong effect on **construction activity**.

Figure 1. Housing makes up a major part of households’ lending

and is an important economic sector

Lending for house purchase

% of net disposable income of households



Gross value added: construction

% of GDP, 2020



Source: ECB, Eurostat.

Positive and negative wealth and income effects from house price rises

Second, the value of an asset is influenced by the net present value of the stream of income from this asset. In the case of housing, this income can either be rental income or the implicit income from using the house (in the case of owner-occupied housing). If the discount rate falls (as implied by lower official interest rates), then the net present value of a home rises. **Looser monetary policy** thus, ceteris paribus, **raises real estate prices**. This rise in housing prices can affect household consumption in various ways. First, it can entail that households feel richer and can take out an additional mortgage on their house, to finance other expenditures. In this case, we observe a **positive wealth effect**. Conversely, rising house prices can also imply that for instance young households need to spend a higher fraction of the disposable income on housing, leaving less for other consumption (see e.g. OECD, 2021). In this case, there would

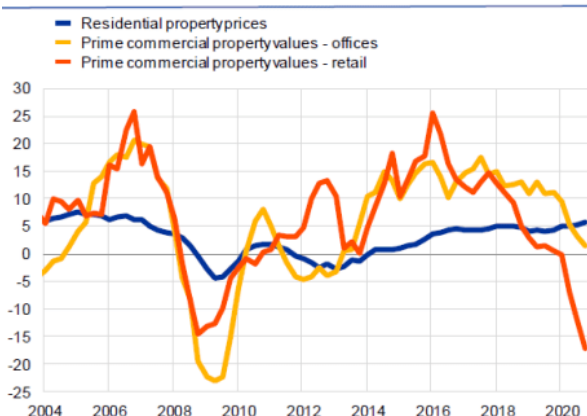
be a **negative income effect** from rising house prices. Whether the positive or negative wealth and income effects prevail, depends on the fraction of homeowners versus tenants and demographic factors. If, for instance homeowners benefiting from wealth increases have a lower propensity to consume than those just buying a home, the net effect on aggregate consumption will likely be negative.

Similarly, rising rents (which are the likely consequence, with some lag and to a certain extent, depending on countries' institutional and legal frameworks, of higher house prices) will benefit landlords, while tenants will have less of their **income left for other consumption**. Assuming that renters are wealthier and have a lower propensity to consume than tenants, then a rise in house prices and rents will on aggregate dampen consumption for non-housing goods. A very similar argument applies to households which take out a loan to finance their homes: higher house prices imply the need for a bigger loan, implying lower disposable household income after loan servicing.

Thus, the wealth and income effects from residential price swings also imply substantial **redistributive effects** across individuals and demographic groups (see e.g. OECD, 2021).

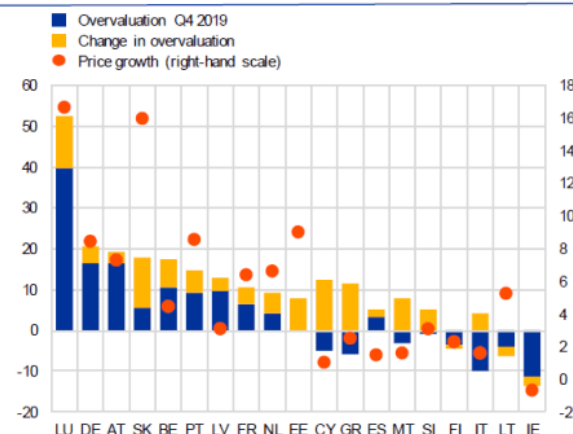
Figure 2. Real estate price developments in the euro area

Euro area residential and commercial property price developments
Q1 2004-Q4 2020; percentage change per annum



Sources: Jones Lang LaSalle, ECB and ECB calculations.

Change in overvaluation and price growth since the end of 2019
Q4 2019-Q3 2020; Q4 2019-Q4 2020; percentages



Sources: ECB and ECB calculations.

