

House prices

After the fall

Jun 16th 2005

From The Economist print edition

Soaring house prices have given a huge boost to the world economy. What happens when they drop?

PERHAPS the best evidence that America's house prices have reached dangerous levels is the fact that house-buying mania has been plastered on the front of virtually every American newspaper and magazine over the past month. Such bubble-talk hardly comes as a surprise to our readers. We have been warning for some time that the price of housing was rising at an alarming rate all around the globe, including in America. Now that others have noticed as well, the day of reckoning is closer at hand. It is not going to be pretty. How the current housing boom ends could decide the course of the entire world economy over the next few years.

This boom is unprecedented in terms of both the number of countries involved and the record size of house-price gains. Measured by the increase in asset values over the past five years, the global housing boom is the biggest financial bubble in history (see [article](#)). The bigger the boom, the bigger the eventual bust.

Throughout history, financial bubbles—whether in houses, equities or tulip bulbs—have continued to inflate for longer than rational folk believed possible. In many countries around the globe, house prices are already at record levels in relation to rents and incomes. But, as demonstrated by dotcom shares at the end of the 1990s, some prices could yet rise even higher. It is impossible to predict when prices will turn. Yet turn they will. Prices are already sliding in Australia and Britain. America's housing market may be a year or so behind.

Many people protest that house prices are less vulnerable to a meltdown. Houses, they argue, are not paper wealth like shares; you can live in them. Houses cannot be sold as quickly as shares, making a price crash less likely. It is true that house prices do not plummet like a brick. They tend to drift downwards, more like a brick with a parachute attached. But when they land, it still hurts. And there is a troubling similarity between the house-price boom and the dotcom bubble: investors have been buying houses even though rents will not cover their interest payments, purely in the expectation of large capital gains—just as investors bought shares in profitless firms in the late 1990s, simply because prices were rising.

Homes as cash machines

One other big difference between houses and shares is more cause for concern than comfort: people are much more likely to borrow to buy a house than to buy shares. In most countries, the recent surge in house prices has gone hand-in-hand with a much larger jump in household debt than in previous booms. Not only are new buyers taking out bigger mortgages, but existing owners have increased their mortgages to turn capital gains into cash which they can spend. As a result of such borrowing, housing

booms tend to be more dangerous than stockmarket bubbles, and are often followed by periods of prolonged economic weakness. A study by the IMF found that output losses after house-price busts in rich countries have, on average, been twice as large as those after stockmarket crashes, and usually result in a recession.

The economic damage this time could be worse than in the past because house prices are more likely to fall in nominal, not just real terms. Not only do houses in many countries look more overvalued than at previous peaks, but with inflation so low, prices would have to stay flat for at least a decade to bring real prices back to long-run average values. Most important of all, in many countries this house-price boom has been driven far more by investors than in the past, and if prices start to dip, they are more likely to sell than owner-occupiers. In America this could mean the first fall in average house prices since the Great Depression. Owners who have been using their home like an ATM to extract cash, or who were relying on rising house prices to provide them with a comfortable pension, will suddenly realise that they need to start saving the old-fashioned way—by spending less of their income.

The Fed frets

The lesson from recent experience in Australia, Britain and the Netherlands is that, contrary to conventional wisdom, a big rise in interest rates is not necessary to make house prices falter. This is bad news for America. Even if prices there initially just flatten rather than fall, this will hurt consumer spending as the impulse to borrow against capital gains disappears. It is by encouraging such borrowing that rising house prices have given a bigger boost to America's economy than elsewhere. Two-fifths of all American jobs created since 2001 have been in housing-related sectors such as construction, real-estate lending and broking. If house prices actually fall, this boost will turn into a substantial drag.

No wonder that the Federal Reserve is starting, belatedly, to fret about house prices. By holding interest rates low for so long after equities crashed, the Fed helped to inflate house prices. This prevented a deep recession, but it may have merely delayed the needed economic adjustments. Ideally, the Fed should have tried to cool the housing boom by raising interest rates sooner and by giving clear verbal warnings to buyers, as Britain's and Australia's central banks have done. Even now some stern words from Alan Greenspan, the Fed's chairman, could restrain more house-price inflation.

