

### III. RECENT HOUSE PRICE DEVELOPMENTS: THE ROLE OF FUNDAMENTALS

#### INTRODUCTION AND SUMMARY

*Real house prices increased unusually rapidly in recent years*

In the vast majority of OECD economies, house prices in real terms (the ratio of actual house prices to the consumer price index) have been moving up strongly since the mid-1990s (Figure III.1).<sup>1</sup> Because of the important role housing wealth has been playing during the current upswing,<sup>2</sup> this paper will look more closely at what is underlying these developments, with a view to shedding some light on whether or not prices are in line with fundamentals.

*This paper examines...*

The paper begins by putting the most recent housing price run-ups in the context of the experiences of the past 35 years. It then examines current valuations against a range of benchmarks. It concludes with a review of the links between a possible correction of housing prices and real activity. The highlights from this analysis are as follows:

*... several aspects of the current episode which are unique...*

- A number of elements in the current situation are unprecedented: the size and duration of the current real house price increases; the degree to which they have tended to move together across countries; and the extent to which they have disconnected from the business cycle.

*... and the role of fundamentals in determining prices*

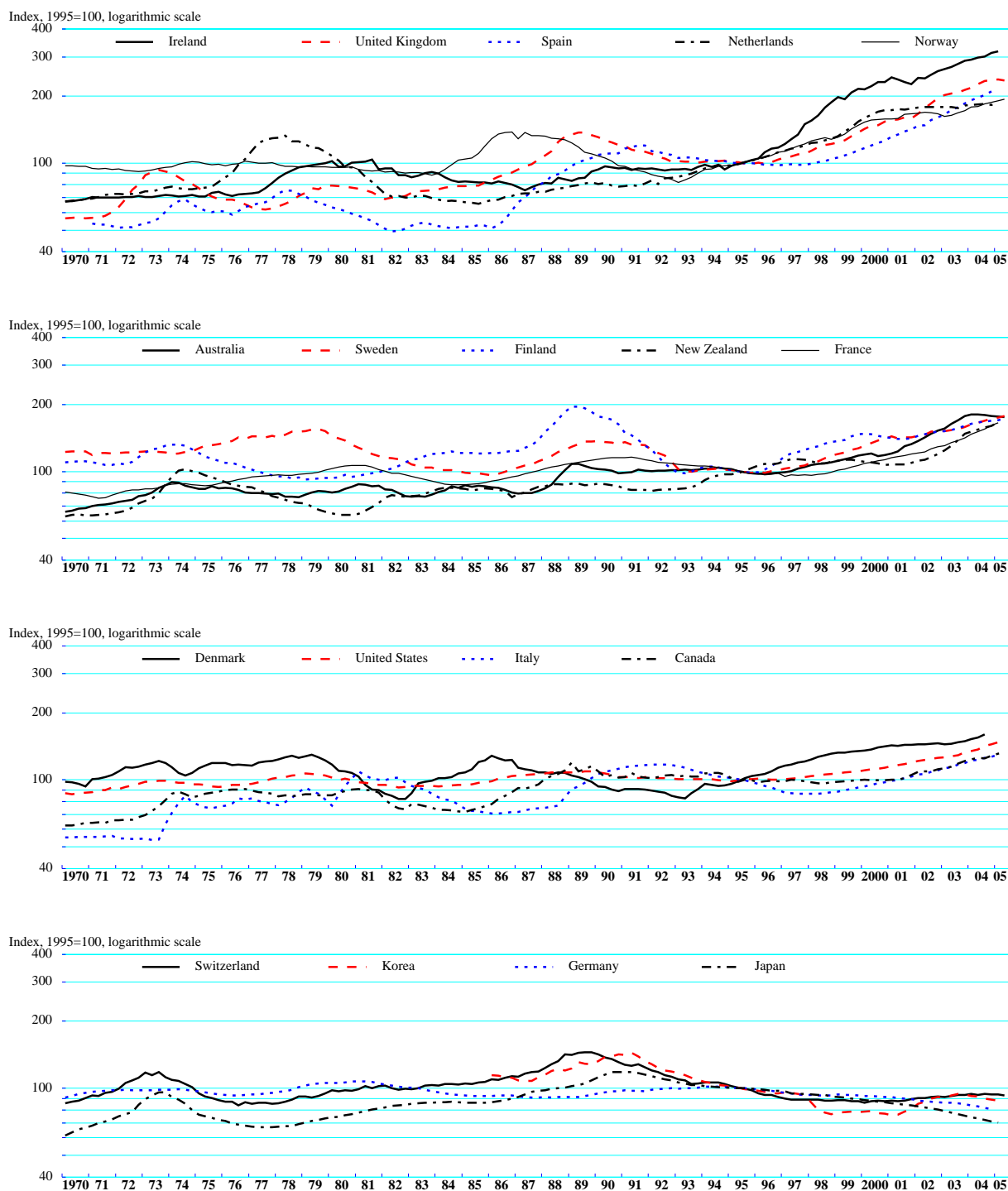
- While concerns have been expressed in several quarters about high housing prices, the evidence examined here suggests that overvaluation may only apply to a relatively small number of countries. However, the extent to which these prices look to be fairly valued depends in good part on longer-term interest rates, which exert a dominant influence on mortgage interest rates, remaining at or close to their current low levels.

---

1 . In Figure III.1, real house prices of the 18 OECD countries for which there is information over the period from 1970 to the present are grouped by the extent of the increases and decreases they have experienced since the mid-1990s. The frequency, definitions and quality of the data vary greatly across countries. Data for Korea start only in 1986. The sources for the series used are detailed in Table III.4 in the Appendix.

2 . See Catte *et al.* (2004).

**Figure III.1. Real house prices have generally been rising**  
 Nominal price deflated by the overall consumer price index



Source: See table III.4. in the Appendix for house prices. OECD Main Economic Indicators for consumer price indices.

***Current low inflation levels will influence any downward adjustment***

- If house prices were to adjust downward, possibly in response to an increase in interest rates or for other reasons,<sup>3</sup> the historical record suggests that the drops (in real terms) might be large and that the process could be protracted, given the observed stickiness of nominal house prices and the current low rate of inflation. This would have implications for activity and monetary policy.

## **THIS HOUSE PRICE BOOM IS DIFFERENT**

### ***The magnitude and duration of house price cycles***

***Up to the mid-1990s, real house price cycles had certain characteristics***

Various statistical and other criteria will be used to put the current period of real house price increases into historical perspective. Based on a procedure to date house price cycles,<sup>4</sup> it appears that, to the extent that there is an “average real-house-price cycle” over the period under consideration, it has lasted about ten years. During the expansion phase of about six years, real house prices have increased on average by close to 40%. In the subsequent contraction phase, which lasts around five years, the mean fall in prices has been on the order of 25%. By implication, at least since 1970, real house prices have fluctuated around an upward trend, which is generally attributed to rising demand for housing space linked to increasing *per capita* income, growing populations, supply factors such as land scarcity and restrictiveness of zoning laws, quality improvement and comparatively low productivity growth in construction.<sup>5</sup>

***However, the current run-ups in prices...***

To put the current large run-ups in these prices in perspective, the characteristics of what are considered *major* real house price cycles are calculated (Table III.6 in the Appendix). To qualify as a major cycle, the appreciation had to feature a cumulative real price increase equalling or exceeding 15%.<sup>6</sup> In this context, the current housing price boom differs from the average of past experiences in two important respects.

***... have surpassed those of previous episodes...***

- First, the size of the real price gains during the current upturn is striking. For Australia, Denmark, France, Ireland, the Netherlands, Norway, Sweden, the United Kingdom and the

---

3. See Borio and McGuire (2004) who document a tendency for house prices to fall about a year or so after equity prices have peaked and note that once prices fall, the declines tend to take on a life of their own.

4. In this paper, the timing of turning points is determined using the Bry and Boschan (1971) cycle-dating procedure, described by Harding (2003). Restrictions were imposed to ensure that the periods of increases and decreases had a minimum length of six quarters so as to avoid spurious cycles. Once the turning points are known, the length of each cycle can be identified. Based on this approach, the main features of the real house price cycles are detailed in Table III.5.

5. See for example Evans and Hartwich (2005) and Helbling (2005).

6. This criterion identified 37 such episodes, corresponding to about two large upswings on average per 35 years for English-speaking and Nordic countries and to 1½ for the continental European countries. Any choice of what is “a large increase” is necessarily *ad hoc*. A similar procedure to that used here, employed by Helbling (2005), identifies boom and bust episodes when a price change exceeded 15%.

United States, the cumulative increases recorded in the recent episode have far exceeded those of previous upturns. With the exception of Finland, real house prices in the countries experiencing gains are above their previous peaks.

*... and their durations have been longer*

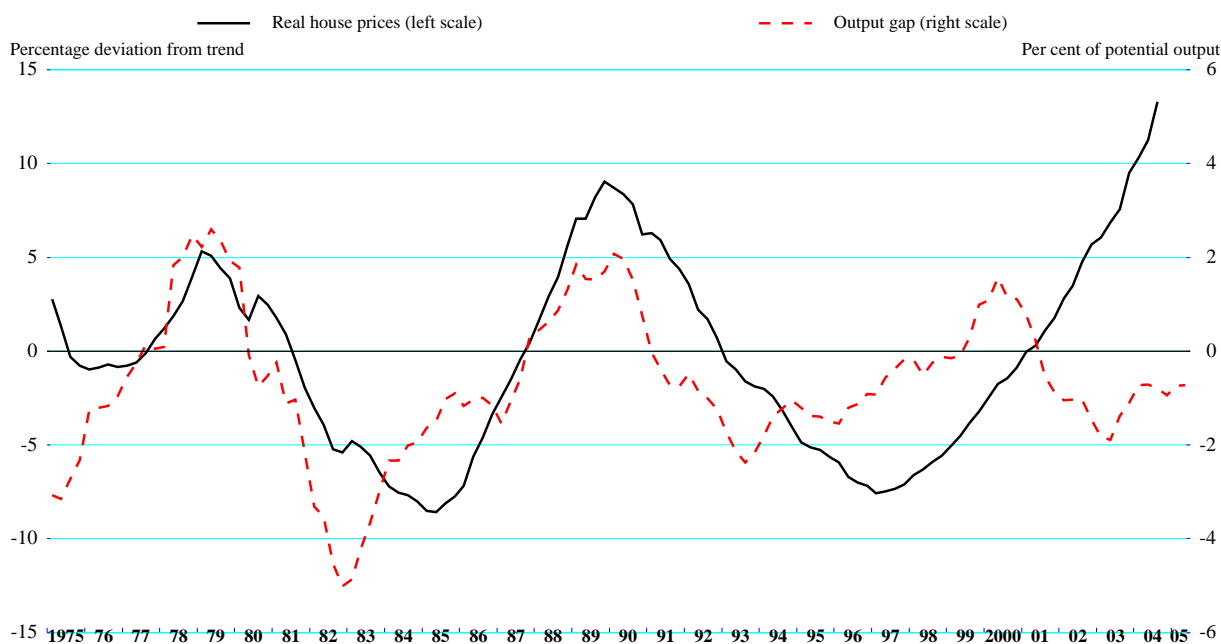
- Second, its duration has surpassed that of similar past episodes of large real price increases for almost all countries. It is at least twice as long in the Netherlands, Norway, Australia, Sweden and the United States.

*The link with the overall business cycle*

*Recent house price gains have been both atypically countercyclical...*

Comparing an aggregate real house price index with the output gap for the OECD as a whole (Figure III.2),<sup>7</sup> house-price and business-cycle turning points roughly coincided from 1970 to 2000, although in some upturns prices appear to have lagged OECD-wide slack. The current house price boom, however, is strikingly out of step with the business cycle.

**Figure III.2. OECD Real house prices and the business cycle**



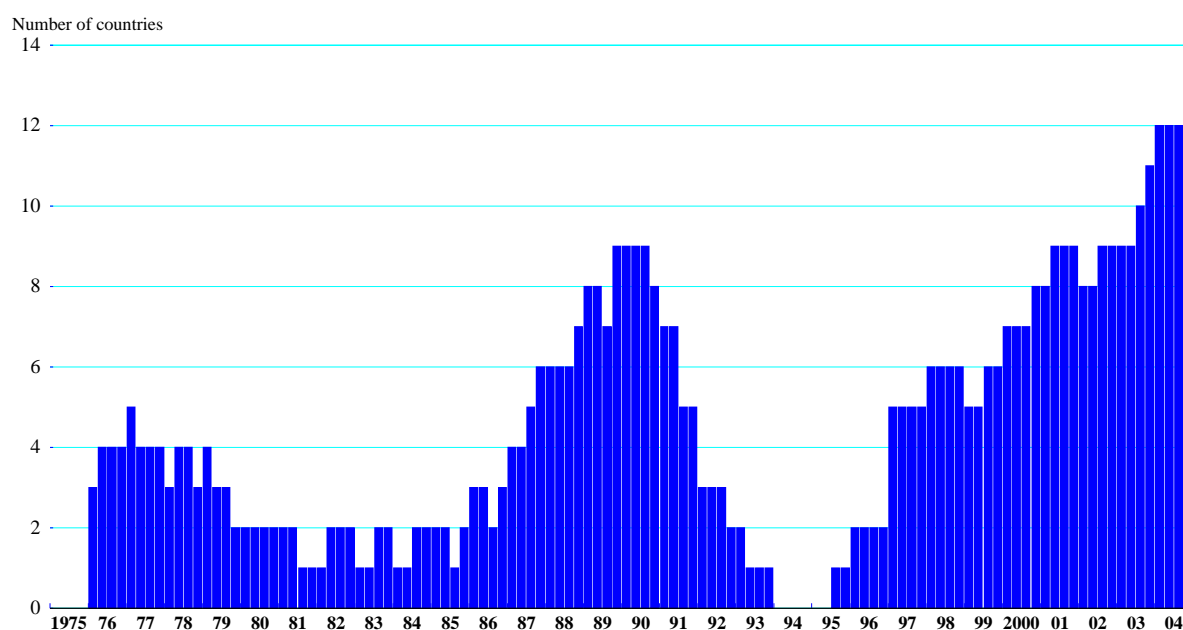
Note: Real house prices have been detrended using a linear trend. The OECD aggregate has been computed using GDP weights in 2000 in purchasing power parities. Source: OECD Economic Outlook 78 database and OECD calculations.

