Abstract (Summary)

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. 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. The bigger the boom, the bigger the eventual bust. 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.

Full Text

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 pages 73-75). 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.

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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.

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