Real estate price peaks in comparative perspective

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Outline:

To get a better grasp of real estate price peaks it helps to realize right away that there is a paradox about the understanding of this phenomenon.

Over the past 50 years there have been several episodes of price peaks and almost all of them showed the *same pattern*: an increase which starts slowly, gains momentum progressively and lasts a time T_1 which is comprised between 4 to 8 years. This rising phase is followed by a phase of falling prices whose duration T_2 is somewhat shorter and which ends at a level which is defined by the rate γ of the long-term trend of housing prices. For inflation-adjusted prices, γ is usually comprised between 0.5% and 1.5%.

The dynamics of such price peaks is also well understood: it is the growing differential between rent and price rises that brings the bull market to an end. Not only do rents grow slower than prices, but rent hikes are necessarily limited by the income of tenants, whereas there is no upper bound for the prices that investors accept to pay because they anyway resell the property a few months latter. So long as prices are going up, the price at which properties are purchased does not matter. Observation shows that, as the ratio of price to annual rent (which is a kind of *price earning ratio* for property owners) becomes higher than 22 approximately, the market becomes unstable. At that point even a small external shock, e.g. a rise in interest rates, may bring about a market downturn.

We now come to the paradox. If this pattern is really so recurrent and its mechanism so well understood how can one explain that until recently a great majority of economists were predicting that the rising phase would be followed by a plateau? Throughout the early 2000s the notion that there may be protracted price falls in housing markets was a taboo and it was carefully avoided in most comments and predictions. Why?

The answer has much to do with *government control* of housing markets.
(i) For several reasons (incidence on consumption, impact on assets held by insurance companies or property funds) housing valuation has a great potential impact on the economy of a country. Japan where housing prices have been falling for 13 years (1992-2005) amid deflation and protracted economic recession is a case in point. Consequently, economists in charge of economic policy such as Alan Greenspan, Ben Bernanke or Gordon Brown are more tempted to emphasize that the *fundamentals* are sound and robust rather than the fact that price rises are driven by speculation. For instance, back in 2005 it was more reassuring to underline the steady increase

expected in urban population than the fact that stock prices of building companies have been multiplied by 5 within 4 years.

(ii) If soothing statements turn out to be insufficient to keep prices on their upward progression, governments have the resource to prop up markets through tax credits and subsidized loans. That was done in Britain in May 2005 and in France in May 2007. So far these remedies were sufficient to prevent these markets from falling. In those cases the rhetoric has not yet been refuted by hard facts.

With inflation-adjusted property prices having been multiplied by more than 3.3, the price peak in London is of unprecedented magnitude. But the support provided by the government is also largely without precedent. This makes any prediction difficult. Anyhow, from a scientific perspective, it will be very instructive to observe the outcome of this battle between market forces and anti-crash medicine.