Of course, by the time American prices begin to fall, probably sometime next year, they will not be Mr Greenspan's headache. He will have retired and someone else will be in his job. If weaker house prices push the economy towards recession, the awkward truth is that America's policymakers will have much less room to manoeuvre than they did after the stockmarket bubble burst. Short-term interest rates of only 3% leave less scope for cuts. In 2000, America had a budget surplus. Today it has a large deficit, ruling out big tax cuts.

The whole world economy is at risk. The IMF has warned that, just as the upswing in house prices has been a global phenomenon, so any downturn is likely to be synchronised, and thus the effects of it will be shared widely. The housing boom was fun while it lasted, but the biggest increase in wealth in history was largely an illusion.

The global housing boom

In come the waves

Jun 16th 2005

From The Economist print edition

The worldwide rise in house prices is the biggest bubble in history. Prepare for the economic pain when it pops

NEVER before have real house prices risen so fast, for so long, in so many countries. Property markets have been frothing from America, Britain and Australia to France, Spain and China. Rising property prices helped to prop up the world economy after the stockmarket bubble burst in 2000. What if the housing boom now turns to bust?

According to estimates by *The Economist*, the total value of residential property in developed economies rose by more than \$30 trillion over the past five years, to over \$70 trillion, an increase equivalent to 100% of those countries' combined GDPs. Not only does this dwarf any previous house-price boom, it is larger than the global stockmarket bubble in the late 1990s (an increase over five years of 80% of GDP) or America's stockmarket bubble in the late 1920s (55% of GDP). In other words, it looks like the biggest bubble in history.

The global boom in house prices has been driven by two common factors: historically low interest rates have encouraged home buyers to borrow more money; and households have lost faith in equities after stockmarkets plunged, making property look attractive. Will prices now fall, or simply flatten off? And in either case, what will be the consequences for economies around the globe? The likely answers to all these questions are not comforting.

The increasing importance of house prices in the world economy prompted *The Economist* to start publishing a set of global house-price indices in 2002 (see [article](#)). These now cover 20 countries, using data from lending institutions, estate agents and national statistics. Our latest quarterly update shows that home prices continue to rise by 10% or more in half of the countries (see table). America has seen one of the biggest increases in house-price inflation over the past year, with the average price of homes jumping by 12.5% in the year to the first quarter. In California, Florida, Nevada, Hawaii, Maryland and Washington, DC, they soared by more than 20%.

In Europe, prices have long been at dizzy heights in Ireland and Spain, but over the past year have also spurted at rates of 9% or more in France, Italy, Belgium, Denmark and Sweden. Both France (15%) and Spain (15.5%) have faster house-price inflation than the United States.

By contrast, some housing booms have now fizzled out. In Australia, according to official figures, the 12-month rate of increase in house prices slowed sharply to only 0.4% in the first quarter of this year, down from almost 20% in late 2003. Wishful thinkers call this a soft landing, but another index, calculated by the Commonwealth Bank of Australia, which is based on prices when contracts are agreed rather than at settlement, shows that average house prices have actually fallen by 7% since 2003; prices in once-hot Sydney have plunged by 16%.

Britain's housing market has also cooled rapidly. The Nationwide index, which we use, rose by 5.5% in the year to May, down from 20% growth in July 2004. But once again, other surveys offer a gloomier picture. The Royal Institution of Chartered Surveyors (RICS) reports that prices have fallen for ten consecutive months, with a net balance of 49% of surveyors reporting falling prices in May, the weakest number since 1992 during Britain's previous house-price bust. The volume of sales has slumped by one-third compared with a year ago as both sellers and buyers have lost confidence in house valuations. House-price inflation has also slowed significantly in Ireland, the Netherlands and New Zealand over the past year.