7. The aggregate real house price index has been calculated using purchasing power parity-adjusted GDP weights.

**... and far more common across countries than before**

The current upswing is also more generalised across OECD countries than in the past.<sup>8</sup> In particular, a historically high number of countries have been experiencing fairly large increases in house prices since the mid-1990s (Figure III.3).<sup>9</sup> A combination of generalised low interest rates across OECD economies, coupled with the development of new and innovative financial products, have no doubt played an important role.

**Figure III.3. Cross-country coincidence of real house price increases**  
Number of countries (out of 17) with over 25% increase in real prices over the previous five years



Source: See table III.4. in the Appendix.

**Downward adjustments have usually been large**

Of the 37 large upturn phases between 1970 and the mid-1990s, 24 ended in downturns in which anywhere from one third to well over 100% of the previous *real-term* gains were wiped out. This in turn had negative implications for activity, particularly consumption.

- 
8. Otrok and Terrones (2005) argue that global factors, including low real interest rates and global business cycles, are important determinant of house price cycles.
9. A large price increase is defined as twice the mean change (which amounts to 5%) over a five-year period, for a total of a 50% increase. Other criteria, for instance price changes of at least one standard deviation from the mean, show a similar pattern. See for example, Ahearne *et al.* (2005).

## HOUSE PRICES AND THEIR UNDERLYING DETERMINANTS

### *Assessing overvaluation requires benchmarks*

Unique and dramatic house price increases are not necessarily evidence of overvaluation. To address this issue, it is necessary to relate these prices to their putative underlying determinants. To this end, evidence from econometric models, affordability indicators and asset-pricing approaches, respectively, is examined below, supplemented by a qualitative discussion of other factors affecting house prices.

### *Evidence from econometric models*<sup>10</sup>

#### *Model-based evidence points to overvaluation...*

Econometric models can be used to compute the “fundamental” price, as determined by demand (derived on the basis of factors such as real disposable income and real interest rates) and supply (derived from factors influencing the available housing stock).

#### *... in the United Kingdom, Ireland and Spain but not elsewhere*

The literature reviewed for this study was confined to recent research (see Table III.7 in the Appendix). It suggests that prices are broadly in line with what were identified as their main determinants in Denmark, Finland, France, the United States and Norway. The findings are mixed for the Netherlands. However, they uniformly point to significant overvaluation in the United Kingdom, Ireland and Spain.

#### *This evidence should be complemented with other approaches*

The results from any econometric study, however, can be subject to a number of valid criticisms. For example, it cannot be excluded that the estimated relationship is unstable, possibly because the price elasticities of supply and demand vary over time, due for instance to changes in regulatory conditions, demographic developments and taxes that cannot be adequately taken into account.<sup>11</sup> Given the margin of uncertainty, this evidence needs to be complemented by other approaches.

### *Affordability of housing*

#### *By themselves, affordability indicators point to overvaluation*

One summary measure commonly used to assess housing market conditions is the price-to-income ratio, a gauge of whether or not housing is within reach of the average buyer. If this ratio rises above its long-term average, it could be an indication that prices were overvalued. In that case, prospective buyers would find purchasing a home difficult, which in turn should reduce demand and lead to downward pressure on house prices. Figure III.4 shows the ratio of nominal house prices to *per capita*

- 
- 10 . Typically, the specification of these models is a long-run (co-integration) relationship between the house price and these determinants, which is then embedded in an error-correction mechanism. The interpretation of the co-integrating relationship provides an estimate of “equilibrium” or long-term house prices, against which current prices can be evaluated.
- 11 . See for example Gallin (2003) and Gurkaynak (2005) stressing several drawbacks from using an econometric approach for such purposes.

disposable income (as well as the ratio of prices to rents, to be discussed next). For almost all the countries shown, the price-to-income ratios in 2005 are substantially above their long-term averages. In the countries with the largest house price increases (Ireland, the Netherlands, Spain and the United Kingdom) as well as in Australia and New Zealand, these ratios exceed their long-term averages by 40% or more. In Canada, Denmark, France and the United States, the run-up has been more moderate but these values still represent historical peaks. The main exception is the sub-group of countries recording declining or more recently stable house prices (Japan, Germany, Korea and Switzerland) and Finland, where price-to-income ratios are below average historical values.

*Taking account of financing costs...*

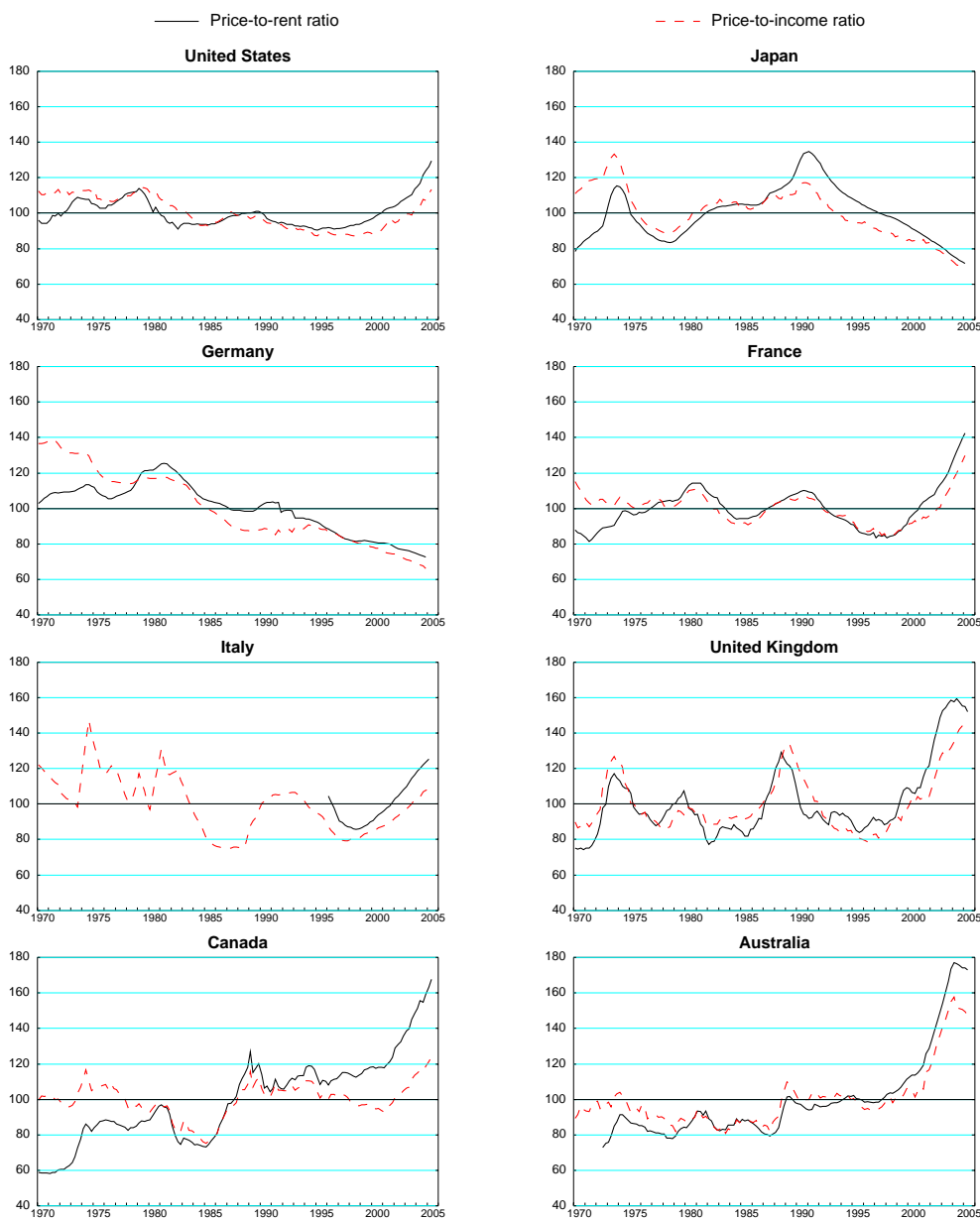
The ratio of prices to household disposable income by itself, however, is not a sufficient metric to evaluate housing affordability. Indeed, house prices do not appear to be linked to income by a stable long-run relationship (see Table III.8 in the Appendix),<sup>12</sup> possibly because the cost of carrying a mortgage has varied over time.

*... household debt service burdens have generally been relatively stable...*

In Table III.1, an indicator of households' mortgage interest payments is constructed based on actual mortgage debt and a typical published mortgage interest rate. These rough-and-ready measures suggest that while mortgage debt burdens have been rising, the ability to service that debt has either been relatively stable or has improved slightly in Denmark, France, Germany, Ireland, Italy, Spain, Sweden and the United Kingdom since the early 1990s. Similarly benign trends have been reported in the literature for several countries.<sup>13</sup> The main exceptions are Australia,<sup>14</sup> the Netherlands<sup>15</sup>

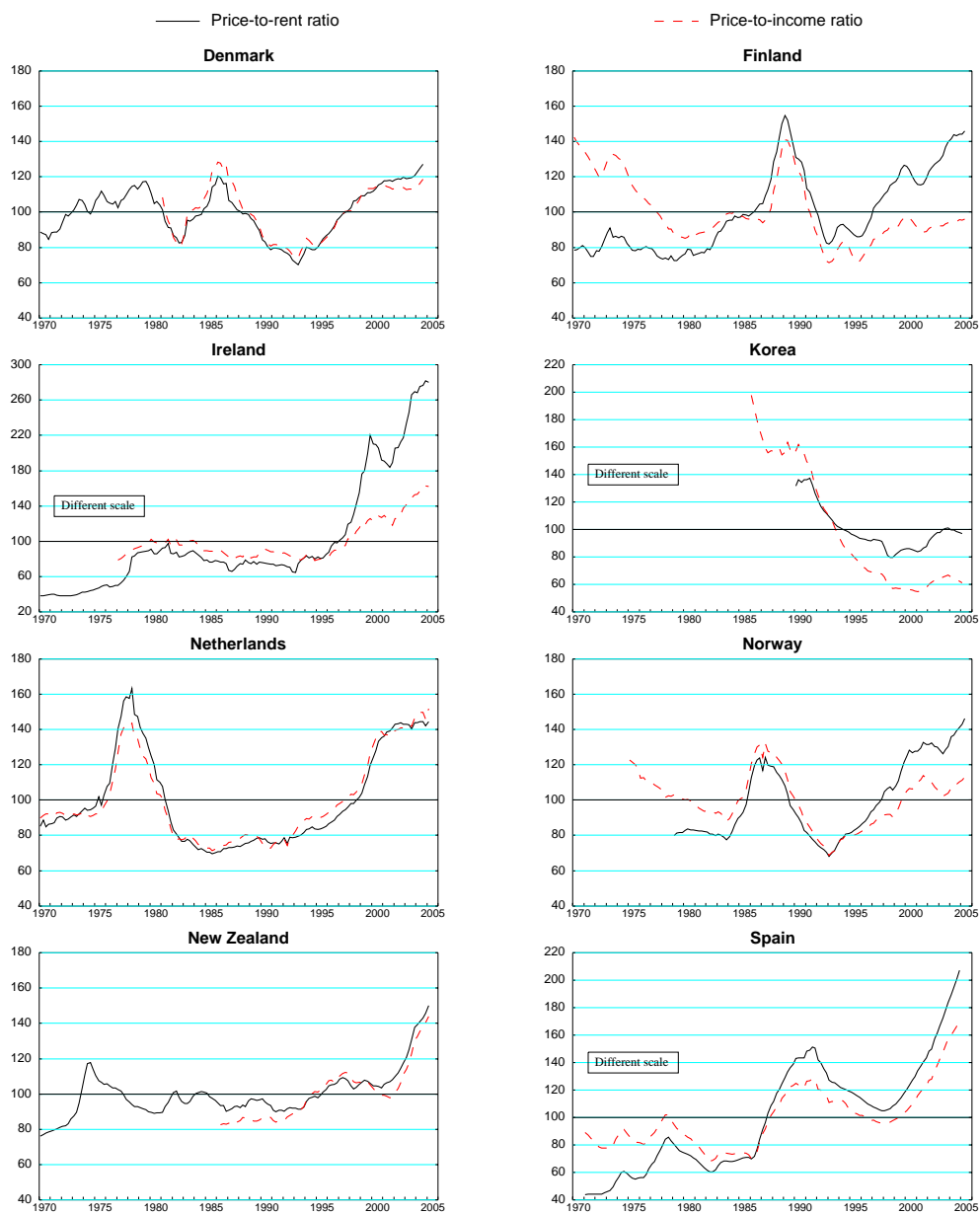
- 
- 12 . In fact, aggregate disposable income is likely not the appropriate denominator. It is an average measure that covers the whole population, whereas house prices are determined in a market where specific groups of sellers and buyers have different and likely higher incomes than the population mean.
- 13 . Debelle (2004) for instance notes that there is no clear upward trend in the interest service ratio for eight countries. Central bank studies for France and the Nordic countries indicate falling household interest burdens in the recent years (Bank of Finland, 2004, Danmarks Nationalbank, 2005, Norges Bank, 2005, Riksbank, 2004 and Wilhelm, 2005). Similarly, Canada Mortgage and Housing Corporation (2005) reports a falling interest burden, and OECD (2005b) a stable interest burden for the United Kingdom.
- 14 . The Reserve Bank of Australia also reports a rising mortgage-servicing ratio. The large increases in household debt are mostly due to a halving of the mortgage rate and the inflation rate from the 1980s to the 1990s. Other factors that have allowed households and investors to maintain higher levels of debt for longer periods than previously are innovative products following financial deregulation and increased competition among providers of credit (Macfarlane, 2003). See also Australian Bureau of Statistics (2004) and Reserve Bank of Australia (2004).
- 15 . Dutch households have strong incentives to maintain mortgages at high levels given the extremely favourable tax treatment of debt-financed owner-occupied housing. Ter Rele and van Steen (2001) have estimated that the subsidy to housing costs for owner-occupiers rises steeply with income for mortgage financing. Mortgage financing combined with a capital insurance policy is subsidised even more. With such a combination, principal repayments are paid into the insurance policy rather than deducted from the outstanding mortgage. This enables the borrower to maximise mortgage interest deductions by not paying off the debt while at the same time accumulating capital in the insurance policy to pay off the debt when the mortgage term expires. See OECD (2004) for more details.

