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Credit availability, macroprudential regulations and the house price-to-rent ratio☆

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Abstract

Quantifying the real economy effects of macroprudential policy is important at a time when such measures are increasingly being promoted as central to the prevention of future credit and house price bubbles. Recently, like other regulatory authorities, the Irish central bank introduced regulatory limits on mortgage lending aimed at protecting greater financial stability. In this paper, we seek to examine some of the wider implications of these measures for tenure choice in the Irish housing market. We find that a reduction in the loan-to-value ratio, such as may occur as a result of regulatory limits, will lead to a greater demand for rental accommodation, prompting higher rents for a given house price level. While this result is somewhat incidental to financial stability, it does have significant implications for housing policy, particularly, at a time when the Irish housing market is confronted by an acknowledged supply shortage.

JEL classification: G12; R21; R30

Keywords: House prices; Rents; Macroprudential policy

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1. Introduction

Given the scale of disruption experienced after 2007 in many international property markets and the associated economies, an increasing number of regulatory authorities and central banks have advanced macroprudential policy as an appropriate tool to temper any future, asset price bubbles.[1] Limits on loan-to-value (LTV) and loan-to-income (LTI) ratios have been used for some time in Hong Kong, China, Korea, Singapore and other emerging market economies, while more recently, regulatory authorities in Hungary, Norway, Sweden, Finland and Ireland have all adopted these types of macroprudential measures.[2]

While the financial stability merits of macroprudential policy have received a considerable amount of attention, there has been a relative dearth of analysis examining the real economy implications of these measures. In this paper, therefore, we examine the potential implications of constraints on LTV ratios on relative prices (purchasing versus renting) in the housing market and, by implication, on housing tenure choices. In particular, we employ a framework presented conceptually by Kim (2007) and implemented empirically by Duca, Muellbauer, and Murphy (2011) to assess the impact on the house price-to-rent ratio of macroprudential measures which restrict LTV ratios. Using data for Ireland, we find that reduced LTV ratios will, ceteris paribus, raise rents relative to house prices over the longer term. This finding has important implications, including when a need to stimulate the rate of housing supply is acknowledged.

The Irish mortgage market provides an interesting case study for assessing macroprudential policy. House prices in Ireland increased more than in any other country in the OECD over the period 1995–2007, culminating in a sizeable credit-driven house price bubble. By 2007, prices were estimated to be approximately 30–35 per cent overvalued.[3] Consequently, when the international and domestic economic downturn occurred, Irish house prices were particularly affected, registering a 50 per cent decline in nominal terms between 2007 and 2012. Alongside these price developments, the supply of houses declined substantially.

Since early 2013, the Irish housing market has shown strong signs of recovery with house prices and rental rates, particularly in the Dublin area, registering strong growth. In 2015, the Irish central Bank introduced regulations placing ceilings on the proportion of mortgage lending at high LTVs and LTIs by domestic financial institutions. The stated objective of these measures is to increase the resilience of the banking and household sectors to the property market and to try and reduce the risk of bank credit and housing price "spirals" emerging in the future (Central Bank of Ireland, 2015).

While the demand side of the Irish housing market appears to have undergone some recovery of late, housing supply remains persistently below the level of structural demand estimated for the Irish economy.[4] Consequently, an increasing amount of domestic policy attention has been devoted

[1] By bubble, we mean a situation where house price movements become dislocated from movements in fundamental, underlying economic variables such as interest rates, household incomes and population levels.

[2] See Magyar Nemezeti Bank (2010), Norges Bank (2010), Swedish Financial Supervisory Authority (2010) and Central Bank of Ireland (2015) for more details.

[3] See Honohan (2010).

[4] Based on demographic trends and household formation rates, Byrne, Duffy, & Fitzgerald, 2014 estimate this structural demand to be 25,000 units per annum in the medium term, whereas actual housing supply in the Irish economy, over the period 2010–2015, averaged just under 11,000 units.

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