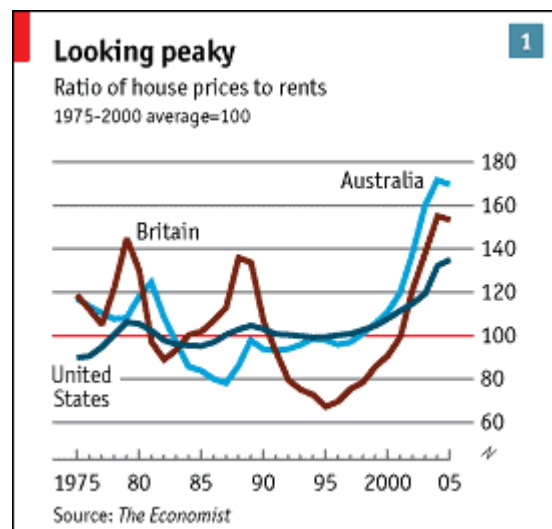
Since 1997, home prices in most countries have risen by much more in real terms (ie, after adjusting for inflation) than during any previous boom. (The glaring exceptions are Germany and Japan, where prices have been falling.) American prices have risen by less than those in Britain, yet this is still by far the biggest boom in American history, with real gains more than three times bigger than in previous housing booms in the 1970s or the 1980s.

The most compelling evidence that home prices are over-valued in many countries is the diverging relationship between house prices and rents. The ratio of prices to rents is a sort of price/earnings ratio for the housing market. Just as the price of a share should equal the discounted present value of future dividends, so the price of a house should reflect the future benefits of ownership, either as rental income for an investor or the rent saved by an owner-occupier.

Calculations by *The Economist* show that house prices have hit record levels in relation to rents in America, Britain, Australia, New Zealand, France, Spain, the Netherlands, Ireland and Belgium. This suggests that homes are even more over-valued than at previous peaks, from which prices typically fell in real terms. House prices are also at record levels in relation to incomes in these nine countries.

America's ratio of prices to rents is 35% above its average level during 1975-2000 (see chart 1). By the same gauge, property is "overvalued" by 50% or more in Britain, Australia and Spain. Rental yields have fallen to well below current mortgage rates, making it impossible for many landlords to make money.

To bring the ratio of prices to rents back to some sort of fair value, either rents must rise sharply or prices must fall. After many previous house-price booms most of the adjustment came through inflation pushing up rents and incomes, while home prices stayed broadly flat. But today, with inflation much lower, a similar process would take years. For example, if rents rise by an annual 2.5%, house prices would need to remain flat for 12 years to bring America's ratio of house prices to rents back to its long-term norm. Elsewhere it would take even longer. It seems more likely, then, that prices will fall.



A common objection to this analysis is that low interest rates make buying a home cheaper and so justify higher prices in relation to rents. But this argument is incorrectly based on nominal, not real, interest rates and so ignores the impact of inflation in eroding the real burden of mortgage debt. If real interest rates are permanently lower, this could indeed justify higher prices in relation to rents or income. For example, real rates in Ireland and Spain were reduced significantly by these countries' membership of Europe's single currency—though not by enough to explain all of the surge in house prices. But in America and Britain, real after-tax interest rates are not especially low by historical standards.

Betting the house

America's housing market heated up later than those in other countries, such as Britain and Australia, but it is now looking more and more similar. Even the Federal Reserve is at last starting to fret about what is happening. Prices are being driven by speculative demand. A study by the National Association of Realtors (NAR) found that 23% of all American houses bought in 2004 were for investment, not owner-occupation. Another 13% were bought as second homes. Investors are prepared to buy houses they will rent out at a loss, just because they think prices will keep rising—the very definition of a financial bubble. “Flippers” buy and sell new properties even before they are built in the hope of a large gain. In Miami, as many as half of the original buyers resell new apartments in this way. Many properties change hands two or three times before somebody finally moves in.

New, riskier forms of mortgage finance also allow buyers to borrow more. According to the NAR, 42% of all first-time buyers and 25% of all buyers made no down-payment on their home purchase last year. Indeed, homebuyers can get 105% loans to cover buying costs. And, increasingly, little or no documentation of a borrower's assets, employment and income is required for a loan.

