BRIEFING PAPER

Developments in the Real Estate Sector in Relation with Monetary Policy

by

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Executive Summary

Developments in the real estate sector in relation with monetary policy

A central hypothesis for the recent financial turmoil is that had interest rates in the US been higher earlier in the cycle, the fragile sub-prime sector for housing investments in the US would have never come into existence. In this case the excess liquidity that caused excessive lending would have never occurred. The conclusion is that central banks and in particular the Fed should have a closer look at financial markets in their future monetary policy strategy. The current paper challenges this hypothesis.

Instead of restricting monetary policy, a two tier policy approach is suggested. Firstly, a good regulation of financial markets increases the leeway for monetary policy. Secondly, industrial countries have to revise their income distribution policy in order to make real economy investment more attractive in relation to financial market investments. In the euro area such an approach should be complemented by wage policies based on productivity and the ECB's target inflation rate. This would ensure that that long term inflation differentials and the ensuing the emergence of regional bubbles would be avoided. With these measures economic development should become more stable.

Introduction

The real estate sector has been in the focus of most recent economic analysis. Many economists consider it the root of present financial turbulences. Indeed the bursting of the US real estate bubble as well as similar developments in the UK and foreseeable ones in Spain seem to point into that direction. There is fear that the global economy may face a severe downturn as consequence of exaggerated housing investment. The result would be global shockwaves of financial distress. Initially home owners are hit. They lose their property and may nevertheless have to carry a heavy debt burden. Subsequently those banks that financed the investment are affected. They lose at least part of the money they had lent to the home owners who can neither serve nor pay back the debt and whose houses have lost significantly in value. Then the distress spills over to those financial institutions that bought part of the above mentioned debt – at least partly leveraged by borrowed money to be refinanced on short term notice. With the break down of these asset markets, the financial institutions face severe difficulties in refinancing the deals. Those that depend solely on these credits go bankrupt, those that have enough reserves or have insured the risks have at least to make significant write-offs. In the next round, all risk insurers that insured these risks will have to make their payments. Finally, each of the surviving financial market institutions, which were hit at the different stages of the shockwaves, will have to adjust its behaviour since the risk content of their portfolios has changed. Therefore they have to become more restrictive in their borrowing behaviour to avoid further risks. At this stage the real economy will be affected, since every investor, whether financial or not, will meet only very reluctant lenders. As a consequence many investments that would have been possible some months before are no longer feasible due to a lack of financial resources. In other words, financial turbulences originating in the real estate sector will be felt in the whole economy and probably trigger a severe downturn.

Many economists state that one of the main factors leading to the financial turbulences was an overly expansionary monetary policy. Especially the reluctance of the Fed to raise interest rates early in the upswing is said to have created excess liquidity. According to this hypothesis, it was predominantly the excess liquidity that spurred the crisis. Against the backdrop of the huge wave of liquidity, banks were in desperate need

