Economist.com FINANCE & ECONOMICS

Global house prices

Hear that hissing sound?

Dec 8th 2005
From The Economist print edition

Our latest update of *The Economist's* global house-price indicators

THE air is slowly leaking from the global housing bubble. In most of the countries that *The Economist* tracks each quarter the pace at which house prices are climbing has slowed over the past year. An overwhelming majority of experts are still predicting a soft landing with no drop in prices. But property in many countries is so overvalued that even if prices do not fall, they could stagnate for up to a decade.

America's market has remained hot for longer than most, but even it now seems to be coming off the boil. The 12-month rate of house-price inflation slowed to 12% in the third quarter of 2005, from 14% in the second. Prices of new homes, however, rose by only 1% in the year to October, down from 16% in early 2004. A glut of new building is forcing developers to cut prices. The best signal of a further slowdown to come is the increase in the stock of unsold homes. The number of existing homes on the market was equivalent to 4.9 months' sales in October, up from 3.8 months' sales in January.

***The Economist's* house-price indices**
% change

	Q3 2005* on a year earlier	Q3 2004 on a year earlier	1997-2005
South Africa	15.8	34.5	271
New Zealand	14.5	16.4	79
Denmark	14.3	9.7	73
France	14.2	15.5	100
Hong Kong	14.1	31.2	-43
Spain	13.4	16.8	150†
United States	12.0	13.0	85
Sweden	9.5	9.8	98
Belgium	9.4	10.9	71
Italy	7.3	9.7	81
Ireland	7.2	11.5	208
China	6.6	9.9	*na*
Netherlands	5.6	2.9	85
Canada	4.4	6.9	50
Singapore	3.3	*nil*	*na*
Britain	2.4	19.3	166
Switzerland	1.3	2.2	13
Australia	1.0	8.2	112
Germany	*na*	-1.3‡	*nil*
Japan	-4.7	-6.0	-30

*Or latest †New series ‡2004 average
Sources: ABSA; Bulwien; ESRI; Japan Real Estate Institute; Nationwide; Nomisma; NVM; OFHEO; Quotable Value; Stadim; Swiss National Bank; government offices

For a clue on where prices are heading, American homeowners should keep a close eye on Britain and Australia, where housing bubbles started to deflate in 2004. In Britain the Nationwide building society's price index has risen by only 2.4% over the past 12 months; in the summer of 2004 it was clocking up annual growth of more than 20%. Two other surveys, published by Hometrack and the Royal Institution of Chartered Surveyors, suggest that prices have in fact fallen over the past year. This week one British lender said that it would no longer offer buy-to-let mortgages on new properties.

The downturn in the Australian market has now spread beyond Sydney, where prices are already at least 10% below their peak. In the third quarter prices also fell in Melbourne, Brisbane, Hobart and Canberra. Nationally, average prices increased by only 1% in the year to the third quarter. In real terms, they fell.

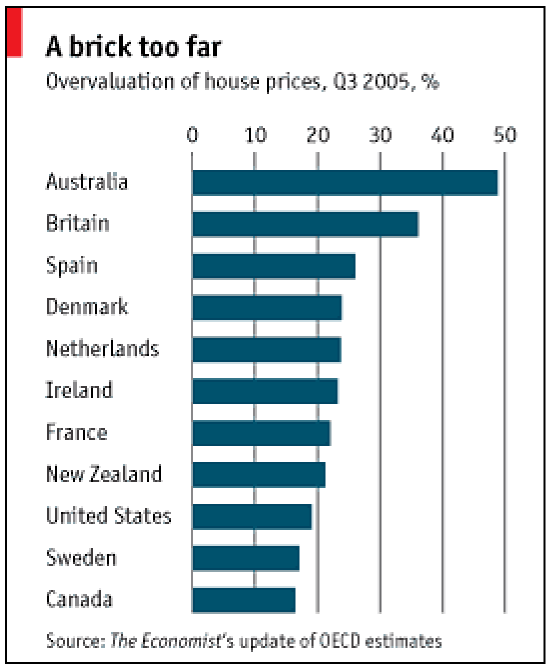
House-price inflation has also eased in France, Spain, Italy and Ireland. However, Japan's 14-year slide in house prices may at last be nearing an end: prices in central Tokyo are now rising, although the national average is still slipping and is now 40% below its peak in 1991.

Japan shows what can happen when home prices lose touch with reality. But exactly how overvalued are property markets elsewhere? A recent report on the rich world's housing markets by the OECD concludes that Australia has the most over-valued housing market, with prices 52% above their "correct" level. Next in line is Britain, where prices are 33% overvalued.

To judge the fair value of homes, the OECD uses the ratio of prices to rents, which is a sort of price-earnings ratio for housing. If prices are too high relative to rents, potential buyers will rent not buy, eventually pushing down real prices. In Australia this ratio is 70% above its average level over the period since 1970.

However, a higher ratio of house prices to rents may be justified by low interest rates, which make it cheaper to buy a home. The OECD tries to calculate the "user cost" of home ownership, which in addition to interest rates takes account of tax relief, property taxes, maintenance costs and expected inflation. It then compares the actual ratio of prices to rents with a "fundamental" ratio based on user cost. It is by this gauge that the OECD finds Australian property to be 52% too dear. It concludes that only Britain, the Netherlands and Ireland also have significantly overvalued housing (ie, by 15% or more). Spain is modestly overvalued, but America, France, Sweden and New Zealand look reasonably close to fair value. Homes in Germany and Japan are undervalued by more than 20%. So is *The Economist* wrong to talk about a global housing bubble?

One problem with the otherwise excellent OECD study is that its numbers are out of date. It is based on the average for 2004, since when several markets have surged. Using our house-price indicators, we have updated the figures for the third quarter of 2005. For instance, American prices are now 15% higher than the average for last year while rents have risen by 3%, so the ratio of house prices to rents has risen by 12%. Using the OECD's method, this suggests that housing is now 14% overvalued. If we also adjust for the rise in the mortgage rate since 2004, the American market is almost 20% overvalued.



The chart above shows our updates for other countries (outside America interest rates have barely altered, so we have adjusted the figures only for changes in prices). France, Spain, Denmark, Sweden and New Zealand also now look significantly overvalued. Germany and Japan (not shown) are still notably undervalued.

These estimates are highly sensitive to changes in interest rates, especially in euro-area economies, such as Ireland and Spain, where rates are very low (and where most mortgages are at variable rates). A rise of one percentage point (including the quarter-point rise announced by the ECB last week) could make Irish homes overvalued by as much as 50%.

Commentators in Britain and Ireland like to talk about the housing market "stabilising" after years of froth. But when you are teetering on a high wire, stability is difficult to maintain. Without a decline in prices, it could take as long as a decade, at current rates of consumer-price inflation, for British property prices to get back to fair value. A decade of falling real prices is not something to relish.