„The impact of commercial real estate on the financial sector, its tracking by central banks and some recommendations for the macro-financial stability policy of central banks in CEE”

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***The presentation presents the personal opinions of the author and does not necessarily reflect the official position of the National Bank of Poland.**

Overview

- main features of the commercial real estate (CRE) market, its cycle and risks related to this market
- relation of CRE to the financial sector
- hints for the macroeconomic and financial stability policy of central banks in CEE, which should help to reduce risk and at the same time enhance the growth of the CRE market

CRE cycles and risk

- The CRE market consists mainly of office, retail and industrial space as well as of hotels.
- Investors usually buy it in order to lease it to other economic entities.
- The income of CRE depends highly on the business cycle. Thus, large price swings appear and can finally lead to economic and banking crises.
- Diversification of risk is not simple (Kearns and Woods 2006).
- Cycles are driven by (Herring and Wachter 1999):
  - Excessive optimism
  - Disaster myopia
  - Long lag between investment start and completion
- The main drivers of CRE price booms are usually strong deregulation, international capital flows and low interest rates.
- The CRE market is highly capital intensive and depends strongly on external financing, thus can create significant risks to the banking sector (see Davis and Zhu, 2009, 2011)

Some lessons for macro-financial policy I

- Data collection
  - The CRE market is opaque, trading is infrequent, valuation methods are heterogeneous
  - Clear definitions and collection of regional data is necessary

- Equilibrium and Misalignment analysis
  - The combination of credit growth and fast rising property prices can result in financial instability (Borio and Lowe 2002). But it is difficult to say precisely when the price growth is excessive (Zhu 2003).
  - Creation of a value index is needed – the German long-term income approach might be a starting point.
  - The comparison of the relation of capital value to 1) GDP, 2) private consumption, 3) employment, 4) rent and finally the yield against its long run levels can help to identify tensions (see ECB 2011).
  - The short-run and long-run equilibrium should be analysed.

Some lessons for macro-financial policy II

- Macroprudential and macrostability policy actions
  - The best policy is to steer the CRE market in a way, which strengthens its growth, but which does not allow for the creation of massive bubbles. Monetary policy and prudential policy are usually seen as complementary (Borio and Shim 2007), and thus should enforce each other.
  - **The macroprudential regulatory framework** should, as Christensson, Spong and Wilkinson (2010) state, consist of three policy steps:
    - 1. countercyclical regulatory policy;
    - 2. control of contagion risk;
    - 3. discretionary policies.
  - Suggestions for **macroprudential policies** to prevent real estate bubbles (Allen and Carletti 2011):
    - 1. mandatory reduction in loan to value ratios;
    - 2. increases in taxes on real estate transfers;
    - 3. increases in real estate taxes;
    - 4. direct restrictions on real estate lending.

Some lessons for macro-financial policy III
Conclusions

- Prices of CRE in different market segments and different regions need to be tracked, as they might behave quite differently.
- A proper valuation method which suits the market characteristics and makes use of available data needs to be chosen and elaborated.
- A database which contains enough data to analyse the connection between the business-cycle and the CRE cycle would be very useful. This information will help to choose the appropriate monetary, regulatory and fiscal policy measures to allow the CRE market to grow but also to minimize the risk that might emerge from it.
- The central bank should give clear statements when it observes tensions in the CRE market. A clear communication can make investors aware of problems and help to mitigate them.
- Monetary, regulatory and fiscal policy needs to cooperate and enforce each other to prevent the creation of bubbles and allow the CRE market to grow safely.
- Finally, the central bank and government should be prepared how to react if problems occur.