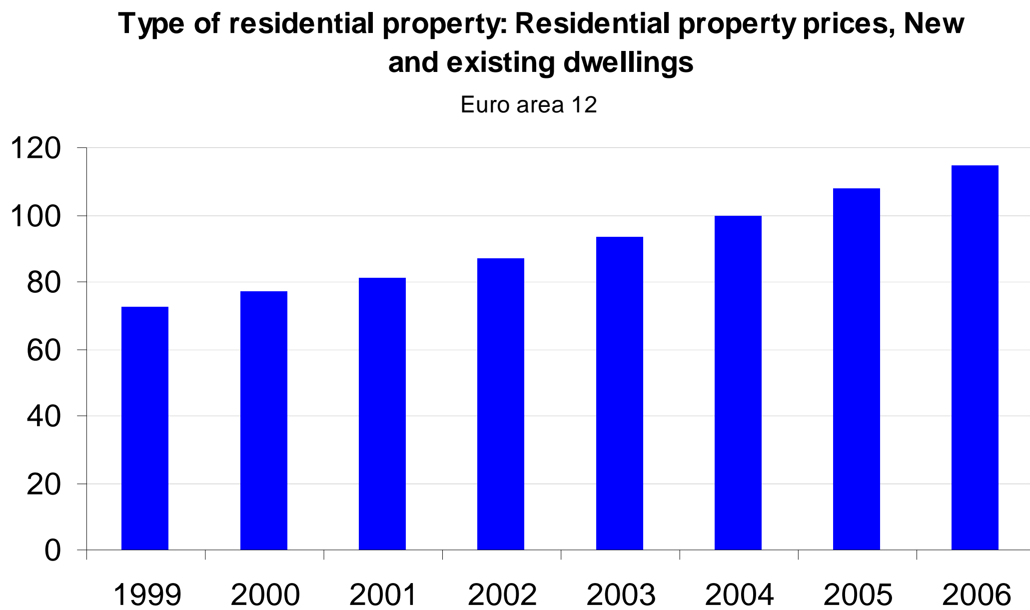
for seemingly profitable investments. That was the time when they discovered sub-prime mortgage market. In fact, during the first years profit expectations proved right inducing more and more investors to enter that business. However, as soon as the Fed started to raise interest rates, the whole system got into difficulties. The argument runs as follows: If interest rates had been higher earlier in the cycle the sub-prime sector would never come into existence since the excess the liquidity would have never occurred. The conclusion is that central banks should have a closer look at financial markets in their monetary policy strategy. Interest rates should be set not only in line with the inflation target and business cycle considerations, but also with respect to financial market developments.

In the following this hypothesis will be challenged. In the next section some developments in the real estate sector with respect to interest rates will be outlined. In the third section some reasons for these developments will be presented. In the final section recommendations for economic policy will be given.

What happened in the Housing Sector?

As a first step one should analyse how prices in the housing sector developed during the past years. The figures show that the picture of a bursting bubble does not really apply. The following table reveals how different relative housing prices behaved in different countries and regions:

Figure 1



Source: ECB.

In the euro area as a whole, the prices for residential property have risen by 58 % since 1999. This is much more than the average price level (measured by the HICP), which increased only by about 20 % since the introduction of the euro. Therefore it is fair to state that a significant change in relative prices has occurred in the euro area. However, this development has by no means been uniform across countries and regions:

Housing Prices (Real Terms)

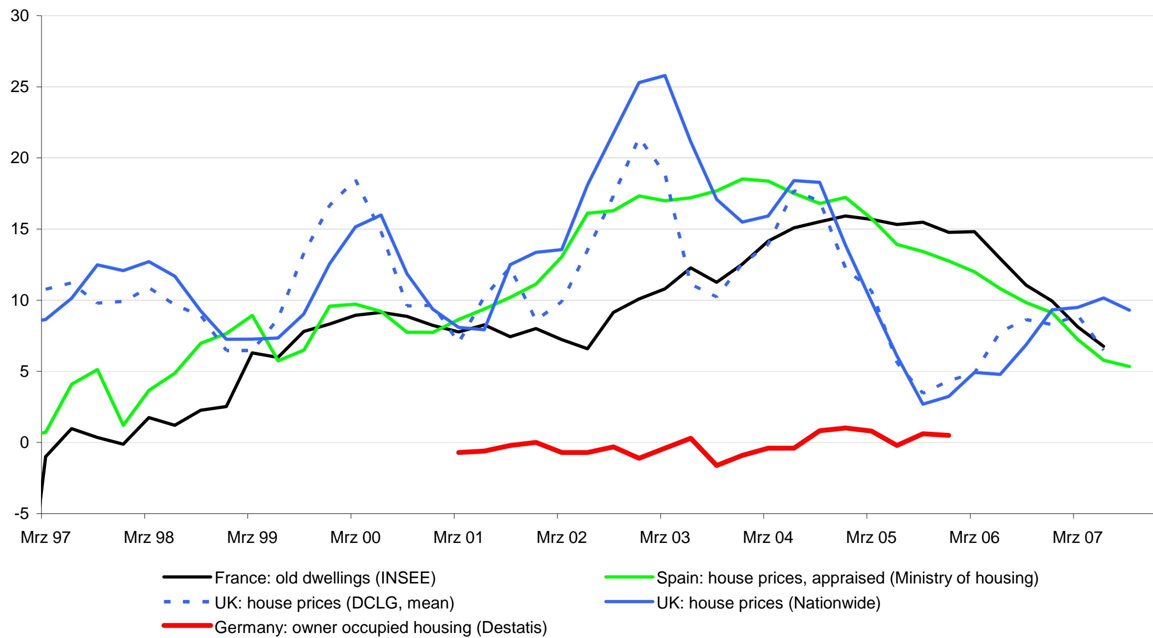
	2000-2006	2005[1]	2006[1]
Germany	-2,4	-1,8	-0,6
France	9,5	12,7	9
Italy	6	4,5	4,5
Spain	11,2	10,2	5,7
Euroarea[2]	4,7	5,3	4,1
UK	8,8	0,1	6,2
USA	6,3	9,1	3,8