**Figure III.4. Price-to-income and price-to-rent ratios**  
 Sample average = 100



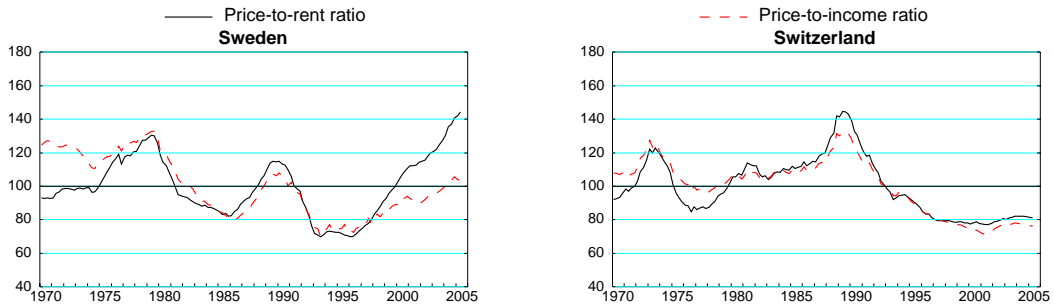
Source: See table III.4. in the Appendix for house prices, OECD Economic Outlook 78 database for income and OECD Main Economic Indicators for rents.

**Figure III.4. Price-to-income and price-to-rent ratios (cont.)**  
 Sample average = 100



Source: See table III.4. in the Appendix for house prices, OECD Economic Outlook 78 database for income and OECD Main Economic Indicators for rents.

**Figure III.4. Price-to-income and price-to-rent ratios (cont.)**  
 Sample average = 100



Source: See table III.4. in the Appendix for house prices, OECD Economic Outlook 78 database for income and OECD Main Economic Indicators for rents.

Table III.1. Households mortgage debt and interest burden

	Mortgage debt			Interest payments			Variable interest rates
	% of household disposable income						% of all loans
	1992	2000	2003	1992	2000	2003	2002
United States	58.7	65.0	77.8	4.9	5.2	4.5	33 <sup>1</sup>
Japan	41.6	54.8	58.4	2.5	1.3	1.4	n.a.
Germany	59.3	84.4	83.0	3.9	4.0	3.0	72 <sup>2</sup>
France	28.5	35.0	39.5	1.7	1.4	1.1	20
Italy	8.4	15.1	19.8	0.7	0.8	0.7	56
Canada	61.9	68.0	77.1	5.9	5.7	4.9	35-45 <sup>1</sup>
United Kingdom	79.4	83.1	104.6	4.4 <sup>1</sup>	3.7	3.0	72
Australia	52.8	83.2	119.5	4.8	6.4	7.9	73 <sup>1</sup>
Denmark	118.6	171.2	188.4	10.6	9.9	8.3	15 <sup>2</sup>
Finland	56.7	65.3	71.0	7.1	2.9	1.9	97
Ireland	31.6	60.2	92.3	2.3	3.0	2.5	70 <sup>2</sup>
Netherlands	77.6	156.9	207.7	5.0	8.4	8.2	15
New Zealand	67.0	104.8	129.0	6.9	9.3	9.4	n.a.
Spain	22.8	47.8	67.4	1.6	2.2	1.7	75
Sweden	98.0	94.4	97.5	5.0 <sup>4</sup>	4.2	3.3	38 <sup>2</sup>

1. 2004-05

2. 2003

3. 1993

4. 1996

Note: Interest payments are approximated using mortgage debt and mortgage interest rates.

Source: European Central Bank, European Mortgage Federation, Eurostat, US Federal Reserve, Canadian Imperial Bank of Commerce (CIBC), Mortgage Choice (Australia), Reserve Bank of New Zealand and Bank of Japan.

and New Zealand where the proportion of household income required to pay the interest on mortgages has been trending upward, reflecting the increased size of mortgages.

**... helped by low interest rates that have kept housing affordable**

Perhaps not surprisingly, taking into account the debt-servicing ratio leads to a different assessment of current house prices than do developments in the affordability ratio itself. The general increase in indebtedness, due in part to deregulation in the mortgage markets (see below), has been mostly offset by the decline in borrowing rates and, with the exception of Australia, the Netherlands and New Zealand, households do not seem to devote a greater share of their income to debt service than in the recent past.

**Asset-pricing approach**

**Price-to-rent ratios point to widespread overvaluation...**

Another summary measure used to get an indication of over or undervaluation is the price-to-rent ratio (the nominal house price index divided by the rent component of the consumer price index). This measure,

which is akin to a price-to-dividend ratio in the stock market, could be interpreted as the cost of owning versus renting a house. When house prices are too high relative to rents, potential buyers find it more advantageous to rent, which should in turn exert downward pressure on house prices. During the recent upswing, this ratio has generally outstripped the affordability measure, hitting historical peaks in several countries (Figure III.4).<sup>16</sup> In Ireland and Spain, two countries experiencing very sharp increases in real house prices, the 2005 level of this ratio is more than 100% above its long-term average. In the other countries reporting high real house price increases and in those experiencing more moderate gains, the ratio is 25% to 50% above its long-term average. Where real house prices have been stable or falling, the price-to-rent ratio lies below its long-run average.

***... but account has to be taken of the user cost of housing***

Like the affordability ratio, this indicator cannot be taken at face value.<sup>17</sup> It has to be assessed against the evolution of the user cost of home ownership, which takes account of the financial returns associated with owner-occupied housing, as well as differences in risk, tax benefits, property taxes, depreciation and maintenance costs, and any anticipated capital gains from owning the house (Box III.1). Equilibrium in the housing market occurs when the expected annual cost of owning a house equals that of renting, while overvaluation is characterised by an actual price-to-rent ratio greater than that calculated with the user cost, suggesting that it is cheaper to rent.

**Box III.1. The user cost of housing**

The user cost of housing is calculated following a method proposed by Poterba (1992). In particular:

$$\text{User cost of housing} = P(i^a + \tau + f - \pi) \quad (1)$$

The first component within the bracket, the after-tax nominal mortgage interest rate  $i^a$ , is the cost of foregone interest that the homeowner could have earned in an alternative investment. It is adjusted to include the offsetting benefit given by the tax deduction or credit of mortgage interest in countries where this applies (Austria, Denmark, Finland, Germany, Ireland, Italy, the Netherlands, Norway, Spain, Sweden, United Kingdom, United States). This calculation takes into account deduction ceilings or credits and the tax base against which the deduction is applied.<sup>1</sup>  $\tau$  is the property tax rate on owner-occupied houses,  $f$  is the recurring holding costs consisting of depreciation, maintenance and the risk premium on residential property, and  $\pi$ , the expected capital gains (or loss).  $P$  is the house price index.

16. Similar results are obtained by Ayuso and Restoy (2003) for Spain, Barham (2004) for Ireland, Weeken (2004) for the United Kingdom and Gallin (2004), Himmelberg *et al.* (2005) and Quigley and Raphael (2004) for the United States.

17. Statistical evidence reported in Table III.8 of the Appendix also shows that house price-to-rent ratios, like the affordability measures, are not stationary.

In equilibrium, the expected cost of owning a house should equal the cost of renting and this implies that the user cost can be expressed as:

$$R = P(i^a + \tau + f - \pi) \quad (2)$$

and by rearranging Equation 2,

$$\frac{P}{R} = \frac{1}{i^a + \tau + f - \pi} \quad (3)$$

Equation 3 provides a relationship between the actual price-to-rent ratio and such features of the user cost as interest rates, depreciation, taxes, etc.

Nominal mortgage interest rates are taken from national sources. Property tax rates are taken from ECB (2003), International Bureau of Fiscal Documentation (1999) and Nagahata *et al.* (2005). The parameter value for  $f$  is constant at 4% and the estimation of  $\pi$  as a moving average of inflation follow the method outlined by Poterba (1992).

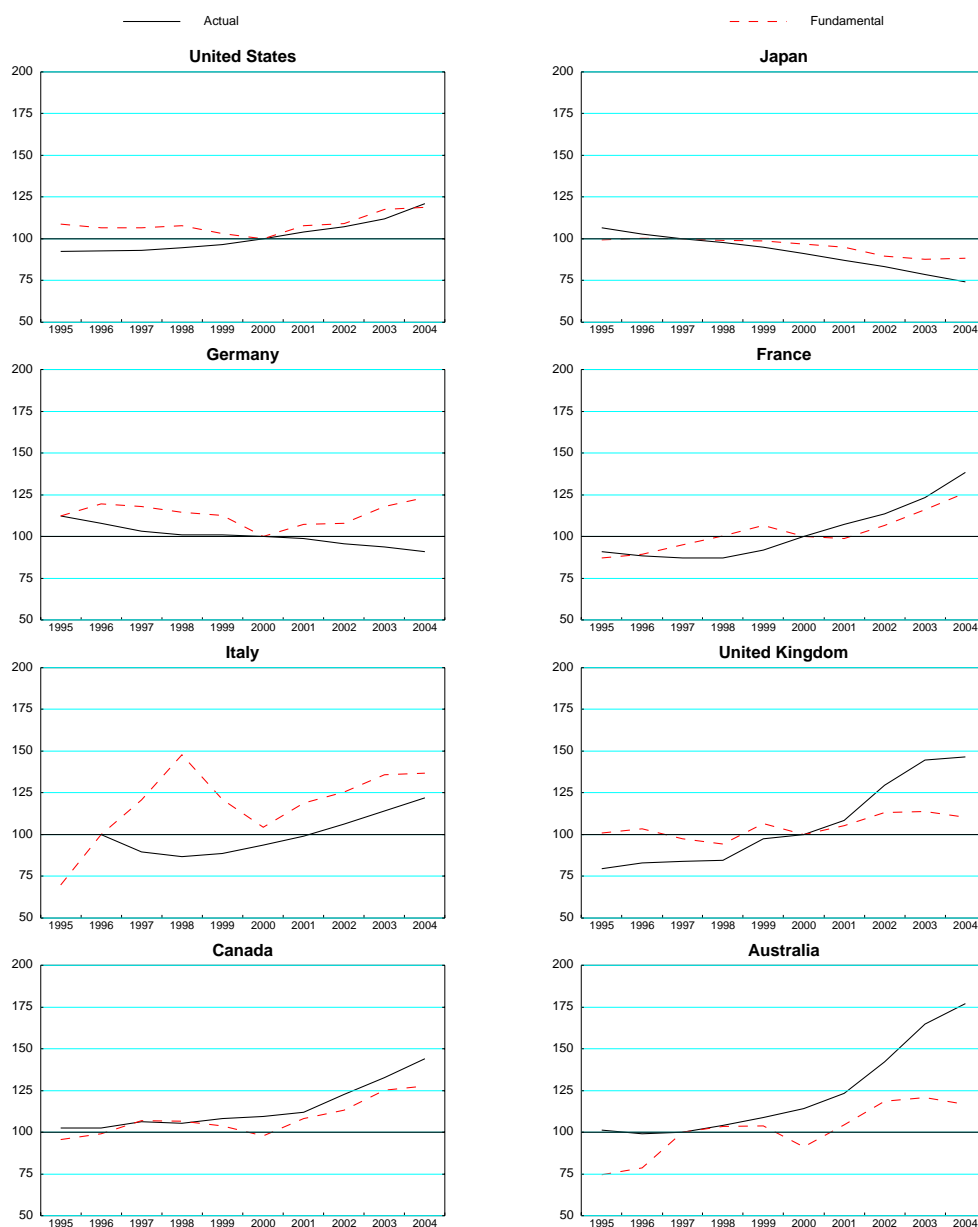
---

1. See van den Noord (2005) for further details on the methodology and Cournède (2005) for an application to the euro area.

