Vitas Vasiliauskas: Should macroprudential policy target real estate prices?

Welcome remarks by Mr Vitas Vasiliauskas, Governor of the Bank of Lithuania, at the Macroprudential Policy Conference, Vilnius,12 May 2017.

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Good morning, Ladies and Gentlemen,

It's my pleasure to join you on the second day of this conference and thank you all – speakers, panellists and participants – for getting together to discuss this relevant topic. And of course, a special thank you to our keynote speakers – Dr Stefan Ingves, Governor of Sveriges Riksbank, and Dr Jon Danielsson, Director of the Systemic Risk Center, who gave a keynote speech yesterday.

Much to my regret I wasn't able to be part of your previous exchange of views on whether and how macroprudential policy should react to real estate price changes. I know you also discussed the current macropudential measures and their ability to efficiently reduce real estate market imbalances. But still a good bunch of pending questions promises us another intensive day.

Dear Colleagues,

Today – when we ask 'should macroprudential policy target real estate prices?', one may answer with a quick 'no'. But this would make us think about the periods, when the real estate boom ended in a bust.

You know better than anyone, that people use various indicators to foresee the turning of the business cycle – industrial production, credit and real estate price growth, or even cranes looming over the city.

Well, this morning while driving through the city I got the impression that they – I mean cranes – do disturb the skyline quite freely and, thus, warn us to watch the market temperature closely.

It's broadly acknowledged that huge fluctuations in real estate prices have a chance of leading to financial disasters. History has taught us that crises are typically preceded by lending booms and formation of asset price bubbles. When the bubble deflates, it hurts the financial system and then – the real economy. Eventually this costs us far too much.

Having in mind what we all witnessed in the last decade, I'm tempted to answer the previous question with a 'yes'.

Let's look at what was happening in real estate sectors of the Baltic States in the years prior to the financial crisis and the years afterwards.

To illustrate: prior to the great turmoil of 2008 Lithuania's real estate sector was flooded by credit. The curve of the real estate price growth was very steep: within 4 years real prices almost tripled.

Back then we didn't have macroprudential policy and, when the shock hit our financial system, we experienced the deepest fall in real estate prices ever seen in our country. We lost around one third of the market value of residential real estate. Unemployment tripled. And GDP contracted by 15 per cent. We experienced one of the deepest economic recessions in the EU. Thankfully, it was also one of the shortest; although we achieved the recovery through great pains.

Or if we were to look towards the other shore of the Baltic Sea and recall Sweden three decades ago, where, by the beginning of the ’90s, real estate values and stock prices had more than doubled. Soon after – the price bubble blew up. Half of the property value was lost. And – that left the Swedes to deal with very painful consequences for their economy.

Dear Stefan,

maybe later you will share your thoughts on how to prevent history from repeating itsel?

From our side I can firmly say that after muddling through the turmoil, we learned our lesson. We took actions. The Bank of Lithuania now has the mandate to shape macroprudential policy. This is a big responsibility and I am confident that we are delivering on the mandate of financial stability. We have a number of well-targeted measures, which, I believe, are doing their job. Had these tools been in place before 2008, the cycle would have been smoother. And the negative consequences for our economy wouldn’t have been so dramatic.

However, despite actions taken and ammunition obtained, my colleagues at the Bank of Lithuania encourage asking ourselves whether we could do more. And I do agree with them –in-depth analysis and discussions are very welcome.

When doing more, it seems obvious to intervene somewhere at the start of the cycle. And if, for example, easy money is needed to invigorate real economy, then we could maybe do something about a probable speculative bubble. Something like setting the speed limit on real estate price growth and then using prudential policy measures to steer the real estate sector when needed.

But maybe we should target real estate imbalances instead? If, for instance, we witnessed that housing prices increase much faster in the big cities than they do outside, it would make sense to consider these imbalances as well. We could adjust and use measures, which are already in our arsenal. Then we would have location-based measures.

Let me tell you that I’m still a bit sceptical about focusing only on real estate prices. Why?

Firstly, we must keep in mind that we have a mandate to ensure the stability of the entire financial system.

Secondly, stability in the real estate sector is not sufficient enough for financial stability in general.

Yes, trends in the real estate sector are extremely important. For prudential policy they are important to the extent that they relate to developments in credit, balance sheets of financial institutions and, the financial system as a whole. But at the same time – the real estate sector is not the only one to keep an eye on. Imbalances in other asset markets, vulnerabilities in the banking sector – these also demand our equal attention.

Let us look at the expansion of credit which is most likely the culprit of “speeding” prices. Some colleagues distinguish between “productive” and “non-productive” credit, because not every credit contributes equally to economic growth. A loan to finance a business is much more productive than a mortgage to buy an old apartment. Non-productive credit instead of fuelling the economy might be felt as a heavy load.

So should macroprudential policies be active in steering credit structure towards some desirable levels? For example, imposing different risk weights on different types of credit? What measures do we already have in order to start implementing such policy?

Today we will hear about prudential policy experiences in different countries. And I’m excited to open the floor to needed and well-targeted discussions.

I wish you an interesting day and fruitful exchange of views.

And now I gladly pass the microphone to our keynote speaker, our good friend Governor Ingves.

Please, Stefan, the floor is yours.