

Comments on “Only in America? Must Housing Booms Always End in Housing Meltdowns?” by Lucy Ellis

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My main takeouts from the paper

The paper considers the question, “Can US housing meltdown happen in other countries which also had housing boom fuelled by credit boom?” That is, Australia, Canada, UK, Spain, Ireland, and New Zealand? And the paper’s conclusion, or the main thesis, is that it is likely to be “Only in America.” For two main – interrelated – reasons.

First, three key factors – or trends – were involved in the demise of the housing market in the US: (i) flexibly housing supply, (ii) high leverage of households, and (iii) deterioration in credit standards. “The three factors working together in the same direction and interacting with each other” (p.23) produced the toxic mix which led to the meltdown of in the US housing market.

Second, the fact that these three conditions existed in the US was no accident: they were largely the products of the institutional arrangements in the US which are in many ways unique to the country.

Implications for New Zealand

Luci’s conclusion probably does not surprise many of us. We have asked the same question in a number of occasions since the onset of the financial crisis, “Can it happen in New Zealand?” And we’ve done our analyses and some of us have reached the similar conclusion, “probably not.”

Most of us focused more on two of the factors that Luci emphasises: Easing of credit standards, and the extent of gearing that households are taking.

For example, we looked at the household surveys spanning from 2001 to 2007, the entire period of the housing boom, and found that, as far as the mortgage on owner-occupied homes are concerned, the LTV ratios fell during this period for all income groups, especially the low income.¹ High current LTV are concentrated among high-income households whose debt servicing capacity remains robust to large shocks to income, unemployment, and interest rates.

But Luci highlights the third factor which is less emphasised in the NZ context: flexibility of housing supply. In fact, in her paper, this is the key reason for the housing market collapse in the US (p.5).

¹ A summary of the study’s founding appeared in the RBNZ’s *Financial Stability Report*, November 2008, pp.20-22 (<http://www.rbnz.govt.nz/finstab/fsreport/3486853.pdf>). The full results were reported in Kida, M (2009) “Financial vulnerability of mortgage-indebted households in New Zealand - evidence from the Household Economic Survey”, Reserve Bank of New Zealand *Bulletin*, 72(1), pp 5-12 (http://www.rbnz.govt.nz/research/bulletin/2007_2011/2009mar72_1kida.pdf).

New Zealand has looked into supply-side rigidities as factors responsible for momentum behaviour in house prices, but the interest in them subsided quickly once the price boom ended.

Luci's paper warns us that increasing supply responsiveness is (a) probably difficult in NZ, given the geographical features and distribution of populations, and (b) doing so may have "undesirable" consequences of increasing, rather than decreasing, the housing cycle, especially on the magnitude of the downturn.

Policy implications

The paper highlights three policy implications.

- Tighten the mortgage underwriting standard in those countries which have more flexibly housing supply and more favourable tax systems for housing
- Policy to increase supply responsiveness in housing is probably not such a good idea from the point of view of reducing housing cycle.
- Regulators need to monitor structural indicators, as well as "soft" signals – such as the presence of speculative activity, the availability of mortgage products that the borrower cannot reasonably sustain over its full life, and the importance of "fringe lenders" in the market – to make a call if house prices are out of touch with the fundamentals.

Questions

- Are these policy changes enough to avoid another credit-fuelled housing boom and bust threatening financial stability?

What policy changes are needed to avoid another credit-fuelled housing boom and bust? The paper's answer is: tighten regulation on underwriting standards, and do a better job at monitoring a wider array of indicators to spot dangerous speculative activities in the housing/ mortgage markets. To me, it sounds like, "business as usual with minor improvements". Are these changes enough, or is next asset price boom-bust ending in financial crisis unavoidable?

- Does your paper have something to say about the idea that central banks should target asset prices ("lean against the wind")?

I thought the paper did. Specifically, the paper suggests that it is difficult for policymakers to "make a call" on when house prices have gone too far, not least because so-called fundamental determinants of house prices do change over short- and long-run, as you point out (and, as Simon Johnson recently noted, "every bubble starts with a genuine shift in the fundamentals.")

- Are you sure it's not just a lag?

Your thesis in the paper is that differences in institutions explain the different outcome in the housing markets.

“Housing meltdown would only happen in the US because the contributing factors were all there in a greater extent there.”

But if the US crisis happened after another 2-3 years of housing boom, wouldn't it have been another country which had the meltdown first? Wasn't New Zealand (or any other countries in your sample) just lucky this time because the US meltdown and the global financial crisis “stop short” the impending crisis and led to a large reduction in mortgage interest rates?