Interest-only mortgages are all the rage, along with so-called “negative amortisation loans” (the buyer pays less than the interest due and the unpaid principal and interest is added on to the loan). After an initial period, payments surge as principal repayment kicks in. In California, over 60% of all new mortgages this year are interest-only or negative-amortisation, up from 8% in 2002. The national figure is one-third. The new loans are essentially a gamble that prices will continue to rise rapidly, allowing the borrower to sell the home at a profit or refinance before any principal has to be repaid. Such loans are usually adjustable-rate mortgages (ARMs), which leave the borrower additionally exposed to higher interest rates. This year, ARMs have risen to 50% of all mortgages in those states with the biggest price rises.

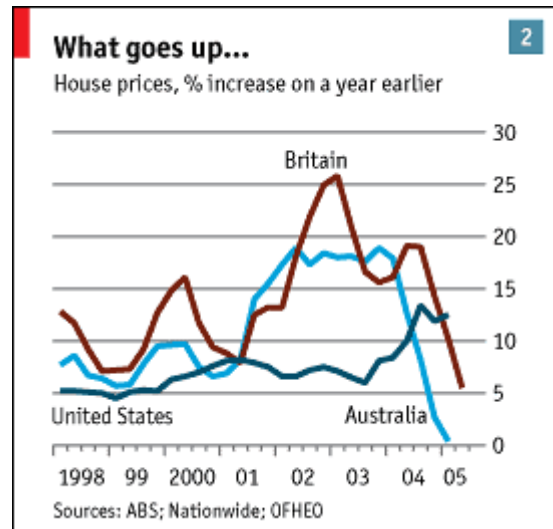
The rapid house-price inflation of recent years is clearly unsustainable, yet most economists in most countries (even in Britain and Australia, where prices are already falling) still cling to the hope that house prices will flatten rather than collapse. It is true that, unlike share prices, house prices tend to be somewhat “sticky” downwards. People have to live somewhere and owners are loth to accept a capital loss. As long as they can afford their mortgage payments, they will stay put until conditions improve. The snag is that eventually some owners have to sell—because of relocation, or job loss—and they will be forced to accept lower prices.

Indeed, a drop in nominal prices is today more likely than after previous booms for three reasons: homes are more overvalued; inflation is much lower; and many more people have been buying houses as an investment. If house prices stop rising or start to

fall, owner-occupiers will largely stay put, but over-exposed investors are more likely to sell, especially if rents do not cover their interest payments. House prices will not collapse overnight like stockmarkets—a slow puncture is more likely. But over the next five years, several countries are likely to experience price falls of 20% or more.

While America's housing market is still red hot, others—in Britain, Australia and the Netherlands—have already cooled (see chart 2). What lessons might they offer the United States?

The first is that, contrary to conventional wisdom, it does not require a trigger, such as a big rise in interest rates or unemployment, for house prices to decline. British home prices started to fall in the summer of 2004 after the Bank of England raised rates by a modest one and a quarter percentage points. Since 2002, the Reserve Bank of Australia has raised rates by exactly the same amount and unemployment is at a 30-year low, yet home prices have fallen. The Federal Reserve's gradual increase in rates by two percentage-points over the past year has done little to scare away buyers, because most still have fixed-rate mortgages and long-term bond yields have remained unusually low. But as more Americans have been resorting to ARMs, so the housing market is becoming more vulnerable to rising rates.



Rung at the bottom

British and Australian prices have stalled mainly because first-time buyers have been priced out of the market and demand from buy-to-let investors has slumped. British first-timers now account for only 29% of buyers, down from 50% in 1999. And, according to the National Association of Estate Agents, buy-to-let purchases are running 50% lower than a year ago. As prices become more and more heady in America, the same will happen there.

British experience also undermines a popular argument in America that house prices must keep rising because there is a limited supply of land and a growing number of households. As recently as a year ago, it was similarly argued that the supply of houses in Britain could not keep up with demand. But as the expectation of rising prices has faded, demand has slumped. According to RICS, the stock of houses for sale has increased by one-third over the past year. America has faster population growth than Britain, but its supply of housing has also been rising rapidly. Economists at Goldman Sachs point out that residential investment is at a 40-year high in America, yet the number of households is growing at its slowest pace for 40 years. This will create excess supply.