### ***Taking this on board...***

Figure III.5 compares the actual price-to-rent ratio with that based on the user cost of housing over the past ten years. For all countries, the two measures have been set equal to 100 in the most recent year when the actual price-to-rent ratio crossed its 35-year average, which by construction means

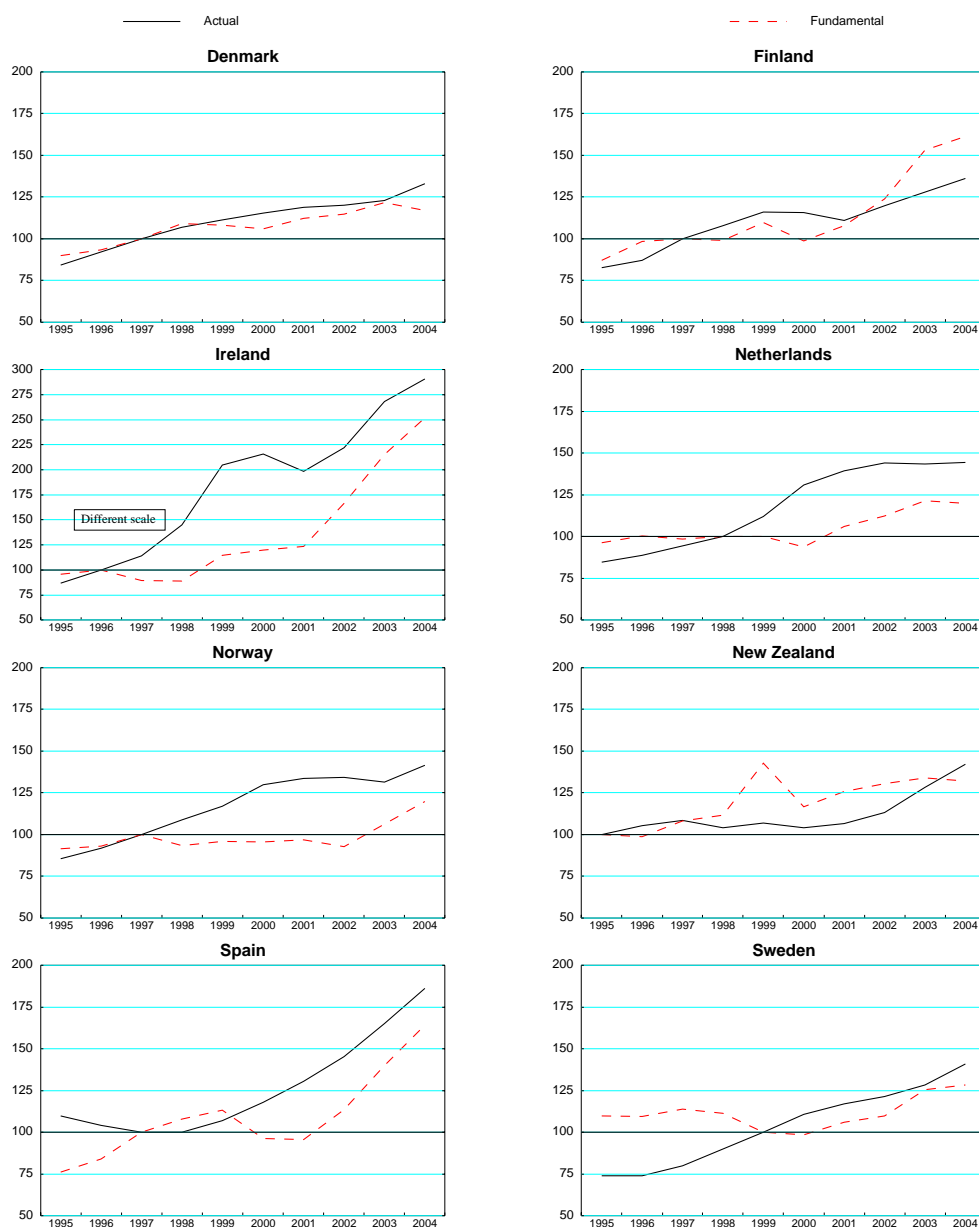
**Figure III.5. Price-to-rent ratios: actual and fundamental**  
 Long-term average = 100<sup>1</sup>



1. For each country, actual and fundamental price-to-rent ratios have been set equal to 100 in the most recent year in which the actual price-to-rent ratio was close to its 35-year average. This procedure does not work well for Germany because of the significant trend decline in the price-to-rent ratio starting in the early 1980s. Consequently, the two series have been arbitrarily set equal to each other in 2000. Choosing an earlier date does not change the results, qualitatively, although the implied degree of undervaluation would be larger.

Source: OECD calculations.

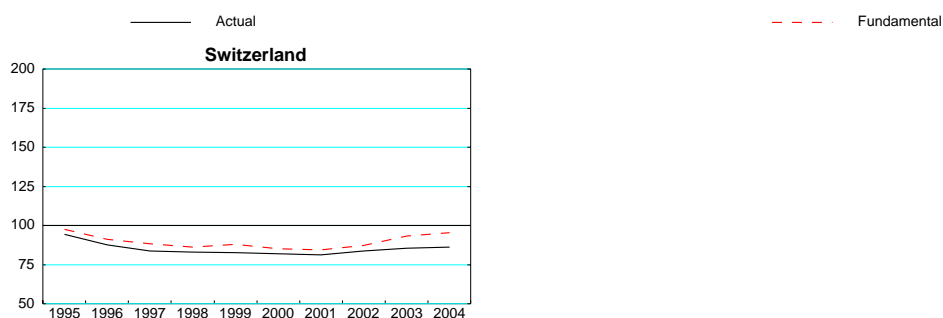
**Figure III.5. Price-to-rent ratios: actual and fundamental (cont.)**  
 Long-term average = 100<sup>1</sup>



1. For each country, actual and fundamental price-to-rent ratios have been set equal to 100 in the most recent year in which the actual price-to-rent ratio was close to its 35-year average.

Source: OECD calculations.

**Figure III.5. Price-to-rent ratios: actual and fundamental (cont.)**  
Long-term average = 100 <sup>1</sup>



1. For each country, actual and fundamental price-to-rent ratios have been set equal to 100 in the most recent year in which the actual price-to-rent ratio was close to its 35-year average.  
Source: OECD calculations.

Table III.2. Sensitivity of fundamental price-to-rent ratio to a change in the housing user cost

	<i>Per cent</i>		
	Estimated over-valuation in 2004	Change in user cost	Mortgage rate in 2004
United States	1.8	-0.2	5.8
Japan	-20.5	1.2	2.4
Germany	-25.8	3.3	5.7
France	9.3	-0.8	4.3
Italy	-10.9	0.7	4.6
United Kingdom	32.8	-2.8	6.1
Canada	13.0	-1.0	6.2
Australia	51.8	-2.6	7.1
Denmark	13.1	-3.1	3.9
Finland	-15.6	0.9	3.4
Ireland	15.4	-0.4	3.5
Netherlands	20.4	-1.9	5.1
New Zealand	7.6	-0.7	8.0
Norway	18.2	-1.3	4.7
Spain	13.4	-0.6	3.6
Sweden	8.0	-0.7	5.3
Switzerland	-9.7	1.1	3.2

Source: OECD calculations.

that the long-run average coincides with fundamentals.<sup>18</sup> The difference between the two series may be considered as an approximate indicator of overvaluation, albeit with qualifications. In particular, this measure, based on a long-run concept (the desired price-to-rent ratio), ignores expected shorter-run movements in the variables that make up the user cost, which could potentially narrow the gap between the two series.<sup>19</sup> One way to interpret the extent of putative overvaluation is to calculate the difference between the user cost implied by the observed price-to-rent ratio and the one that would align it to its estimated level, based on the fundamentals listed in Box III.1 (see Figure III.5 and Table III.2). This difference is expressed in terms of percentage points. In interpreting this information, it is important to note that the results are sensitive to the choice of a base year as well as to the existing level of interest rates.

***... overheating is still visible in the high-priced countries***

- In the countries with high real house price gains (the United Kingdom, Ireland the Netherlands and Spain) and in Australia (where very high real prices have more recently been edging down) and in Norway, actual price-to-rent ratios were noticeably above their “fundamental” levels in 2004, suggesting overvaluation.

***Elsewhere, measured overvaluation is not large...***

- In France, Canada, Denmark and Sweden, actual and “fundamental” ratios moved in tandem until 2003, but have tended to move apart slightly since. On this score, overvaluation is not very significant in New Zealand.

***... or absent altogether***

- In Finland and Italy, the desired price-to-rent ratio has exceeded its actual level in recent years. In the United States, the “fundamental” price-to-rent ratio was above its actual level until 2000, the benchmark year. Since then, the series have moved together and the gap between them has been negligible. On this measure, there does not appear to be much of a case for overvaluation, at least at the national level.

***Prices look undervalued in Japan, Germany and Switzerland***

- At the other end of the spectrum, undervaluation (indicated by a “fundamental” price-to-rent ratio above the actual value) has increased in Japan (since 1997), Germany (since 2000) and, to a

---

18 . This crude measure of equilibrium partly adjusts for the series’ non-stationarity. Another approach would have been to benchmark the series to a point when actual rents were equal to the user cost; however, the user cost series go back only to 1995. This procedure does not work well for Germany because of the significant trend decline in the price-to-rent ratio starting in the early 1980s. For Germany, the two series were therefore arbitrarily set equal to each other in 2000. Choosing an earlier date would imply a larger degree of undervaluation.

19 . Short-run dynamics in housing markets can have powerful effects on house prices. Ortola-Magné and Rady (2005) for example, using a life-cycle model, show that changes in income of credit-constrained homeowners can lead to sharp price movements, especially when homeowners are moving up the property ladder. So can inter-generational transfers of housing wealth.

lesser extent, in Switzerland. In Germany and Japan, this reflects previous building excesses.

### *Other factors affecting house prices*

#### *Supply conditions also contribute to sharp house price increases...*

House prices can also be affected by other features that are particular to this market. Of note are restrictions on the availability of land for residential housing development that can constrain the responsiveness of supply. These would include tough zoning rules, cumbersome building regulations, slow administrative procedures, all of which would restrict the amount of developable land. However, while the price of housing may be affected, measures like the price-to-rent ratio would not necessarily be, since such factors would presumably raise both prices and rents.

#### *... in several countries*

In the United Kingdom, complex and inefficient local zoning regulations and a slow authorisation process are among the reasons for the rigidity of housing supply, underlying both the trend rise of house prices and their high variability.<sup>20</sup> In Ireland and the Netherlands<sup>21</sup> similar factors affect house price dynamics. In Korea, government limitations on urban land supply (Restricted Development Zone) have been important causes of the rapid rise in housing prices.<sup>22</sup> Heavy land-use regulations in some US metropolitan areas have been associated with considerably lower levels of new housing construction which have restricted housing supply and thus increased house prices in the regulated municipalities as well as in neighbouring towns (Box III.2).

#### *Demographic developments...*

Demographic developments, over and above their influence through real disposable incomes can also raise housing demand, thereby increasing price levels.<sup>23</sup> In particular, high rates of net migration, declines in the average size of households and increases in population shares of cohorts of individuals in their thirties will boost housing demand by increasing the share of the population of household formation age. In several countries (including Ireland, Spain, Australia, the United Kingdom, the Netherlands and Norway) the high shares of such households in the total population since the mid-1990s have been associated with large increases in real house prices (Figure III.6). By contrast, in Germany and Japan, house price declines are associated with a low share of such households in the overall population. As above, these factors should affect both prices and rents, provided that there were no distortions in the rental markets.

---

20 . See OECD (2004a and 2005b) and Barker (2004).

21 . See OECD (2004 and 2005a).

