FINANCIAL TIMES

UNDERCOVER ECONOMIST November 21, 2014 3:49 pm

Why a house-price bubble means trouble

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A housing boom is the economic equivalent of a tapeworm infection

Buying a house is not just a big deal, it's the biggest. Marriage and children may bring more happiness – or misery, if you're unlucky – but few of us will ever sign a bigger cheque than the one that buys that big pile of bricks, mortar and dry rot.

It would be nice to report that buyers and sellers are paragons of rationality, and the housing market itself a well-oiled machine that makes a sterling contribution to the working of the broader economy. None of that is true. House buyers are delusional, the housing market is broken and a housing boom is the economic equivalent of a tapeworm infection.

As a sample of the madness, consider the popular concept of "affordability". This idea is pushed by the UK's Financial Conduct Authority and seems simple common sense: affordability asks whether potential buyers have enough income to meet their mortgage repayments. That question is reasonable, of course – but it is only a first step, because it ignores inflation.

To see the problem, contrast today's low-inflation economies with the high inflation of the 1970s and 1980s. Back then, paying off your mortgage was a sprint: a few years during which prices and wages were increasing in double digits, while you struggled with mortgage rates of 10 per cent and more. After five years of that, inflation had eroded the value of the debt and mortgage repayments shrank dramatically in real terms.

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Today, a mortgage is a marathon. Interest rates are low, so repayments seem affordable. Yet with inflation low and wages stagnant, they'll never become more affordable. Low inflation means that a 30-year mortgage really is a 30-year mortgage rather than five years of hell followed by an extended payment holiday. The previous generation's rules of thumb no longer apply.

Because you are a sophisticated reader of the Financial Times you have, no doubt, figured all this out for yourself. Most house buyers have not. Nor are they being warned. I checked a couple of the most prominent online "affordability" calculators. Inflation simply wasn't mentioned, even though in the long run it will affect affordability more than anything else.

This isn't the only behavioural oddity when it comes to housing markets. Another problem is what psychologists call "loss aversion" – a disproportionate anxiety about losing money relative to an arbitrary baseline. I've written before about a study of the Boston housing crash two decades ago, conducted by David Genesove and Christopher Mayer. They found that people who bought early and saw prices rise and then fall were realistic in the price they demanded when selling up. People who had bought late and risked losing money tended to make aggressive price demands and failed to find buyers. Rather than feeling they had lost the game, they preferred not to play at all.

The housing market also interacts with the wider economy in strange ways. A study by Indraneel Chakraborty, Itay Goldstein and Andrew MacKinlay concludes that booming housing markets attract bankers like jam attracts flies, sucking money away from commercial and industrial loans. Why back a company when you can lend somebody half a million to buy a house that is rapidly appreciating in value? Housing booms therefore mean less investment by companies.

Zucman) that "capital is back" in developed economies. Piketty and Zucman have found that relative to income, the total value of capital such as farmland, factories, office buildings and housing is returning to the dizzy levels of the late 19th century.

But as Piketty and Zucman point out, this trend is almost entirely thanks to a boom in the price of houses. Much depends, then, on whether the boom in house prices is a sentiment-driven bubble or reflects some real shift in value. One way to shed light on this question is to ask whether rents in developed countries have boomed in the same way as prices. They haven't: research by Etienne Wasmer and three of his colleagues at Sciences Po shows that if we measure the value of houses using rents, there's no boom in the capital stock.

The housing market then, is prone to bubbles and bouts of greed and denial, is shaped by financial rules of thumb that no longer apply, and sucks the life out of the economy. It even muddies the waters of the great economic debate of our time, about the economic significance of capital.

One final question, then: is it all a bubble? That is too deep a question for me but there is an intriguing new study by three German economists, Katharina Knoll, Moritz Schularick and Thomas Steger. They have constructed house-price indices over 14 developed economies since 1870. The pattern is striking: about 50 years ago, real prices started to climb inexorably and at an increasing rate. If this is a bubble, it's been inflating for two generations.

At least dinner-party guests across London will continue to have something to bore each other about. Not that anybody will be able to afford a dining room.

Tim Harford's latest book is 'The Undercover Economist Strikes Back'. Twitter: @TimHarford

Illustration by Harry Haysom