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Real Estate Booms

Real estate boom-bust cycles can have far-reaching consequences. Booms are generally accompanied by fast credit growth and sharp increases in leverage, and when the bust comes, debt overhang and deleveraging spirals can threaten financial and macroeconomic stability. Why is real estate more dangerous than other asset-price bubbles? Can policies reduce the likelihood and impact of real estate booms? A recent IMF Staff Position Note explores these questions (available at: http://www.imf.org/external/pubs/ft/sdn/2011/sdn1102.pdf).

Despite the dangers of real estate booms, the traditional policy approach has been one of benign neglect. This was based on two main premises. First, the belief that, as for other asset prices, it is extremely difficult to identify unsustainable real estate booms, or bubbles (sharp price increases not justified by fundamentals), in a timely manner. Second, the notion that the distortions associated with preventing a boom outweigh the costs of cleaning up after a bust.

The global financial crisis has challenged these assumptions. The burst of the real estate bubble in the United States triggered the deepest recession since the Great Depression, which quickly spread to other countries. Traditional macroeconomic policy rapidly reached its limits, as monetary policy rates approached the zero bound and sustainability concerns emerged on the fiscal front. And despite the recourse to extraordinary measures, the aftermath of the crisis has been characterized by a weak recovery, as debt overhang and financial sector weakness continue to hamper economic growth. More recently, concerns of overheating in pockets of real estate markets in some Asian countries has emerged.

So what makes real estate so special? First of all, real estate is an important, if not the most important, storage of wealth in the economy: the majority of households tend to hold wealth in their homes rather than in equities. Second, supply-side effects associated with house price dynamics can be substantial. The construction sector takes property prices as a signal and adjusts production accordingly. In most advanced economies, house price cycles tend to lead credit and business cycles. Third, boom-bust cycles are an intrinsic feature of real estate markets. This reflects delays in the supply response to demand shocks and the slow pace of price discovery due to opaque and infrequent trades as well as illiquidity owing to high transaction costs.

Finally, what matters may be not the asset-price boom itself, but how it is funded. Busts tend to be more costly when booms are financed through credit and leveraged institutions are directly involved. This is because the balance sheets of borrowers (and lenders) deteriorate sharply when asset prices fall. When banks are involved, this can lead to a credit crunch with negative consequences for real economic activity. In contrast, booms with limited leverage and bank involvement tend to deflate without major economic disruptions. For example, the burst of the dot-com bubble was followed by a relatively mild recession, reflecting the minor

role played by leverage and bank credit in funding the boom. Real estate markets are special in this regard. The vast majority of home purchases and commercial real estate transactions involve borrowing and banks and other levered players are actively involved in the financing. Moreover, homebuyers are allowed leverage ratios orders of magnitude higher than for any other investment activity. A typical mortgage loan carries a loan-to-value ratio of 71 percent on average across a global sample of countries. In contrast, stock market participation by individuals hardly ever relies on borrowed funds. And when it does, loans are subject to margin calls that prevent the buildup of highly leveraged positions.

Hence, policy efforts should focus on booms that are financed through credit and when leveraged institutions are directly involved; i.e. real estate. What are the tools at policymakers' disposal? Monetary policy is too blunt and costly a tool to deal with the vulnerabilities associated with increased leverage, unless the boom occurs as a result of or at the same time as broader economic overheating. Monetary policy affects the entire economy and is likely to entail substantial costs if the boom is limited to the real estate market. A marginal change in the policy rate would also have little effect on the speculative component of demand.

Fiscal tools may be, in principle, effective. In most systems, a variety of fiscal measures (transaction taxes, property taxes, credits, deductibility of interest payments) bear on the decision to invest in real estate. In theory, some of these fiscal tools could be adjusted in a counter-cyclical manner to influence house price volatility. But, in practice, they would likely create distortions and technical and political economy problems may complicate implementation. Furthermore, the evidence suggests that the tax treatment of housing does not appear to be related across countries to the amplitude of real estate cycles.

Macroprudential tools are the best candidates to deal with the dangers associated with real estate booms as they can be aimed directly at curbing leverage and strengthening the financial sector. Such measures include capital requirements or risk weights that change with the real estate cycle or dynamic provisioning, which refers to the practice to increase banks' loan-loss provisions during the upswing phase of the cycle. Another macroprudential measure would be the cyclical tightening/easing of eligibility criteria for real estate loans through loan-to-value and/or debt-to-income ratios. Such tools may be able to achieve both objectives: (i) reducing the likelihood and/or magnitude of a real estate boom (for instance, by imposing measures to limit household leverage), and (ii) strengthening the financial system against the effects of a real estate bust (for example, by urging banks to save in good times for rainy days). But their careful design is key to minimize circumvention through nonbank intermediaries, foreign banks, and off-balance-sheet activities. As they raise credit costs, close monitoring is essential to avoid lenders making riskier loans to maintain their net-interest margins and their careful design is key to avoid regulatory arbitrage.

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