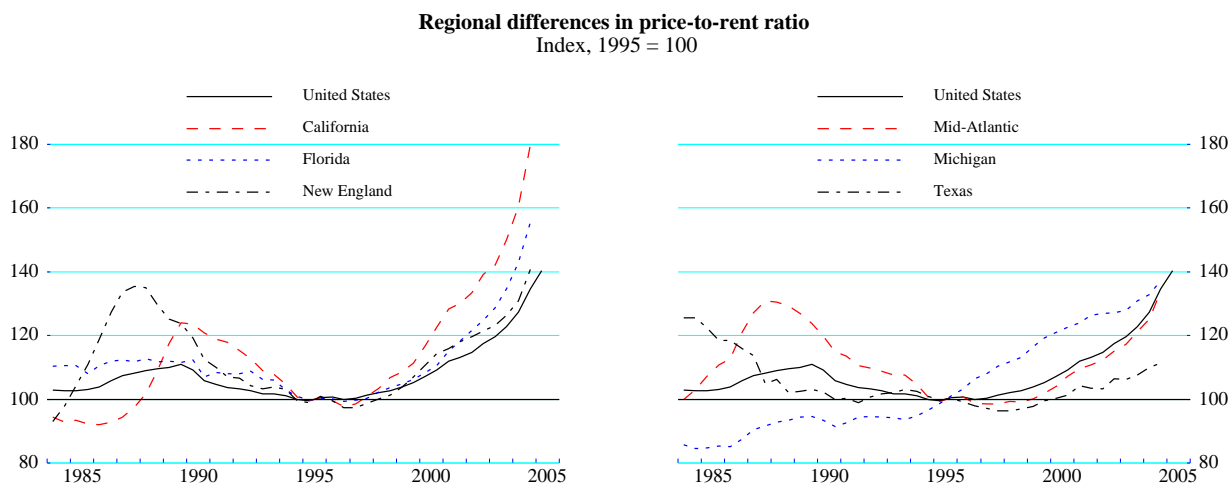
22 . See Gallent and Kim (2001) and Hannah *et al.* (1993) and OECD (2005).

23 . Several studies have looked at the impact of demographic trends on the demand for housing. See Cerny *et al.* (2005) for the United Kingdom; FitzGerald (2005) for Ireland; Kohler and Rossiter (2005) for Australia; and Krainer (2005) for the United States.

**Box III.2. Regional housing markets in the United States**

Several studies of US regional housing markets have found that the low supply elasticity of housing units is an important factor behind the recent larger price increases in some urban markets.<sup>1</sup> In particular, house prices are much higher than construction costs throughout parts of the Northeast and the West coast. The studies suggest that recent regional patterns of house price expansion do not just reflect faster growing income and population, but also other factors including building regulations on the size and characteristics of houses. They also report that US homebuilders have faced increasing difficulty in obtaining regulatory approval for the construction of new homes in some states, notably California, Massachusetts, New Hampshire, New Jersey and in Washington, D.C. An additional factor has been the increased ability of established residents to block new projects.

The effects of these developments are reflected in price-to-rent ratios, which can serve as an indicator of house price overheating in local US housing markets. These show that while some markets behave as the national market, other markets – such as California and Texas – have returns that are much higher or lower respectively than the national average. The local markets where price-to-rent ratios have reached historical peaks are also the ones where the supply constraint on new construction appears to be most binding, making prices there more volatile. They include the San Francisco, Boston and Los Angeles areas.



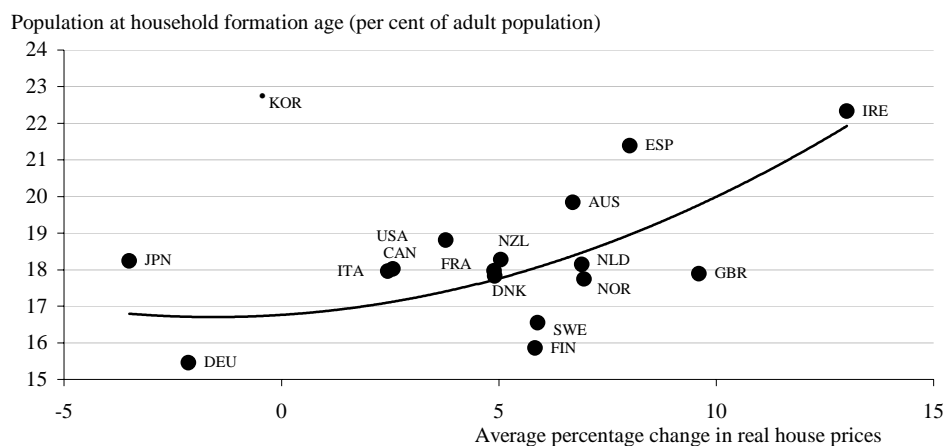
Source: Office of Federal Housing Oversight for house prices and Bureau of Labor Statistics for rents.

1. Glaeser and Gyourko (2003), Glaeser *et al.* (2005), Krainer, J. and C. Wei (2004), Gyourko, Mayer and Sinai (2004), Capozza *et al.* (2002), McCarthy and Peach (2004) and Mayer and Somerville (2000).

**... and speculative pressures...**

Other factors, however, may raise the price of housing. Buy-to-let markets, which have grown substantially over the past several years in the countries for which data are available (United States, United Kingdom, Australia and Ireland), are one example. Lower interest rates have increased the return on rental property for investors, enhancing the attractiveness of,

**Figure III.6. Population and house prices  
1995-2004**



Note: Korea is an outlier and therefore has not been included into the estimation of the trendline.

Source: See table III.4. in the Appendix for house prices, United Nations for population.

and demand for, housing as an investment. Fiscal incentives in some countries have also played a role by providing favourable conditions for those choosing to invest in housing. These markets are, however, dominated by small, first-time investors and their effect on the housing market is not well understood.<sup>24</sup>

*... in Ireland...*

- In Ireland, the buy-to-let market, while still representing a small share of private rental dwellings in the overall housing stock, at about 8%, has been growing. New buy-to-let mortgages constituted 20% of all mortgage transactions in 2004 and 30% of the second-hand dwellings sold during the first half of 2004.<sup>25</sup>

*... the United States...*

- In the United States, the proportion of sales attributable to such investors has been rising quickly starting in the late 1990s, reaching around 15% of all home purchases in 2004, much higher than the normal 5%. Such buyers are estimated to be about equally concentrated in fast-growing as well as less-active markets.<sup>26</sup>

24 . See for example Scanlon and Whitehead (2005) for a description of the profile and intentions of buy-to-let investors in the United Kingdom.

25 . See Koeva and Moreno (2004).

26 . See Morgan Stanley (2005).

*... the United Kingdom...*

- In the United Kingdom, buy-to-let mortgages have grown substantially since they were introduced in the late 1990s, from about 3% of total mortgage lending in 1999 to around 7% in 2004. The levelling-off in this ratio since mid-2004 has coincided with slowing house price appreciation.

*... and Australia could also be contributing to buoyant house prices*

- In Australia, the proportion of such investors doubled from around 15% of total mortgage lending in 1992 to about 30% at the end of 2003 and is high in some regional markets (42% in New South Wales and 35% in Victoria), fuelling concerns about such high levels of property investment and exposure to a significant downturn in the market.

*Innovations in mortgage markets are also playing a role*

A particularly important factor has been financial deregulation in mortgage markets, which has significantly reduced borrowing constraints on households. This process started in the 1980s and saw rapid growth of mortgage credit, starting in the second half of that decade, in several countries. Australia, Canada, New Zealand, the Nordic countries, the United Kingdom and the United States all experienced a sharp rise of mortgage lending and large run-ups in house prices in the late 1980s.<sup>27</sup> More recent changes in mortgage markets including lending innovations, the adoption of new technologies and the growing use of payment reduction features in mortgages have offered households greater choices and lowered borrowing costs (Table III.3). In several countries, variable rate loans have become more accessible in recent years.<sup>28</sup> Some of these instruments offer options allowing households to convert their debt to a fixed rate, thus providing them with a degree of protection against rising rates. In Denmark, the Netherlands and the United States, interest-only mortgage loans have become increasingly available. In Australia, increased competition among credit providers has contributed to the doubling of the number of products provided by lenders. Most other mortgage innovations have taken the form of lengthening terms.

---

27 . See Girouard and Blöndal (2001). Ortalo-Magné and Rady (1999) report particularly strong effects of financial deregulation on the cohort of first-time buyers in the United Kingdom.

28 . For example, in the United States, the share of adjustable rate mortgages rose from about 15% in 2000-03 to around 33% in 2004-05 according to the Federal Housing Finance Board Monthly Interest Rate Survey.

Table III.3. **Recent mortgage product innovations in selected countries**

Country	Recent innovations
United States	Interest-only loans; Flexible mortgages with variable repayments.
Germany	New Pfandbriefe Law abolishing penalties for early mortgage pay-offs
France	Variable payment mortgages; Lengthening mortgage terms.
United Kingdom	Flexible mortgages; Offset mortgages (savings and mortgage held in same/linked accounts, with savings offset against mortgage balance); Base rate trackers.
Canada	Shorter-term mortgages, initial fixed-rate period shortened from five years to one year; Skip-a-payment, early mortgage renewal and flexible payment schedules.
Australia	Flexible mortgages with variable repayments; Split-purpose loans (splits loan into two sub-accounts, giving tax advantages); Deposit bonds (insurance company guarantees payment of deposit at settlement); Non-conforming loans; Redraw facilities and offset accounts; New providers including mortgage originators and brokers.
Denmark	"Interest-adjusted" loans: interest rate set at regular intervals by sale of bonds; Capped-rate loans; BiligXloans: interest adjusted every six months with reference to ten-day average of CIBOR; Interest-only loans.
Finland	Lengthening mortgage terms; Introduction of state guarantee for mortgages.
Netherlands	Savings or equity mortgages: part of payment covers interest, part goes into fixed interest savings account or equity account (confers tax advantages); Interest-only mortgages.

Source: Scanlon and Whitehead (2004), Canada Mortgage and Housing Corporation (2005) and OECD.

## HOUSING CYCLES AND ECONOMIC ACTIVITY

### *Low inflation would influence how house price would adjust*

While other housing-market specific factors have had an influence, interest rate developments are likely to play a key role. If these rates were to rise sharply over the coming period – a possibility that is currently treated as a risk in the OECD's projections – house prices would come under downward pressure.<sup>29</sup> In that event, the shape and duration of any

29. Getting a handle on how much downward pressure would be exerted on house prices from an interest rate increase in isolation is difficult. Based on asset-price models, for example, the effect would be large but

subsequent downward adjustments are likely to be conditioned by the current low level of inflation. Based on the historical record, declines in real house prices, when they have followed large run-ups, have taken place more slowly (quickly) if increases in the overall price level are small (large). This is illustrated by the negative cross-country correlation observed between the level of inflation and the duration of the house-price-contraction phases, suggesting that it can be quite protracted at very low inflation rates (Figure III.7, upper panel). There is also a tendency for real prices to fall less at low inflation (Figure III.7, lower panel). This feature of the adjustment process stems from the fact that nominal house prices have tended to exhibit downward stickiness. Indeed, housing markets are not as liquid as other asset markets, due to high search and transactions costs as well as the heterogeneous nature of the product. In addition, when overall conditions weaken, owners of existing homes tend to withdraw from the market rather than suffer a capital loss, while builders will not develop new properties.

***Housing affects overall activity via wealth effects on consumption...***

The main channels through which housing cycles affect activity are wealth effects, residential construction and the financial sector. The feed-through from house prices to private consumption occurs either via saving responses to households' perceived wealth or via collateral effects on household borrowing.<sup>30</sup> In a number of countries (Australia, Canada, the Netherlands, the United Kingdom and the United States) changes in housing wealth have a significant effect on consumption, exceeding the effect of changes in financial wealth, in part because financial markets provide easy access to mortgage financing and to financial products that facilitate house equity withdrawal. By contrast, in France, Germany, Italy, Japan and Spain, the housing wealth effect appears to be smaller or insignificant. The strength of the aggregate wealth effect also depends on several other factors including homeownership rates, transaction costs, and housing taxes and subsidies.

