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Housekeeping for regulators of volatile housing markets

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One year on, the global financial crisis that took the wind out of the world economy last autumn is now showing some indications of an earlier than expected recovery. Surveying the wreckage and trail of destruction, many questions have been raised, including, especially, those on the global housing markets.

Just as the inflating American housing market was at the core of the previous boom, the bursting of the US housing bubble was also the trigger point of plummeting financial markets, which led to repercussions ringing far and wide in the real economy.

Some of the questions asked: What can be done to prevent such volatility in an asset so physical - and critical - as that of a house? Who is to shoulder the biggest blame for the mess in the housing market? Should regulators step in with harsh measures, like direct price controls?

According to economics professor Kim Kyung-Hwan (http://www.economics.smu.edu.sg/faculty/adjuncts/kimkyunghwan.asp), policy-makers, under pressure to "make things right", need curb the urge to implement new policies aimed at exerting strong controls over housing prices.

Kim, a visiting professor at SMU's School of Economics (http://www.economics.smu.edu.sg/index.asp) and a research fellow at the Centre for Asset Securitisation in Asia (CASA) (http://www.smu.edu.sg/institutes/skbife/centres/casa/index.asp) of Sim Kee Boon Institute of Financial Economics (http://www.smu.edu.sg/institutes/skbife/index.asp), believes that governments should focus on two main goals when crafting their countries' housing policies. First, to enable society to keep improving housing standards over time – this requires a responsive housing supply system. Next, to secure adequate shelter for the socially disadvantaged - this would involve government intervention.

Meanwhile, here is a recap of the plot.

Too low, for too long

As far back as the late 1990s, US housing prices were already starting to rise. Then, two major economic shocks: First, the implosion of the wildly-inflated technology bubble in April 2000, and the September 11th attacks the following year. These two events raised real and imminent worries of an economy unable to curb its downward spiral, where millions might be thrown out of work.

"In this environment, the most important consideration was to keep the economy going, and that was the context in which the interest rate was kept low," says Kim. "Looking back, the low interest period lasted too long. For some years during this period, short-term interest rate, adjusted for inflation, was actually negative."

The Fed, central bank of the US, according to Kim, was too preoccupied with making sure the economy then would not head into a recession. The effect of keeping interest rates too low for too long, was to accelerate the rise of housing prices.

For quite a while, the party was fun. Rising housing prices, driven further by strong consumer demand (stemming from fears of buying later at higher prices), helped sustain the housing boom, and kept the macro-economy buoyant. Cheap credit and innovative mortgage products helped fan the fire.

Soon, there were clear signs that mortgage underwriting standards had been compromised. "Loans were extended to those who should not qualify for the loans and some naive consumers were talked into borrowing (by mortgage brokers) and becoming home owners on these risky subprime mortgages, where interest rate was set low for first 2-3 years before going up sharply," says Kim.

Sharing the blame

With the housing market seemingly heading only up and never down, a growing support industry of mortgage brokers, real estate agents, and so on was created. It was estimated that three out of every five new jobs created in America between 2000 and 2005 were housing related.

All the elements - low interest rates set by the Fed, lax lending standards on loans made outside the reach of financial supervision and regulations, strong encouragement from mortgage brokers, as well as homebuyers' irrationality - interacted in a euphoric mix. When it came to a boil, it set in motion a wave of foreclosures on risky mortgages which rippled through the capital markets where mortgage-backed securities and their derivatives were traded. The resulting consequences of are now all too clear for everyone to see.

There were too many villains in the finger pointing that ensued. "A whole line of perverse incentives throughout the chain of mortgage business, from mortgage brokers to lenders, the investment banks, the credit rating agencies, the Fed and financial regulators, made it difficult to single out one particular villain in this whole chain. Everyone has some share of the blame," Kim says. The mess represents government failure as well as market failure.

Asia is relatively unscathed – why?