1) Percentige Change to previous year.
2) Germany, France, Italy, Spain, Ireland, Netherlands.
Source: OECD Economic Outlook No. 81, Table I.4.

The steepest increases within the euro area have occurred in France and Spain. Outside the euro area house prices soared in the US and the UK. The outlier is Germany, the only country where the relative price of housing declined. Therefore the development of German house prices remained far below the euro area average. This explains why the overall price increases in the euro area were fairly moderate. Interestingly, except for the UK, the price hikes already cooled down in 2006. Nevertheless the increase in France was still substantial. From these figures we learn that there was not a sudden burst of a bubble. That would have shown up in a sudden dramatic fall in house prices. Figure 1 reveals nothing but a continuous increase of relative prices in the housing sector that already started to slow down in 2006. On the aggregate euro area level it is all the more difficult to detect a bubble, because the development in Germany offset strong price increases elsewhere.

The following analysis of developments in Europe will show that monetary policy was at least not the only cause of the housing boom. In the US the situation may have been slightly different. The general view on housing activity in Europe outlined above is confirmed when looking at national quarterly data sources:

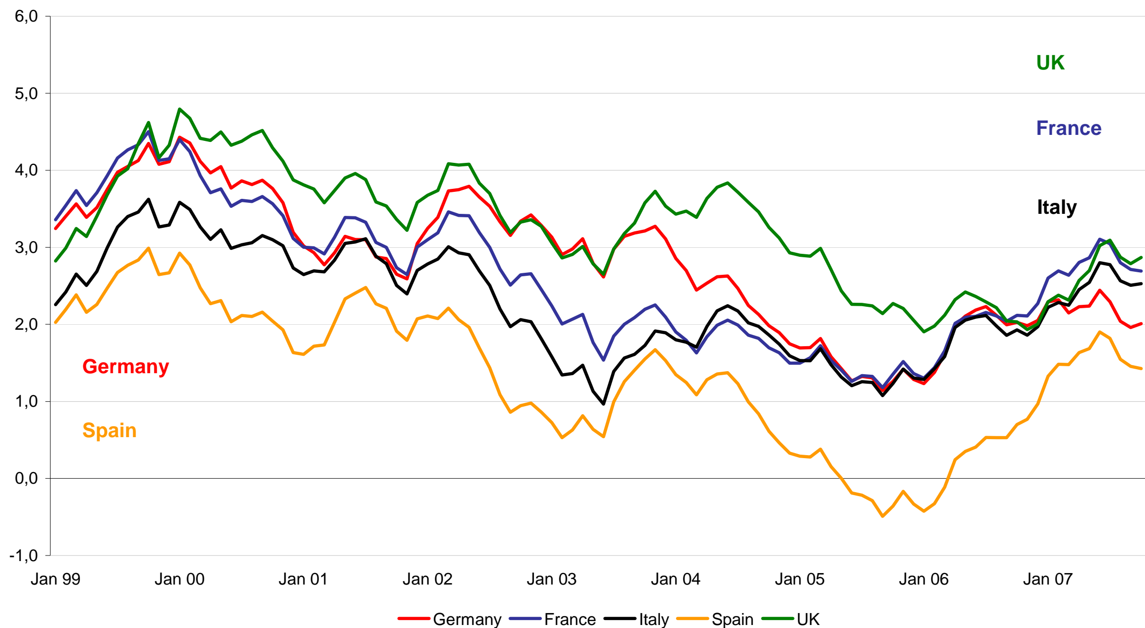
Figure 2



In contrast to the figures above, these are no changes of relative prices but of absolute ones. The higher frequency of the data allows us to see developments over time more accurately, although the availability of quarterly national data on housing is rather limited. Nevertheless, the picture is not that of a bursting bubble, but rather a soft landing. The most pronounced upward movement in Europe occurred in the UK. But the climax of price hikes was already in 2003, when house prices soared by 25 %. Since then the dynamics of price adjustments have slowed down in waves. This is not what one would expect when a bubble bursts. In Spain as in France the highest increases were seen in 2004. Again, Germany is the outlier with more or less stagnating real estate prices..

Real interest rates have a significant impact on the real estate market. If one compares the relevant real interest rates in some European countries one realises that they were lowest in Spain among the larger member states of the euro area.

Figure 3



Interest rates are part of the explanation why Spain showed such a strong housing boom and why the development in Germany was so weak In Germany real interest rates were comparatively high at least until mid 2004 and housing activity was very subdued. In mid 2004 real interest rates started to decline and the housing sector showed signs of recovery soon after. For an extended period France and Italy showed real interest rates that were well below those in Germany. Consequently the real estate sector there was way more vivid than in Germany. The only exception is the UK. There real interest rates were even higher than in Germany for most of the recent past. Nevertheless the housing market was much more dynamic than in Germany. There, other reasons such as the positive income development seem to have played a major rule.