***... residential construction activity...***

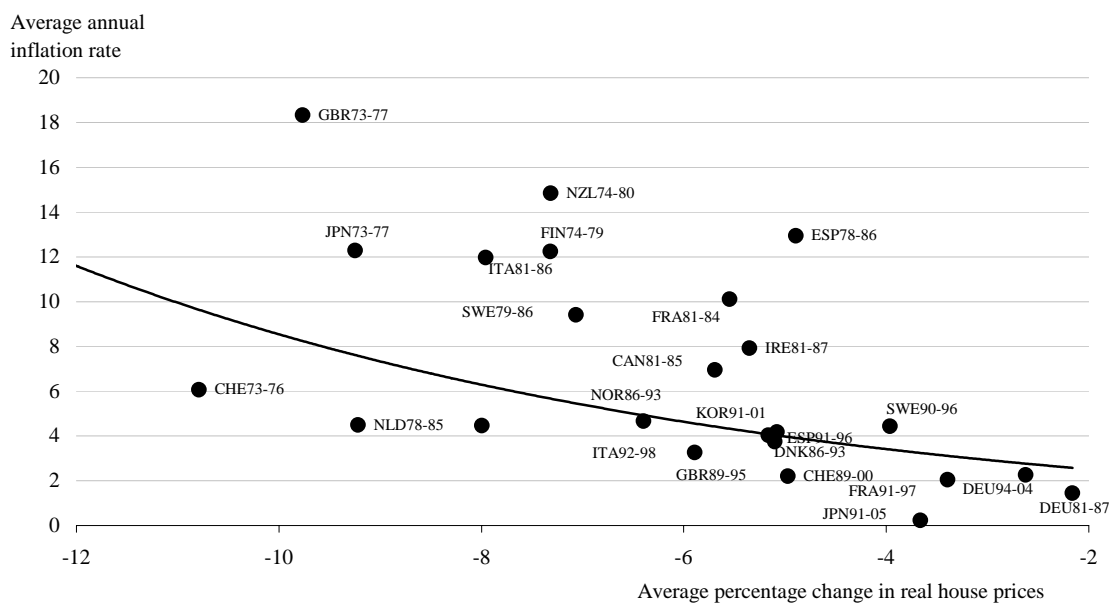
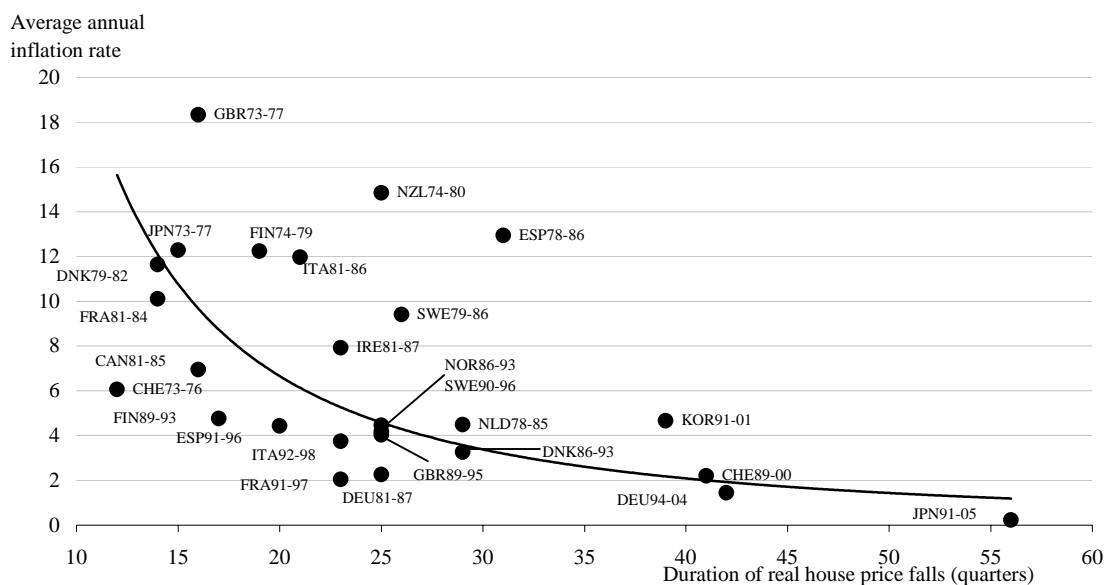
House prices also have important effects on private residential investment. Changes in the profitability of housing investment affect the construction sector as well as employment and demand in property-related sectors. Figure III.8 relates housing investment to its profitability and shows a small but significant positive relationship over the 1995 to 2004 period for most countries. These results suggest that additional factors are important in determining construction activity. Specifically, supply constraints in the form of planning restrictions, the availability of land or the competitive conditions in the construction sector may have played a role in restraining the growth of housing investment.

---

such calculations only suggest what would happen to the desired price. In practice, the actual adjustment path would depend also on other factors – demographics, regulation, the share of variable rate mortgages, the ability of households to refinance their mortgages, tax deductibility and the overall economic situation.

30 . See Catte *et al.* (2004).

Figure III.7. Inflation and real house price adjustment

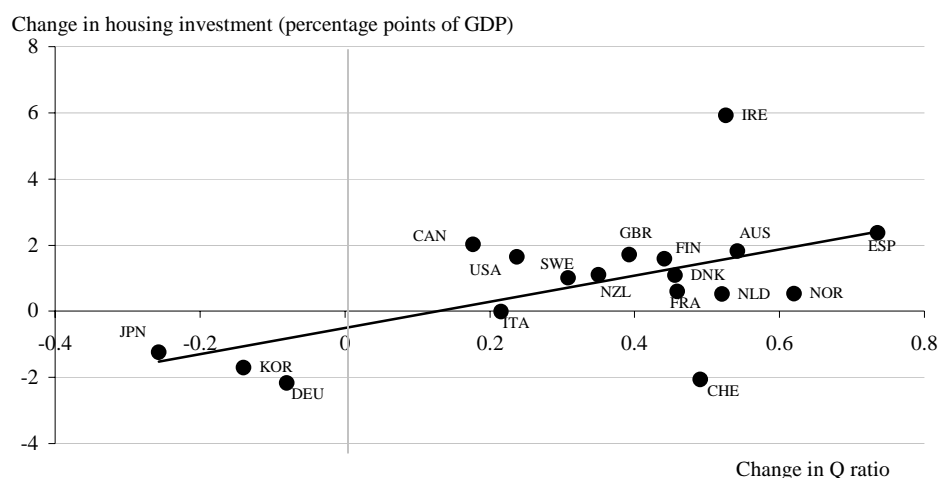


Source: See table III.4. in the Appendix for house prices. OECD Economic Outlook 78 database for inflation.

**... and financial stability**

Sharp downward corrections in asset markets, including in housing markets, can impact the banking sector, which in turn may adversely affect public finances and macroeconomic stability at large.<sup>31</sup> If financial intermediaries misjudge risks, the potential for credit and asset booms to derail and turn into busts is increased. In this context, the pro-cyclicality of bank provisioning is a concern. Banks may be reluctant to make adequate provision for their loan losses when housing markets are buoyant, and supervisors may be reluctant to suggest it without solid evidence.<sup>32</sup> Hence, when a large shock occurs, banks may find themselves with inadequate cushions to absorb the loss, which could affect credit availability.

**Figure III.8. Housing investment and the Q ratio**  
1995-2004



Note: The Q ratio is defined as nominal house prices divided by the housing investment deflator.

Source: See table III.4. in the Appendix for house prices, OECD Economic Outlook 78 database for housing investment.

**Views differ on the role of monetary policy**

The range of views on how the monetary authorities should respond to asset price developments, including house prices, is broad. Some advocate central banks responding to house (or other asset) prices only to the extent that they contain information about future output growth and inflation, and that, if desired, using alternative policy instruments (taxes and regulations) to stabilise housing cycles.<sup>33</sup> Others advocate that central banks should “lean against the wind” by having a tighter stance than would otherwise be

31 . See Eschenbach and Schuknecht (2002) and Girouard and Price (2004).

32 . See Dobson and Hufbauer (2001).

33 . See Bernanke (2002). Under this view, the costs of intervention in the face of rapidly increasing real house prices is judged to outweigh the benefits, in good part because the lags in the transmission mechanism are long and variable. In this regard, a pre-emptive hike in interest rates (over and above what is judged necessary for overall price stability purposes), may well be counterproductive (*i.e.* the effects would kick in when the housing market has already peaked). Moreover, a tighter policy to prick a housing bubble (if one could safely be identified) is also considered potentially damaging for other sectors.

warranted by overall demand conditions in the face of abnormally rapid increases in real house prices, particularly as there might be risks to financial stability, and vice versa.<sup>34</sup> In the event of a downturn, the extent to which policy has to respond depends importantly on the size of the shock and ability of the economy to absorb it.<sup>35</sup>

---

34 . See ECB (2005) and Issing (2003).

35 . In the United States, for example, one estimate is that a reversion to the long-run price-to-rent ratio would represent a shock that is about half the size of the US stock market decline in 2000-02, and would likely be easily absorbed (Yellen, 2005). Economies that tend to be resilient to shocks are those that have flexible labour and product markets and well-functioning financial systems. These typically have potential growth rates that are higher than the average of OECD economies.

*Appendix*

Table III.4. Definition and source for house prices

Country	House price definition	Seasonal adjustment	Source
United States	Nationwide single family house price index	No	OFHEO, 1975Q1-2005Q2
Japan	Nationwide urban land price index	No	Japan Real Estate Institute, 1990S1-2005S1
Germany	Index for total Germany, total resales	--	Bundesbank, 1994-2004
France	Indice de prix des logements anciens, France	No	INSEE, 1996Q1-2005Q1
Italy	Media 13 area urbane numeri indice dei prezzi medi di abitazioni, usate	No	Nomisma, 1991S1-2005S1
United Kingdom	Mix-adjusted house price index	No	ODPM, 1968Q2-2005Q2
Canada	Multiple listing series, average price in Canadian dollars	Yes	Ministry of Finance, 1980Q1-2005Q2
Australia	Index of a weighted average of 8 capital cities	No	Australia Bureau of Statistics, 1986Q2-2005Q2
Denmark	Index of one-family house sold	No	Statistics Denmark, 1971Q1-2004Q3
Spain	Precio medio del m <sup>2</sup> de la vivienda, mas de un ano de antiguedad	No	Banco de Espana, 1987Q1-2004Q4
Finland	Housing prices in metropolitan area, debt free, price per m <sup>2</sup>	No	Bank of Finland, 2000Q1-2005Q2
Ireland	Second hand houses	Yes	Irish Department of Environment 1980Q1-2005Q1
Korea	Nationwide house price index	No	Kookmin Bank, January 86-May 2005
Netherlands	Existing dwellings	No	Nederlandsche Bank, January 76-May 2005
Norway	Nationwide index for dwellings	Yes	Statistics Norway, Table 03860, 1992Q1-2005Q2
New Zealand	Quotable value index for dwellings(new and existing)	No	Reserve Bank, 1979Q4-2005Q1
Sweden	One and two dwelling buildings	No	Statistics Sweden, 1986Q1-2005Q2
Switzerland	Single-family home	No	Swiss National Bank, 1970Q1-2005Q2

*Note:* Quarterly and/or annual data provided by the Bank for International Settlements (based on national sources) have been used in the countries for which the sample period (1970Q1 – 2005Q2) was incomplete.

Table III.5. Summary statistics on real house price cycles

1970 Q1 -2005 Q1

	Number of upturns	Average duration (quarters)	Average price change (per cent)	Maximum duration (quarters)	Maximum price change (per cent)	Number of upturns > 15%
United States	3	17.0	15.3	23	17.0	1
Japan	2	34.5	67.0	54	77.6	2
Germany	3	21.3	12.1	27	15.7	1
France	2	35.5	32.1	44	33.0	2
Italy	2	34.5	81.9	44	98.0	2
Canada	4	15.5	31.6	27	66.5	2
United Kingdom	3	18.3	64.2	30	99.6	3
Australia	6	14.3	31.6	32	84.7	3
Denmark	2	25.0	44.3	37	56.5	2
Finland	3	25.7	61.9	40	111.8	3
Korea <sup>1</sup>	2	12.5	29.0	15	33.5	2
Ireland	2	29.0	40.8	46	53.9	2
Netherlands	1	33.0	98.4	33	98.4	1
New Zealand	4	15.8	37.3	22	62.7	4
Norway	3	21.3	-19.8	28	-40.6	1
Spain	3	19.3	-21.6	31	-32.2	2
Sweden	2	19.0	35.8	22	42.5	2
Switzerland	3	28.3	40.2	53	73.5	2
Average	2.6	23.7	30.2	33.6	36.9	2.0
	Number of downturns	Average duration (quarters)	Average price change (per cent)	Maximum duration (quarters)	Maximum price change (per cent)	Number of downturns > 15%
United States	3	14.3	-9.9	21	-13.9	0
Japan	1	15.0	-30.5	15	-30.5	1
Germany	2	16.5	-10.7	25	-15.3	1
France	2	18.5	-18.0	23	-18.1	2
Italy	2	22.0	-30.6	23	-35.3	2
Canada	4	13.0	-13.5	17	-20.9	1
United Kingdom	3	16.3	-25.0	25	-33.7	2
Australia	5	10.0	-10.1	19	-14.7	0
Denmark	2	21.5	-36.2	29	-36.8	2
Finland	3	14.0	-28.4	19	-49.7	2
Korea <sup>1</sup>	2	22.5	-26.7	39	-47.5	1
Ireland	2	16.0	-15.5	23	-27.1	1
Netherlands	1	29.0	-50.4	29	-50.4	1
New Zealand	4	15.0	-15.1	25	-37.8	1
Norway	3	21.3	-19.8	28	-40.6	1
Spain	3	19.3	-21.6	31	-32.2	2
Sweden	3	22.3	-22.7	26	-37.9	2
Switzerland	2	26.5	-34.8	41	-40.7	2
Average	2.6	21.4	-25.7	29.0	-38.1	1.4

1. The period covered for Korea starts in 1986 Q1.

Note: The minimum length for a phase (upturn or a downturn) has been set to 6 quarters and phases continuing beyond 2005 Q1 are excluded.

