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Parallels between the U.S. and Asian property markets

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U.S. home prices are on an upswing. What does this mean for the Asian property market?

American homeowners might never forget the pain inflicted by the subprime mortgage crisis of 2007-2009, but recent economic numbers have injected a little optimism. According to the February 2013 S&P/Case-Shiller Home Prices Indices, home prices across 10 selected cities rose an average of 8.6 percent compared to February 2012. When expanded to 20 cities, the figures were even better: up 9.3 percent.

“The numbers both reflects a general recovery, and is instrumental in that general recovery,” explains **Susan Wachter**, Professor of Real Estate and Finance at The Wharton School of the University of Pennsylvania. “The economy is recovering slowly, not robustly, but nonetheless it is recovering, and that is the major fundamental that’s supporting the housing market along with historically low interest rates.”

Wachter adds, “But then again, the recovery is aided by the housing market price increases which brings wealth to households, puts equity back into their homes, making homes sellable. They become less ‘underwater’, brings consumer confidence back because people’s wealth is heavily related to their housing assets. So in fact, it’s this recovery in the housing market that’s driving this overall recovery.”

The use of Indices

Speaking to *Perspectives@SMU* on the sidelines of the *SKBI Annual Conference on Financial Economics*, Wachter described the importance of quality data, and how the lack thereof contributed to the subprime crisis: “In 2005, there was evidence of under-pricing of debt, that is, cost of credit for mortgages was decreasing relative to cost of other credit at a time when risk was patently growing. There were some funds who used the data to hedge, take positions that protected their funding sources which in the end protected their investors.”

“Nonetheless, there was great surprise in the end, and part of the surprise was due to the lack of information on how bad credit quality had become. If there had been information that was real-time on the decline in credit quality, then that would have been priced in, and also there might have been policymaker steps to intervene, to at least stop the trend in deteriorating credit conditions.”

Preventing a property crash in Asia

Two major factors contributed to the United States property bubble that eventually led to an eventual crash: a large inflow of foreign funds and low interest rates. Given that these are the same conditions that currently exist in much of Asia, fears of a repeat of the U.S. property market crash on the continent is well justified.

“Interest rates are extraordinarily low. They are low in part because of policy, in part because recovery has not been strong across the world,” Wachter explains. “I think the key vulnerability going forward is, ‘What happens when recovery does come about? There’s no doubt at that point that interest rates will increase, but how sharp an increase?”

“The second related concern is: many economies in Asia are exposed to the housing sector short-term interest rates. They’re exposed to adjustable-rate mortgages that are short-term. If interest rates increase sharply, this could cause mortgage payment shock to households, and that is a concern that needs to be watched out for.”

To what extent mortgagers would experience difficulty in meeting monthly payments depends on how, and if, they are over-leveraging in order to move up the property ladder. But Wachter believes the key question is the health of the banking sector as a whole.

“What is the exposure of the banking system? That is really the key question. In China, the real concern is the very rapid increase of house prices, which are far beyond increases in income. But the questions are: Is the banking sector exposed? What’s the quality of the credit? And how much of the credit of the banking system is backed by housing? My understanding is, relative to the U.S., it’s far, far less. The banking system is far less exposed to real estate and more exposed to industry generally."

"I don't necessarily see the same threat (in Asia) as I did in the U.S. when there was an astonishing unknown expansion and at the same time, deterioration in mortgage credit to which the banks are exposed."

Lesson learnt?

The fear of foreclosures, sparking a full-blown banking crisis that leads to a recession, is one that haunts policymakers. However, Wachter believes the events of the past five years have taught policymakers worldwide valuable lessons.

"China has implemented several initiatives to cool off a heated housing market. Korea has done the same. Right at this moment, Switzerland and Norway have housing price increases. Much of the world has seen major housing price declines but not throughout the world. Asia, after the Asian Financial Crisis, has seen housing prices rise. They were not part of the extreme decline that occurred in the U.S., Spain, Ireland and elsewhere."

Going forward, Wachter believes central banks in Asia are aware of the potential problems that a sharp rise in interest rates could cause, and are working to soften the impact should it happen. Even so, she advises caution. "We've had decades of decreasing interest rates, and we have not seen the impact of a major rise in interest rates on consumers at a time when consumers have obligations in terms of adjustable-rate mortgages. It's likely to be a global problem when it occurs because adjustable-rate mortgages are the standard."