Another mantra of housing bulls in America is that national average house prices have never fallen for a full year since modern statistics began. Yet outside America, many

countries have at some time experienced a drop in average house prices, such as Britain and Sweden in the early 1990s and Japan over the past decade. So why should America be immune? Alan Greenspan, chairman of America's Federal Reserve, accepts that there are some local bubbles, but dismisses the idea of a national housing bubble that could harm the whole economy if it bursts. America has in the past seen sharp regional price declines, for example in Boston, Manhattan and San Francisco in the early 1990s. This time, with prices looking overvalued in more states than ever in the past, average American prices may well fall for the first time since the Great Depression.

But even if prices in America do dip, insist the optimists, they will quickly resume their rising trend, because real house prices always rise strongly in the long term. Robert Shiller, a Yale economist, who has just updated his book "Irrational Exuberance" (first published on the eve of the stockmarket collapse in 2000), disagrees. He estimates that house prices in America rose by an annual average of only 0.4% in real terms between 1890 and 2004. And if the current boom is stripped out of the figures, along with the period after the second world war when the government offered subsidies for returning soldiers, artificially inflating prices, real house prices have been flat or falling most of the time. Another sobering warning is that after British house prices fell in the early 1990s, it took at least a decade before they returned to their previous peak, after adjusting for inflation.

Another worrying lesson from abroad for America is that even a mere levelling-off of house prices can trigger a sharp slowdown in consumer spending. Take the Netherlands. In the late 1990s, the booming Dutch economy was heralded as a model of success. At the time, both house prices and household credit were rising at double-digit rates. The rate of Dutch house-price inflation then slowed from 20% in 2000 to nearly zero by 2003. This appeared to be the perfect soft landing: prices did not drop. Yet consumer spending declined in 2003, pushing the economy into recession, from which it has still not recovered. When house prices had been rising, borrowing against capital gains on homes to finance other spending had surged. Although house prices did not fall, this housing-equity withdrawal plunged after 2001, removing a powerful stimulus to spending.

Housing-equity withdrawal has also fallen sharply over the past year in Britain and Australia, denting household spending. In Australia, the 12-month rate of growth in retail sales has slowed from 8% to only 1.8% over the past year; GDP growth has halved to 1.9%. In Britain, too, a cooling of the housing market has been accompanied by an abrupt slowdown in consumer spending. If, as seems likely, home prices continue to fall in both countries, spending will be further squeezed.

Even a modest weakening of house prices in America would hurt consumer spending, because homeowners have been cashing out their capital gains at a record pace. Goldman Sachs estimates that total housing-equity withdrawal rose to 7.4% of personal disposable income in 2004. If prices stop rising, this "income" from capital gains will vanish.

And after the gold rush?

The housing market has played such a big role in propping up America's economy that a sharp slowdown in house prices is likely to have severe consequences. Over the past four years, consumer spending and residential construction have together accounted for 90% of the total growth in GDP. And over two-fifths of all private-sector jobs created

since 2001 have been in housing-related sectors, such as construction, real estate and mortgage broking.

One of the best international studies of how house-price busts can hurt economies has been done by the International Monetary Fund. Analysing house prices in 14 countries during 1970-2001, it identified 20 examples of "busts", when real prices fell by almost 30% on average (the fall in nominal prices was smaller). All but one of those housing busts led to a recession, with GDP after three years falling to an average of 8% below its previous growth trend. America was the only country to avoid a boom and bust during that period. This time it looks likely to join the club.

Japan provides a nasty warning of what can happen when boom turns to bust. Japanese property prices have dropped for 14 years in a row, by 40% from their peak in 1991. Yet the rise in prices in Japan during the decade before 1991 was less than the increase over the past ten years in most of the countries that have experienced housing booms (see chart 3). And it is surely no coincidence that Japan and Germany, the two countries where house prices have fallen for most of the past decade, have had the weakest growth in consumer spending of all developed economies over that period. Americans who believe that house prices can only go up and pose no risk to their economy would be well advised to look overseas.