Source: ECB (2021).

Housing booms and busts threaten financial and macroeconomic stability

There is a second reason why central banks carefully look at housing market developments, which has gained prominence in the Global Financial Crisis (GFC): **housing market bubbles can trigger and fuel economic booms, which subsequently end up in deep busts**. Monetary policy can fuel such housing booms by making credit very cheap, thus encouraging excessive leverage among households. Real estate booms can also, at a more structural level, entail that an excessive fraction of economic activity goes into construction (as was the case in several countries prior to the GFC). Once the housing bubble bursts, a deep financial crisis can be the result, which requires the central bank to take emergency measures to prevent a collapse of the financial system, but also to dampen the resulting recession and the accompanying excessive fall of consumer price inflation, way below the central bank's target, potentially even into negative territory. Some economists thus argue that central banks should "lean against the wind" in the face of rising real estate prices. Even if the central bank might not target asset prices, leaning against the wind might be justified since it also helps to cushion excessive swings in consumer price inflation which may be triggered by real estate booms and busts. Others argue that such "preemptive" monetary policy tightening entails high macroeconomic costs in terms of foregone employment and output. Monetary policy is, according to this view, too crude a tool to take real estate prices into account and should exclusively focus on consumer price inflation.

Macroprudential policies as a new tool to address housing cycles

This is why, notably after the GFC, a consensus has emerged that an additional set of instruments, "macroprudential rules", should be applied to cool down overheating asset price

developments, e.g. by raising loan-to-value ratios or loan service-to-income ratios applied by banks when they grant housing credits (see e.g. ESRB, 2021, ECB, 2021 and OECD, 2021). These new policies have been implemented around the world and experience is accumulating in their application. Note, however, that in practice the stylized notion of two totally separate tools for two clearly distinct economic goals – monetary policy to stabilize consumer price inflation, and macroprudential policies to prevent asset booms and busts – does not fully do justice to a far more complex reality.

Including owner-occupied housing in consumer price inflation to better reflect households' comprehensive cost of living developments in central banks' reaction functions

One way how home prices feed into the central bank's reaction function is by including the cost of accommodation in the consumer price index. This is already the case for rents. By contrast, at least in most European countries, it is not yet the case for owner-occupied homes. This implies that the cost of housing for owner-occupiers (including e.g. young families buying a home) is neglected in the measurement of consumer prices and thus in the central bank's reaction function; it also implies that house price bubbles risk to escape the central bank's formal reaction function. Including owner-occupied housing is thus useful for improving the metrics used to inform monetary policy.

Side effects and proportionality of monetary expansion gain weight as economies bounce back from COVID

Another way how asset price developments, including house prices, can enter the central bank's reaction function is through explicit consideration of side effects and the proportionality of monetary policy measures. Not even the best medicine comes without **side effects**. To take the current situation of the COVID crisis, clearly central banks had to step in to contain damage to our economies. Central banks are

aware of the “side effects” of these policies, such as rising stock prices but also, in many countries, further rising house prices. To contain the latter, e.g. the ECB explicitly excluded mortgage credit from eligibility for meeting banks’ lending benchmarks in order to benefit from preferential interest rates on the ECB’s Targeted Long-Term Refinancing Operations (TLTROs).

As mentioned, asset price increases in general, and housing price rises more specifically, may also entail large wealth gains for those already owning these assets, implying large **distributive effects**. Strongly expansionary, unconventional monetary policies over long periods thus ultimately raise the question of **proportionality**. It is not straightforward how to weigh the benefits against the (potential) costs – there is substantial uncertainty and any decisions ultimately rely on careful judgement. What seems clear, though, is that as the duration of expansionary monetary policy measures extends and as signs of “**exuberance**” in asset markets including residential real estate markets intensify, while the economy seems clearly back on track, the case for taking side effects and proportionality duly into account is becoming more urgent.

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