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Back to housing bubbles

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It is widely agreed that a series of collapsing housing-market bubbles triggered the Global Financial Crisis of 2008 to 2009, along with the severe recession that followed. While the United States is the best-known case, a combination of lax regulation and supervision of banks and low policy interest rates fueled similar bubbles in the United Kingdom, Spain, Ireland, Iceland, and Dubai.

Now, five years later, signs of frothiness - if not outright bubbles - are reappearing in housing markets in Switzerland, Sweden, Norway, Finland, France, Germany, Canada, Australia, New Zealand and, back for an encore, the UK (well, London). In emerging markets, bubbles are appearing in Hong Kong, Singapore, China, and Israel, and in major urban centers in Turkey, India, Indonesia, and Brazil.

Signs that home prices are entering bubble territory in these economies include fast-rising home prices, high and rising price-to-income ratios, and high levels of mortgage debt as a share of household debt. In most advanced economies, bubbles are being inflated by very low short- and long-term interest rates. Given anemic GDP growth, high unemployment, and low inflation, the wall of liquidity generated by conventional and unconventional monetary easing is driving up asset prices, starting with home prices.

The situation is more varied in emerging market economies. Some that have high per capita income - for example, Israel, Hong Kong, and Singapore - have low inflation and want to maintain low policy interest rates to prevent exchange-rate appreciation against major currencies. Others are characterised by high inflation (even above the central-bank target, as in Turkey, India, Indonesia, and Brazil). In China and India, savings are going into home purchases because financial repression leaves households with few other assets that provide a good hedge against inflation. Rapid urbanisation in many emerging markets has also driven up home prices, as demand outstrips supply.

With central banks - especially in advanced economies and the high-income emerging economies - wary of using policy rates to fight bubbles, most countries are relying on macro-prudential regulation and supervision of the financial system to address frothy housing markets. That means lower loan-to-value ratios, stricter mortgage-underwriting standards, limits on second-home financing, higher counter-cyclical capital buffers for mortgage lending, higher permanent capital charges for mortgages, and restrictions on the use of pension funds for down payments on home purchases.

In most economies, these macro-prudential policies are modest, owing to policymakers' political constraints - households, real-estate developers, and elected officials protest loudly when the central bank or the regulatory authority in charge of financial stability tries to take away the punch bowl of liquidity. They complain bitterly about regulators' "interference" with the free market, property rights, and the sacrosanct ideal of home ownership. Thus, the political economy of housing finance limits regulators' ability to do the right thing.

To be clear, macro-prudential restrictions are certainly called for - but they have been inadequate to control housing bubbles. With short- and long-term interest rates so low, mortgage-credit restrictions seem to have a limited effect on the incentives to borrow to purchase a home. Moreover, the higher the gap between official interest rates and the higher rates on mortgage lending as a result of macro-prudential restrictions, the more room there is for regulatory arbitrage.

For example, if loan-to-value ratios are reduced and down payments on home purchases are higher, households may have an incentive to borrow from friends and family - or from banks in the form of personal unsecured loans - to finance a down payment. After all, although home-price inflation has slowed modestly in some countries, home prices in general are still rising in economies where macro-prudential restrictions on mortgage lending are being used. So long as official policy rates - and thus long-term mortgage rates - remain low, such restrictions are not as binding as they otherwise would be.

But the global economy's new housing bubbles may not be about to burst just yet, because the forces feeding them - especially easy money and the need to hedge against inflation - are still fully operative. Moreover, many banking systems have bigger capital buffers than in the past, enabling them to absorb losses from a correction in home prices. And, in most countries, households' equity in their homes is greater than it was in the US subprime mortgage bubble. But, the higher home prices rise, the further they will fall - and the greater the collateral economic and financial damage will be - when the bubble deflates.

In countries where non-recourse loans allow borrowers to walk away from a mortgage when its value exceeds that of their home, the housing bust may lead to massive defaults and banking crises. In countries (for example, Sweden) where recourse loans allow seizure of household income to enforce payment of mortgage obligations, private consumption may plummet as debt payments (and, eventually, rising interest rates) crowd out discretionary spending. Either way, the result would be the same - recession and stagnation.

What we are witnessing in many countries looks like a slow-motion replay of the last housing-market train wreck. And, like last time, the bigger the bubbles become, the nastier the collision with reality will be.

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