In all these European countries interest rates peaked in 2000 and then declined until 2003. That was the climax of the real estate boom in most countries. The subsequent rise in real interest rates led to the cooling down of prices outlined above. After a brief slump in 2004/2005, rates started to rise again with accelerating economic activity in 2006. That prevented price increases from speeding up again.

An important point to consider is that the differences in real interest rates within the euro area did not occur because nominal interest rates differed. Instead they resulted from differences in national inflation rates. Thus, in the euro area monetary policy cannot be held responsible for the price hikes. Under a uniform monetary policy for all countries we simultaneously observed a slump in German housing activity and a boom in France and Spain. To understand the roots of the boom, in the euro area, one needs to understand the roots of the inflation differentials.

Two Explanations for the Housing Boom

There is no doubt that monetary policy has been very expansionary throughout most of the time since 2001. This applies in particular to the US, but also to the euro area and to some extent to the UK. An expansionary monetary policy leads to relatively low real interest rates. In that respect monetary policy contributed to a housing boom. This was at least partly intended, since the major reason for an expansionary monetary policy is to stimulate economic activity, also by stimulating the real estate sector. Whilst this is basically not seen as a problem, the intensity and duration of the expansionary monetary policy course especially in the US is. According to this hypothesis the turnaround to a phase with higher interest rates came too late and was insufficient.

Consequently there was too much liquidity striving for profitable investment. The excess liquidity induced financial market institutions to invent new risky products in order to offer investment opportunities for otherwise idle money. Among these new products were asset-backed securities that were based on sub-prime lending for housing. On the one hand they benefited from the relatively good income situation of households that usually were not in a position to afford a house of their own. But the economic upturn had improved their income position for some unknown time-span. On the other hand financial investors for these products were easily found – not least because low interest rates seemed to make leveraged investment very profitable. When interest rates are low, borrowing money is not very costly and profitable investments are therefore easy to find. A leveraged investment increases the volume of investment significantly, so the respective market grew very fast.

All these investments were based either on overly optimistic assumptions or on a significant lack of information about the nature of the respective products. With every basis point of higher interest rates this business became more and more endangered. The house owners had growing difficulties to serve their debt, since interest payments were increasing, too. Financial investors faced increasing difficulties to refinance their assets, as leveraged investments became more and more costly and potential lenders became more risk-averse. In the end markets collapsed with the potential consequences outlined above.