Amidst the wreckage in the US housing market, it is a decidedly different picture in Asia. While Asia is highly diverse region with different economies at varying stages of development, the housing market picture is also dotted by pockets of extreme examples, some markets more volatile than others. Nevertheless, while housing prices in this region generally declined when the crisis broke, the drop was of a smaller magnitude.

Some markets, like Singapore, China, Hong Kong and Korea, are already showing more than just strong signs of recovery. In fact, the speculative fervour had already prompted governments to step in with measures to prevent 'overheating' in these countries.

"Compared with US and EU countries – by the way, increase in US was moderate compared with some EU countries – the rate of appreciation in Asia was moderate, which means potential for falling house prices was smaller," says Kim. Furthermore, unlike in America, there wasn't a subprime mortgage market, and investment banking, packaging and reselling, the loans wasn't on such an extensive scale. Therefore, when housing prices started falling in most Asian countries last year, it was because of macroeconomic shocks, and not factors within the housing sector itself, he notes.

Asia, in a twisted way, also benefited from an earlier tumultuous event: the Asian Financial Crisis of 1997 to 1998, which put to a halt a roaring era of double-digit growth. Thanks to the "structural adjustments that followed, the financial system is more resilient," says Kim. Indications also abound that Asia – aided in no small part by intra-region trade – is already making a comeback in this current crisis.

"Overall, Asian economies did not suffer as much as they did in 1997, with a few exceptions," says Kim. The decline this time around was mainly a collateral damage caused by the macro-economic shock and not an implosion like the American subprime market. Furthermore, loan-to-value ratios in most Asian markets are lower.

Think big picture, think long term

For regulators surveying housing markets, this round of boom and bust could have cultivated temptations to enact controls on housing prices. But, according to Kim, they should think twice, for the market is far more complex than it might seem.

"Housing is such a multi-faceted commodity. It is not just a roof over one's head; it is the most important asset for any household, and for any nation, a large portion of national wealth. The stake is really very large," says Kim. Policy makers should therefore pay attention the close linkages between housing and financial systems, the macro-economy across local, national and global levels.

"A stable macroeconomic environment is essential for a stable housing market; a well-functioning housing market is very important for the stability of the wider economy," notes Kim. But there is debate over the proper role for monetary policy towards the housing sector.

"Although housing prices are affected by macroeconomic variables, the central bank cannot conduct monetary policy, thinking just about housing prices, as there will be repercussions on other sectors of the economy. At the microeconomic level, housing prices are determined by forces of demand and supply in the local markets, rather than a direct policy variable. Yes, you can have a sort of ideal ratio between house prices and the average income to keep housing affordable for a large segment of the population, but you cannot fully control either the household income (and its distribution) or the house price," he explains.

What governments can and should do is to ensure that the various factors influencing the housing market are well calibrated. From the financial system side of the equation, regulators need to make sure that mortgage underwriting standards are sound, risk management properly done, and consumers given the right information to make prudent choices. "On the 'real' side, it is important that you have a system where supply is forthcoming where and when demand is identified," says Kim.

For sure, forecasting housing demand is never an easy business. "We don't know what will happen 10, 20 years from now, with the ageing of population, reduction in size of families, growth of income, changes in lifestyle and what not; there is no way the government can predict everything and incorporate that into planning," he says. Thus, the greater emphasis should be on having a flexible and responsive supply system with the ability to meet housing needs of the locality. "This will enable the society to improve housing conditions in a steady manner, which should be a primary goal for housing policy.

The other goal is to secure adequate shelter for the social disadvantaged. This requires direct government intervention, preferably in the form of transparent subsidies targeted at those who truly deserve assistance

Finally, Kim adds, "Housing policy is not just an economic issue; it is a social and political issue". The lukewarm response by the US government to the potential risks associated with an increasing reliance on subprime mortgages might be attributed to political pressure to make more Americans homeowners. Overstretching home ownership can be dangerous. This is why serious attention should be paid to viable rental housing.

While there is certainly no guarantee that the financial system and home owners will not get carried away in the future, the least regulators can do is to put in place reasonable conditions, so that everyone can access this basic need.

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