Table III.6. Major real house price cycles by country

Country	Upturns	Duration (quarters)	Downturns	Duration (quarters)
United States	1982Q3-1989Q4: +17.0%	23		
	1995Q1-2005Q2: +52.7%	41		
Japan	1970Q1-1973Q4: +56.5%	15	1973Q4-1977Q3: -30.5%	15
	1977Q3-1991Q1: +77.6%	54	1991Q1-2005Q1: -40.7%	56
Germany	1976Q2-1981Q2: +15.7%	20	1981Q2-1987Q3: -15.3%	25
			1994Q2-2004Q4: -20.5%	42
France	1970Q1-1981Q1: +31.2%	44	1981Q1-1984Q3: -18.1%	14
	1984Q3-1991Q2: +33.0%	27	1991Q2-1997Q1: -18.0%	23
	1997Q1-2005Q1: +74.3%	32		
Italy	1970Q1-1981Q1: +98.0%	44	1981Q1-1986Q2: -35.3%	21
	1986Q2-1992Q3: +65.8%	25	1992Q3-1998Q2: -26.0%	23
	1998Q2-2005Q1: +49.6%	27		
Canada	1970Q1-1976Q4: +46.4%	27	1981Q1-1985Q1: -20.9%	16
United Kingdom	1985Q1-1989Q1: +66.5%	16		
	1998Q3-2005Q2: +39.2%	27		
	1970Q1-1973Q3: +64.9%	14	1973Q3-1977Q3: -33.7%	16
Australia	1977Q3-1980Q1: +28.0%	11		
	1982Q1-1989Q3: +99.6%	30	1989Q3-1995Q4: -27.8%	25
	1995Q4-2005Q2: +137.4%	38		
Denmark	1970Q1-1974Q1: +36.3%	16		
	1987:1-1989Q1: +35.9%	8		
	1996Q1-2004Q1: +84.7%	32		
Finland	1970Q1-1979Q2: +32.1%	37	1979Q2-1982Q4: -36.8%	14
	1982Q4-1986Q1: +56.5%	13	1986Q1-1993Q2: -35.6%	29
	1993Q2-2004Q3: +93.4%	45		
Ireland	1970Q1-1974Q2: +23.6%	10	1974Q2-1979Q1: -30.3%	19
	1979Q1-1989Q1: +111.8%	40	1989Q1-1993Q2: -49.7%	17
	1993Q2-2000Q1: +50.3%	27		
	2001Q3-2005Q2: +23.6%	15		
Korea <sup>1</sup>	1970Q1-1981Q3: +53.9%	46	1981Q3-1987Q2: -27.1%	23
	1987Q2-1990Q2: +27.7%	12		
	1992Q3-2005Q1: +242.7%	50		
Netherlands	1987Q3-1991Q2: +33.5%	15	1991Q2-2001Q1: -47.5%	39
	2001Q1-2003Q3: +24.5%	10		
New Zealand	1970Q1-1978Q2: +98.4%	33	1978Q2-1985Q3: -50.4%	29
	1985Q3-2005Q1: +183.1%	78		
Norway	1970Q1-1974Q3: +62.7%	18	1974Q3-1980Q4: -37.8	25
	1980Q4-1984Q2: +32.5%	14		
	1986Q4-1989Q1: +15.1%	9		
	1992Q1-1997Q3: +38.9%	22		
	2000Q4-2005Q1: +56.0%	17		
Spain	1983Q4-1986Q4: +56.3%	12	1986Q4-1993Q1: -40.6%	25
	1993Q1-2005Q2: +136.3%	49		
Sweden	1970Q1-1974Q3: +27.5%	14		
	1976Q2-1978Q2: +28.6%	8	1978Q2-1986Q1: -32.2%	31
	1986Q1-1991Q4: +134.8%	23	1991Q4-1996Q4: -18.3%	20
	1996Q4-2004Q4: +114.2%	32		
Switzerland	1974Q1-1979Q3: +29.2%	22	1979Q3-1986Q1: -37.9%	26
	1986Q1-1990Q1: +42.5%	16	1990Q1-1996Q2: -28.2%	25
	1996Q2-2005Q2: +80.1%	36		
Switzerland	1970Q1-1973Q3: +37.7%	14	1973Q3-1976Q3: -29.0%	12
	1976Q3-1989Q4: +73.5%	53	1989Q4-2000Q1: -40.7%	41

1. The period covered for Korea starts in 1986 Q1.

Country and authors	Methodology	Elasticity of real house prices relative to housing stock supply	Elasticity of real house prices relative to real disposable income	Elasticity of real house prices relative to real interest rate	Other variables	Estimated overvaluation	Comments
<b>United States</b> Meen (2002)	ECM, 1981Q3-1998Q2	-7.94	2.71	-1.3	Real wealth = 0.70		High growth in real house prices is not attributable to weak supply response. If the housing stock variable is removed, the income elasticity is biased downward.
Schnure (2005)	Panel estimation for regional house prices, short-run specification, 1978-2004		0.21 to 0.28, short-run impact	-0.6 to -1.65, short-run impact	Unemployment = -0.9 to -1.2, labor force = 0.4 to 1.8, short-run impact	No evidence of overvaluation	Increased sensitivity to interest rates since 1990 due to liberalisation of mortgage lending access and higher securitisation. No. obs.:531 to 946.
McCarthy and Peach (2004)	Demand and supply equations, Johansen ML estimation, 1981Q1-2003Q3	-3.2	3.2			No overvaluation since the mid-1990s.	OFHEO and constant quality new home price index give the same conclusions.
<b>Japan</b> Nagahata <i>et al.</i> (2004)	Panel cointegration analysis for 47 prefectures, 1976-2001		0.2 to 0.5	-0.6 to -4.5	Price expectations = 0.8 to 0.9	Land prices in Tokyo have bottomed out around 2002 but not in other areas.	Non-performing loan ratios have a significant explanatory power in the short-run.

Table III.7. Review of recent empirical studies on house price determination (continued)

Country	Model	Elasticity of real house prices relative to housing stock supply	Elasticity of real house prices relative to real disposable income	Elasticity of real house prices relative to real interest rate	Other Elasticities	Estimated overvaluation	Notes
<b>Euro area</b> Annett (2005)	ECM for eight countries		0.7, variable in log differences	-0.01 to -0.02, variables in log differences	Real credit = 0.19 or real money = 0.13, variables in log differences Real credit = 0.08 to 0.15, real money = 0.38 to 0.62 short-run impact.		Real credit and money are important determinants of long-run trends.
Annett (2005)	Panel regressions for sub-groups of countries based on common institutional characteristics, short-to medium run equations		0.1 to 1.4, short-run impact	-0.01 to -0.03, short-run impact			Institutional factors help to explain the relationship between credit and house prices.
<b>France</b> Bessone <i>et al.</i> (2005)	Demand and supply equations, Johansen ML estimation, 1986-2004	-3.6	8.3			No evidence of overvaluation in 2004.	House prices for Paris only.
<b>United Kingdom</b> Meen (2002)	ECM, 1969Q3-1996Q1	-1.91	2.51	-3.5	Real wealth = 0.35		High growth in real house prices is in part attributable to weak supply response. If the housing stock variable is removed, the income elasticity is biased downward.

Table III.7. Review of recent empirical studies on house price determination (continued)

Country	Model	Elasticity of real house prices relative to housing stock supply	Elasticity of real house prices relative to real disposable income	Elasticity of real house prices relative to real interest rate	Other Elasticities	Estimated overvaluation	Notes
<b>United Kingdom (continued)</b>							
Hunt and Badia (2005)	ECM, 1972Q4-2004Q4		1.91 in 1999Q4 and 1.5 in 2004Q4	-6.0 in 99Q4		34% in 1999Q4 and 60% in 2004Q2	Improvements in monetary and fiscal policy frameworks have raised sustainable prices beyond what these linear estimation technique can capture, suggesting there is little overvaluation.
<b>Australia</b>							
Abelson <i>et al.</i> (2005)	ECM, 1975Q1-2003Q1	-3.6	1.7	-5.4	CPI = 0.8, unemployment = -0.2, stock index = -0.1		The CPI captures the after-tax investment advantages (expected capital gains and tax benefits)
<b>Denmark</b>							
Wagner (2005)	ECM, 1984Q4-2005Q1	-2.9	2.9	-7.7	Demography = 2.9	9/10 of the increase since 1993 is explained by fundamentals.	Scarcity of land in the Copenhagen area, temporary effect from the introduction of interest only mortgage loans could also account for the rise in house prices.
<b>Ireland</b>							
OECD Economic Survey (2005a)	ECM, 1977Q1-2004Q4 for new and existing houses	-2.0 for new houses, -0.007 for existing houses (time trend relative to pop. 25-44)	1.8 for new and existing houses  0.7 to 0.9	-1.9 for new and existing houses		20% since end 2004 for new houses and 10% for existing houses.	The sharp increase in the price of existing house relative to new houses since the mid-1990s may reflect in part relative supply constraints  Short-run income elasticities are high in both equations.  In the short-run, mortgage credit growth has also a positive effect on house price growth
Fitzpatrick and McQuinn (2004)	Stock and Watson DOLS, FM-OLS and OLS, 1981-1999	-1.2			Mortgage credit = 1.3, population 24-36 = 2.0		

Table III.7. Review of recent empirical studies on house price determination (continued)

Country	Model	Elasticity of real house prices relative to housing stock supply	Elasticity of real house prices relative to real disposable income	Elasticity of real house prices relative to real interest rate	Other Elasticities	Estimated overvaluation	Notes
<b>Finland</b>							
Oikarinen (2005)	ECM, 1975Q1-2005Q2		0.8 to 1.3	-2.2 to -7.5	Construction costs = 1.1 to 2.3	No overvaluation in recent years.	Helsinki Metropolitan Area only. Uses a trend variable to capture financial liberalisation.
<b>Netherlands</b>							
OECD Economic Survey (2004)	ECM, 1970-2002	-0.52	1.94	-7.14		.	High growth in real house prices is mainly attributable to weak supply response.
Verbruggen <i>et al.</i> (2005)	ECM, 1980-2003	-1.44	1.33	-5.91		10% in 2003	
Hofman (2005)	ECM, 1974Q1-2003Q3		1.5	-9.42		No deviation from fundamentals in 2004	Van Rooij (1999) also failed to find any long-run effects of housing supply.
<b>Norway</b>							
Jacobsen (2005)	ECM, 1990Q1-2004Q1	-1.7	1.7	-3.2	Unemployment = 0.5	No overvaluation in recent years.	If housing stock is excluded, income elasticity drops to 1.2.
<b>Spain</b>							
OECD Economic Survey (2004b)	ECM, 1989-2003	-6.9 to -8.1	3.3 to 4.1		Population total = 12 to 16.9		High growth in real house prices is not attributable to weak supply response.
Ayuso <i>et al.</i> (2003) and Banca de España (2004)	1978-2002		2.78	-4.5 (in nominal terms) if the elasticity of income is 1 otherwise insignificant	Stock market return = -0.33	8% to 17% in mid-2002, 14% to 19% in 2003 and 24% to 31% in 2004.	

Table III.7. Review of recent empirical studies on house price determination (continued)

Country	Model	Elasticity of real house prices relative to housing stock supply	Elasticity of real house prices relative to real disposable income	Elasticity of real house prices relative to real interest rate	Other Elasticities	Estimated overvaluation	Notes
<b>Group of countries</b> Sutton (2002)	VAR model for the US, Australia, Canada, UK, the Netherlands and Ireland, 1970s-2002Q1			Short rates = -0.5 to 1.5, weaker for long-rates, with lowest estimates for the US and the UK and largest for the Netherlands.	GNP = 1 to 4 after 3 years, largest in Ireland. Share prices = 1 to 5 after 3 years, largest in the UK	Overvaluation in all countries except Canada over 1995Q1 to 2002Q2, largest in Ireland.	
Tsatsaronis and Zhu (2004)	VAR model for 17 countries, grouped on their mortgage finance structures, 1970-2003	Account for less than 10% of total variation in house prices after 5 years	Account for than 11% of total variation in house prices after 5 years		Inflation account for 50% of total variation in house prices after 5 years, while bank credit and term spread account each for around 10 %		Mortgage market structures matter for the importance of inflation sensitivity to interest rates and the strength of the bank credit channel..
Terrones and Otrok (2004)	Dynamic panel regressions for 18 countries, 1970-2003	1.1		-1.0	Population growth = 0.25, housing affordability = -0.14, lagged dependent variable = 0.51	Between 1997 to 2003, overvaluation by 10% to 20% in Australia, Ireland, Spain and the United Kingdom, by 10% or less in Sweden and the US.	The growth rate of real house prices is very persistent, shows long-run reversion to fundamentals and dependence on economic fundamentals. No. observations = 524.

