Economic SYNOPSIS

cannot fall or the rate of return to empty apartments can consistently dominate that of cash. But nowhere in the world is this guaranteed—housing prices do fall sometimes, as they did in the United States in 2007. Thus, speculative demand generates bubbles because, more so than fundamental demand, it is fickle and prone to sharp reversals.

Significant store-of-value demand for housing suggests a bubble that could burst, especially when both the household income growth rate and the savings rate start to decline and capital controls in China start to relax.

Given the evidence for significant speculative demand, how should authorities, including monetary policymakers, react? There are generally two views on this question: (i) Intervention is not necessary because the bubble is not highly leveraged and will not significantly impair the financial system. And (ii) the bubble requires appropriate policy action because regardless of financing, it promotes inefficient resource allocation. Mishkin (2009) captures the first view; he argues that responding to "a pure irrational exuberance bubble" (i.e., a bubble that is inflated through investors' own savings) risks doing more harm than good. Chen and Wen (2013) argue for policies under which housing can maintain its role as a store of value but mitigate related inefficiencies.

Housing is not an ideal store of value. Building houses consumes productive resources, and those who need housing as a basic necessity must compete for its acquisition with those who want it to preserve wealth. Chen and Wen (2013) demonstrate that private investment in fixed capital in China is negatively correlated with housing price growth. In addition, more low-income households are excluded from purchasing homes because their income growth falls behind housing price growth.5

In order to alleviate inefficiencies, Chen and Wen (2013) advocate government policies to (i) ensure that the growth rate of home prices equals or is slightly above the rate of return on bank deposits but does not exceed the average growth rate of household income, (ii) provide government-subsidized housing units to low-income households, and (iii) facilitate the development of rental markets so that empty apartments can be used more efficiently. This approach allows housing to still serve as a store of value (for middle- or upper-middle-income households), but its rate of return is not high enough to distort firms' investment incentives and low-income families are not pushed out of the home market. Middle-income Chinese households demand a good store of value, and a policy of bursting the bubble would likely generate substantial negative wealth effects and hinder China's urbanization process.

The Chinese housing boom has generated global attention because of fears that it is not sustainable and its collapse would intensify the current world slump and significantly prolong the worldwide recession. Because of its speculative nature, significant store-of-value demand for housing suggests a bubble that could burst, especially when both the household income growth rate and the savings rate start to decline and capital controls in China start to relax. But how soon and how fast these events will happen—and if, when, and how investors might lose faith in housing as a store of value—are naturally difficult, if not impossible, to predict.

Notes

1 Average annual earnings in 2012 were around 44,000 yuan ($7,000 U.S. dollars). In Beijing, household income is roughly 1.5 times the national average, but housing is three times more expensive.

2 In large cities, price-to-rent ratios are as high as 40 to 1 or 50 to 1. In equilibrium, these ratios would imply user costs to homeowners in the range of 2 to 2.5 percent, which Wu et al. (2010) demonstrate would imply large expected capital gains.

3 See Williams (2013).

4 Unlike U.S. savers, Chinese savers do not have access to international financial markets or a wide variety of diversified investment funds.

5 In sharp contrast, the U.S. housing bubble is frequently associated with the increasing affordability of houses, including subprime lending.

References


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