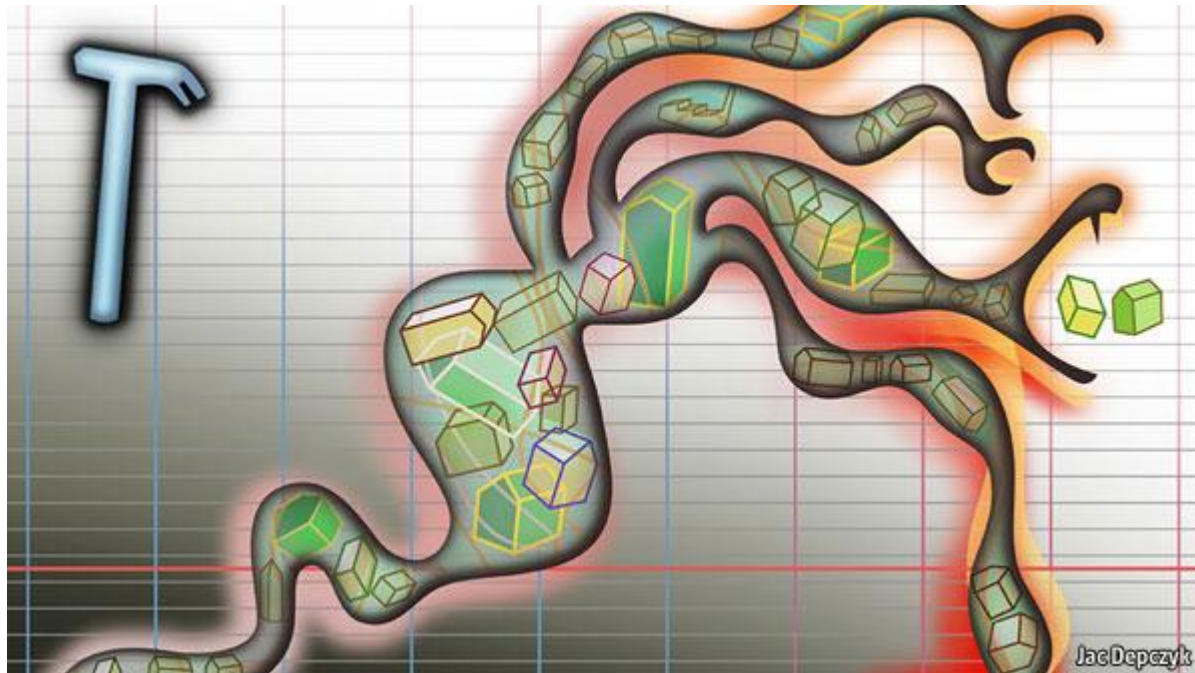


Economics focus

Home improvements

Policymakers are experimenting with ways to stop a property boom

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IN AMERICA policymakers are too busy coping with the aftermath of the last housing bubble to worry about preventing the next one. But elsewhere in the world, things are different. In China's cities, house prices rose by 11.7% in the year to March, according to official estimates, and by much more, according to unofficial ones. That is one reason why the central bank raised reserve requirements (the share of deposits banks must keep in their vaults) on May 2nd for the third time this year. In Canada, the Canadian Real Estate Association calculates that homes were worth 17.6% more in March than a year earlier, taking them well above their pre-crisis peak. And down under home values only seem to go up, rising by 20% in Australia's eight state capitals in the first three months of this year, compared with a year earlier.

How should policymakers respond? In a December speech, Adam Posen, an economist who sits on the Bank of England's rate-setting committee, complained that policymakers need a bigger toolkit. Before the crisis many central bankers believed that all they needed was a "hammer" (interest rates) to strike a "monetary nail" (consumer-price inflation). But not every problem is a nail. Policymakers also need a full set of "macroprudential" tools, from wrenches to duct tape.

To fix housing bubbles, Mr Posen suggests, policymakers should consider a tax on real estate that varies over the cycle, rising in property booms and falling in busts. His suggestion

echoes an idea proposed a year earlier by Olivier Jeanne of Johns Hopkins University. According to Mr Jeanne, debt, including mortgage debt, is like pollution. It imposes costs on others that the borrower fails to take into account. The right response to an externality of this kind is to tax it—to make the polluter pay.

In a preliminary paper^{*}, he and Anton Korinek of the University of Maryland spell out the logic further. When people borrow to buy houses (or any other asset), they push up the price. This raises the value of the collateral against which borrowing is secured. It then becomes easier to borrow to buy homes, which pushes prices even higher. This “financial accelerator” (a term coined by Ben Bernanke, now chairman of the Federal Reserve, and Mark Gertler of New York University and Simon Gilchrist of Boston University) operates in reverse during a downturn. Falling prices erode the value of collateral, tightening credit and depressing demand. When they take on debt, borrowers fail to take into account the effect of their actions on the collateral constraints faced by others. To offset this, Mr Jeanne proposes a counter-cyclical tax on debt.

No one really knows how well such measures would work. But economists have increasing amounts of evidence to sift, mainly from Asia. As Jaime Caruana of the Bank of International Settlements pointed out recently: “Asian central banks have taken the lead in implementing various macroprudential tools.” He cited the Reserve Bank of India, which in 2005 began requiring banks to make larger provisions against losses from property loans, among other things. It also forced them to set aside more capital. These measures had a big effect on commercial-property lending, which grew by only 26.7% in the year to February 2008, having grown by almost 160% in the year to August 2005.

Hong Kong’s property market has endured some wild gyrations, falling by more than 70% from 1997 to 2003. But because Hong Kong’s currency is pegged to the dollar, its central bank cannot use the interest-rate hammer even if it wanted to. Instead it has relied on macroprudential policies. In the early 1990s it told banks to lend homebuyers no more than 70% of the value of a home, and to limit their exposure to the property market to 40%.

In Singapore and China, policymakers are now trying something similar. In February the Singapore authorities barred lenders from making loans for more than 80% of the value of a home. It also imposed a stamp duty on all residential properties sold within a year of purchase. In April China’s cabinet, the State Council, said it would increase downpayment requirements on second and third homes, as well as big first homes. It set a floor on mortgage rates and ordered cash-rich state-owned enterprises to stop moonlighting as property developers. According to the *Economic Observer*, a Chinese weekly newspaper, it has also decided to subject some swanky homes to a property tax that previously excluded homes occupied by their owners.

Wrenching changes

In the West central banks are happy to set interest rates for the economy as a whole, but prefer to let the market decide who should lend how much to whom. In emerging markets, central banks are happier to get their hands dirty in the credit-allocation process, arm-twisting banks, favouring some industries with credit and discriminating against others. Some Western policymakers are now following Asia’s lead. Since April 19th house buyers in Canada have had to make a downpayment of at least 20% on investment properties they do

not occupy themselves. And even though variable mortgage rates are low (just 1.75%, according to the Bank of Canada), borrowers must meet the creditworthiness standards required for a five-year, fixed-rate mortgage. These measures should make households less vulnerable to the hammer blows that will fall when the Bank of Canada raises rates.

Besides, policymakers in places like America, Australia and Canada are happy to offer temporary tax breaks to homebuyers in a bust. Symmetry demands they raise taxes on homeowners in a boom. Until February 1st Canadians could claim a tax credit of up to C\$1,350 (\$1,180) for home renovations such as installing a hot tub. If governments are prepared to subsidise bubbly baths, they can surely bring themselves to tax bubbly markets.

* “Managing Credit Booms and Busts: A Pigouvian Taxation Approach”. Available at www.korinek.com

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