Table III.8. Stationarity test for price to income and price to rent ratios

*Augmented Dickey-Fuller unit root test*

	Price to income ratio		Price to rent ratio	
	1970Q1 - 2004Q4	1970Q1 - 2000Q4	1970Q1 - 2004Q4	1970Q1 - 2000Q4
United States	-1.15	-0.98	-0.92	-2.37
Japan	-1.34	-2.03	-2.05	-2.58
Germany	-1.04	-1.31	-0.23	-0.61
France	-1.71	-1.85	-1.33	-2.89**
Italy	-2.37	-2.13	..	..
United Kingdom	-2.43	-3.51***	-1.53	-3.15**
Canada	-1.36	-1.58	0.14	-1.58
Australia	1.47	-1.76	-0.49	-1.82
Denmark	-1.91	-1.94	-1.68	-2.08
Finland	-3.20 **	-2.97**	-1.53	-2.13
Ireland	-0.03	-2.82*	0.73	-1.14
Netherlands	-1.97	-2.29	-2.09	-2.74*
New Zealand	-2.25	-1.81	-1.12	-3.61***
Norway	-0.39	-2.18	-1.41	-1.89
Spain	-0.18	-1.55	-0.13	-1.36
Sweden	-2.08	-1.93	-2.17	-2.91**
Switzerland	-1.60	-1.46	-2.64 *	-2.70*
Korea	-0.97	-0.65	-3.32**	-1.91

*Note:* \*, \*\* indicate the stationarity at the 10%, 5% and 1% level respectively. The lag structures for the ADF equations are chosen using the Schwarz Information Criterion. The critical values are from MacKinnon (1996). For Denmark, Ireland, Italy, Korea and Norway, the sample is shorter due to date availability.

**BIBLIOGRAPHY**

- Abelson, P., R. Joyeux, G. Milunovich and D. Chung (2005), “Explaining house prices in Australia: 1970-2003”, *Economic Record*, Vol. 81.
- Ahearne, A., J. Ammer, B. Doyle, L. Kole and R. Martin (2005), “House prices and monetary policy: A cross-country study”, *International Finance Discussion papers*, No. 841, Board of Governors of the Federal Reserve System.
- Annett, A. (2005), “Euro area policies: Selected issues”, *IMF Country Report*, No. 05/266.
- Australian Bureau of Statistics (2004), “The impact of rising house prices on the WA economy”, *Western Australian Statistical Indicators*, December Quarter.
- Ayuso, J., J. Martinez, L. Maza and F. Restoy (2003), “House prices in Spain”, *Economic Bulletin*, Banco de Espana, October.
- Banco de Espana (2004), “Annual Report”.
- Bank of Finland (2004), “Financial Stability, Special issue”, *Bank of Finland Bulletin*.
- Barker, K. (2004), *Review of Housing Supply*, Final Report, HM Treasury.
- Barham, G. (2004), “The effects of taxation policy on the cost of capital in housing – a historical perspective (1976 to 2003)”, Financial Stability Report of Ireland.
- Bernanke, B. (2002), “Asset-price bubbles and monetary policy”, Remarks before the New York Chapter of the National Association for Business Economics, 15 October, New York.
- Bessone, A.-J., B. Heitz and J. Boissinot (2005), “Marché immobilier: voit-on une bulle?”, *Note de Conjoncture*, INSEE, mars.
- Borio, C. and P. McGuire (2004), “Twin peaks in equity and housing prices?”, *BIS Quarterly Review*, March.
- Bry, G. and C. Boschan (1971), *Cyclical Analysis of Time Series: Selected Procedures and Computer Programs*, NBER, New York.
- Canada Mortgage and Housing Corporation (2004), “House prices, borrowing against home equity, and consumer expenditure”, *Research Highlights, Socio-economic Series 04-006*, January.

- Canadian Imperial Bank of Commerce (CIBC) (2005), “Household credit analysis”, *World Markets, Economics and Strategy*, 13 June, Toronto.
- Capozza, D., P. Hendershott, C. Mack and C. Mayer (2002), “Determinants of real house prices dynamics”, *NBER Working Paper Series*, No. 9262.
- Catte, P., N. Girouard, R. Price and C. André (2004), “Housing markets, wealth and the business cycle”, *OECD Economics Department Working Papers*, No. 394.
- Cerny, A., D. Miles and L. Schmidt (2005), “The impact of changing demographics and pensions on the demand for housing and financial assets”, *CEPR Discussion paper series*, No. 5143.
- Cournède, B. (2005), “Housing prices and inflation in the euro area”, *OECD Economics Department Working Papers*, No. 450.
- Danmarks Nationalbank (2005), *Financial Stability Report*.
- Debelle, G. (2004), “Household debt and the macroeconomy”, *BIS Quarterly Review*, March.
- Dobson, W. and G. Hufbauer (2001), *World Capital Markets – Challenges for the G10*, Institute for International Economics, Washington DC.
- Eschenbach, F. and L. Schuknecht (2002), “The fiscal costs of financial instability revisited”, *ECB Working Papers*, No. 191.
- European Central Bank (ECB) (2003), *Monthly Bulletin*, October.
- European Central Bank (ECB) (2005), “Asset price bubbles and monetary policy”, *Monthly Bulletin*, April.
- European Mortgage Federation (2004), *Hypostat 2003 European Housing Finance Review*, Brussels.
- Evans, A. and O. Hartwich (2005), “Bigger, better, faster, more: Why some countries plan better than others”, Policy Exchange, Localis, London.
- Fitzpatrick, T. and K. McQuinn (2004), “House Prices and Mortgage Credit: Empirical Evidence for Ireland”, *Research Technical Paper*, No. 5/RT/04, Economic Analysis and Research Department, Central Bank and Financial Services Authority of Ireland.
- FitzGerald, J. (2005), “The Irish housing stock: growth in number of vacant dwellings”, Special Article in ESRI, *Quarterly Economic Commentary*, Dublin, Spring.
- Gallent, N. and K. Kim (2001), “Land zoning and local discretion in the

- Korean planning system”, *Land Use Policy*, Vol. 18, Issue 3.
- Gallin, J. (2003), “The long-run relationship between house prices and incomes: evidence from local housing markets”, *Finance and Economics Discussion Series*, No. 2003-17, Board of Governors of the Federal Reserve System.
- Gallin, J. (2004), “The long-run relationship between house prices and rents”, *Finance and Economics Discussion Series*, No. 2004-50, Board of Governors of the Federal Reserve System.
- Girouard, N. and S. Blöndal (2001), “House prices and economic activity”, *OECD Economics Department Working Papers*, No. 279.
- Girouard, N. and R. Price (2004), “Asset price cycles, “one-off” factors and structural budget balances”, *OECD Economics Department Working Papers*, No. 391.
- Glaeser, E. and J. Gyourko (2003), “The impact of building restrictions on housing affordability”, *Federal Reserve Bank of New York Economic Policy Review*, June.
- Glaeser, E., J. Gyourko and R. Saks (2005), “Why have housing prices gone up?”, *Harvard Institute of Economic Research Discussion Paper*, No. 2061.
- Gurkaynak, R. (2005), “Econometric tests of asset price bubbles: taking stock”, *Finance and Economics Discussion Series*, No. 2005-04, Board of Governors of the Federal Reserve System.
- Gyourko, J., C. Mayer and T. Sinai (2004), “Superstar cities”, *Wharton Working Paper*, July.
- Hannah, L., K-H. Kim and E. Mills (1993), “Land use controls and housing prices in Korea”, *Urban Studies*, Vol. 30, No. 1.
- Harding, D. (2003), “Towards an econometric foundation for turning point based analysis of dynamic processes”, Paper presented at the 2003 Australian Meeting of the Econometric Society.
- Helbling, T. (2005), *Housing Price Bubbles – A Tale based on Housing Price Booms and Busts*, BIS Papers, No. 21, Real Estate indicators and Financial Stability.
- Himmelberg, C., C. Meyer and T. Sinai (2005), “Assessing high house prices: Bubbles, fundamentals, and misperceptions”, *Staff Report* No. 218, Federal Reserve Bank of New York, September.
- Hofman, D. (2005), “Kingdom of the Netherlands-Netherlands: Selected issues”, *IMF Country Report*, No. 05/225.

- Hunt, B. and M. Badia (2005), “United Kingdom: Selected issues”, *IMF Country Report*, No. 05/81.
- International Bureau of Fiscal Documentation (1999), *European Tax Handbook 1999*, Amsterdam.
- Issing, O. (2003), “Monetary and financial stability: Is there a trade-off?”, Address at the Conference on “Monetary stability, Financial Stability and the Business Cycle”, Bank for International Settlements, Basle.
- Jacobsen, D. and B. Naug (2005), “What drives house prices?”, *Norges Bank Economic Bulletin*, No. 05 Q1.
- Koeva, P. and M. Moreno (2004), “Ireland: selected issues”, *IMF Country Report*, No. 04/349.
- Kohler, M. and A. Rossiter (2005), “Property owners in Australia: a snapshot”, *Research Discussion Paper*, No. 2005-03, Economic Research Department, Reserve Bank of Australia.
- Krainer, J. (2005), “Housing markets and demographics”, *FRBSF Economic Letter*, No. 2005-21, Federal Reserve Bank of San Francisco.
- Krainer, J. and C. Wei (2004), “House prices and fundamental values”, *FRBSF Economic Letter*, No. 2004-27, Federal Reserve Bank of San Francisco.
- Macfarlane, I. (2003), “Do Australian households borrow too much?”, *Reserve Bank of Australia Bulletin*, April.
- MacKinnon, J.G. (1996), “Numerical distribution functions for the unit root and cointegration tests”, *Journal of Applied Econometrics*, No. 11.
- Mayer, C. and C. Somerville (2000), “Land use regulation and new construction”, *Regional Science and Urban Economics*, Vol. 30, Issue 6.
- McCarthy, J. and R. Peach (2004), “Are home prices the next bubble?”, *Federal Reserve Bank of New York Economic Policy Review*, Federal Reserve Bank of New York, December.
- Meen, G. (2002), “The time-series behaviour of house prices: A transatlantic divide”, *Journal of Housing Economics*, No. 11.
- Morgan Stanley (2005), “Housing bubble metrics”, *US Economics*, 27 May.
- Nagahata, T., Y. Saita, T. Sekine and T. Tachibana (2004), “Equilibrium land prices of Japanese prefectures: A panel cointegration analysis”, *Bank of Japan Working Paper Series*, No. 04-E-9.

- Norges Bank (2005), *Financial Stability*, 1/2005.
- OECD (2004), *Economic Survey of the Netherlands*, Paris.
- OECD (2004a), *Economic Survey of the United Kingdom*, Paris.
- OECD (2004b), *Economic Survey of Spain*, Paris.
- OECD (2005), *Economic Survey of Korea*, Paris.
- OECD (2005a), *Economic Survey of Ireland*, Paris.
- OECD (2005b), *Economic Survey of the United Kingdom*, Paris.
- Oikarinen, E (2005), "Is housing overvalued in the Helsinki Metropolitan Area", *Keskusteluaiheita Discussion papers*, No. 992, The Research Institute of the Finnish Economy.
- Ortalo-Magné, F. and S. Rady (1999), "Boom in, bust out: Young households and the housing price cycle", *European Economic Review*, No. 43.
- Ortalo-Magné, F. and S. Rady (1999), "Housing market dynamics: On the contribution of income shocks and credit constraints", *University of Munich, Department of Economics Discussion paper*, No. 2005-01 .
- Otrock, C. and M. Terrones (2005), *House Prices, Interest Rates and Macroeconomic Fluctuations*, IMF and University of Virginia, mimeo.
- Poterba, J. (1992), "Taxation and housing: Old questions, new answers", *American Economic Review*, Vol. 82, No. 2.
- Quigley, J. and S. Raphael (2004), "Is housing unaffordable? Why isn't it more affordable?", *Journal of Economic Perspectives*, Vol. 18, No. 1.
- Rele H. ter and G. van Steen (2001), "Housing subsidisation in the Netherlands: measuring its distortionary and distributional effects", *CPB Discussion Paper*, No. 2.
- Reserve Bank of Australia (2004), *Statement on monetary policy*, February.
- Riksbank (2004), "Household indebtedness in an international perspective", *Financial Stability Report*, No. 1.
- Scanlon, K. and C. Whitehead (2004), "International trends in housing tenure and mortgage finance", Council of Mortgage Lenders Research, November.
- Scanlon, K. and C. Whitehead (2005), "The profile and intentions of buy-

- to-let investors”, Council of Mortgage Lenders Research, March.
- Schnure, C. (2005), “United States: Selected issues”, *IMF Country Report*, No. 05/258.
- Sutton, G. (2002), “Explaining changes in house prices”, *BIS Quarterly Review*, September
- Terrones, M. and C. Otrok (2004), “The global house price boom”, *IMF World Economic Outlook*, September
- Tstsaronis, K. and H. Zhu (2004), “What drives housing price dynamics: Cross country evidence”, *BIS Quarterly Review*, Bank for International Settlements, March.
- Van den Noord, P. (2005), “Tax incentives and house prices in the euro area: Theory and evidence”, *Economie Internationale*, No. 101.
- Verbruggen, J., H. Kranendonk, M. van Leuvensteijn and M. Toet (2005), “Welke factoren bepalen de ontwikkeling van de huizenprijs in Nederland?”, *CPB Document*, No. 81, April.
- Wagner, R. (2005), “En model for de danske ejerboligpriser”, *Økonomi – og Erhvervsministeriets arbejdspapir*, No. 1.
- Weeken, O. (2004), “Asset pricing and the housing market”, *Bank of England Quarterly Bulletin*, Spring.
- Wilhelm, F. (2005), “L’évolution actuelle du crédit à l’habitat en France est-elle soutenable?”, *Bulletin de la Banque de France*, No. 140.
- Yellen, J. (2005), *Housing bubbles and monetary policy*, Presentation to the fourth annual Haas Gala, Federal Reserve Bank of San Francisco, 21 October.