Could that have been avoided if the Fed had increased interest rates earlier? It is hardly possible to prove either this hypothesis or the contrary. The reason is that it is very difficult, if not impossible, to detect bubbles in financial markets, before they burst. Otherwise a central bank could certainly prevent bubbles from coming into existence. But then, investors would have the same information and the bubble would not have come into being in the first place. One should not forget that there is a price to pay for such a strategy. If the Fed had raised rates interest rates earlier, the real economy would not have shown such a dynamic upturn. Growth and employment would have been lower during that phase. One could argue that the prevention of a severe slowdown due to the bursting of the bubble would justify early intervention by the central bank. The initial weakness would be compensated by stronger growth later on. However, the success of such a policy crucially depends on correct detection of the bubble in time.Since this is highly uncertain, the suggested strategy is extremely risky. There is a severe danger that it may cause an unnecessary loss of growth and employment.

There is an alternative explanation for the financial turbulences and their roots and reasons. The hypothesis outlined above is based on the assumption that there was excess liquidity in the economic system. One can also interpret the very same facts as excessive saving. In other words given all other circumstances real economy investment should have been higher in order to keep the upturn alive. There are several arguments in favour of this hypothesis. World wide countries faced two kinds of redistribution. Firstly, profits grew much faster than labour incomes. Secondly, higher wages grew faster than lower wages. As a result incomes of the already wealthy soared during the

upturn, whereas low income earners hardly benefited at all. As a consequence saving also increased in most economies with the notable exception of the US. On the other hand consumption remained below potential, since consumption intensive income groups benefited less than proportionally from the economic upswing. In the US people got indebted by keeping consumption high, a situation that is not sustainable and also leads to a downturn sooner or later.

Given the strength of the cycle, relatively weak consumption leads to relatively weak investment compared to the development of profits. The result is excessive saving creating the potential for excessive financial market investments. The conclusion is that redistribution at the expense of lower incomes much rather than an overly expansionary monetary policy is at the root of the crisis.

In the euro area an additional phenomenon has to be considered: Inflation differentials. During most of the recent years the euro area experienced very heterogeneous price developments. Whereas inflation e.g. in Spain usually exceeded the the ECB's target, German price increases remained well below it.. This led to the relative low real interest rates in Spain that contributed to the housing sector boom. On the other hand real interest rates in Germany were high. One major cause of these differentials lies in national wage developments. Wages in Germany increased much more slowly than in all other countries of the euro area. The wage dynamics have contributed to the divergence of housing markets. Especially those countries with relatively high wage hikes and accordingly high inflation rates were more likely to experience excessive housing booms, whereas Germany suffered from an excessive weakness. Monetary policy cannot be held responsible for these divergences since it can only act on an aggregate level. Instead wage developments need to be more in line with the ECB's inflation target.

Consequences for Economic Policy

What can be done to avoid financial turmoil under these circumstances? First a more appropriate regulation of financial markets is necessary to avoid the trade of risky products including those of the housing sector that simply exploit informational asymmetries between seller and buyer. One major element of the regulation should be

that the *first broker* keeps a significant part of the underlying risks. In that case the original creditors would probably have shown a more responsible behaviour when investing in the sub-prime market. At least they would not have been able to sell risks so easily. Furthermore a stricter regulation for credits on housing as is the case in some European countries like Germany also seems advisable. If a minimum amount or a minimum share of capital is required to obtain a credit for housing investment, a legal sub-prime investment would not have happened in the first place.

All these measures help monetary policy to focus on aggregate developments of inflation and growth. With functioning financial markets there is no need the central bank can remain on an expansionary course for an extended period. Good regulation of financial markets thus increases the leeway for monetary policy. Higher growth and higher employment is the result.

In addition industrial countries have to revise their income distribution policy. To stabilise economic development it is necessary that households with a lower income participate in the economic upturn. If that happens investment into the real economy is strengthened, since consumption and domestic sales are strengthened making investment into these sectors more profitable. That would give incentives to divert investment from financial products to the real sector. Therefore an appropriate income policy also serves to avoid financial instability.

European countries should coordinate their wage policies, focusing on productivity increases as well as the ECB's inflation target. Then regional bubbles and slumps would be far less likely.

The bottom line of these considerations is that the root of the financial turmoil cannot be found in monetary policy. One has to concentrate on financial market regulations as well as on income distribution policy.