Back to Basics

Are Housing Markets Broken?

Many people aspire to own their own home, but it's becoming increasingly unaffordable

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FEW ECONOMIC ISSUES ARE AS contentious as housing. Concerns about affordability are top of mind for many people, young people especially, as aspirations for homeownership appear increasingly far-fetched. Are housing markets broken?

Thomas Carlyle, the 19th century philosopher, famously lambasted economists for parroting "demand and supply" as the answer to every question. But it must be the starting point for any explanation of the seemingly relentless rise in house prices: income and population growth boosts demand for housing and, unless supply keeps up, house prices continue to rise.

Consider the case of Canada. House prices (adjusted for inflation) have risen at an annual rate of about 5 percent since 2016, driven by steady growth in income and population, including strong immigration. But housing supply has lagged. The Canada Mortgage and Housing Corporation estimates that the country faces a shortage of 3.5 million homes for a population of about 41 million. Similar mismatches in supply and demand are inflating house prices elsewhere, too.

Demand amplification

Of course, economists recognize that housing is different from the other products people buy. Housing is a major long-lasting purchase and investment—for most people, the biggest they will make—and is typically financed by borrowing. This has two important consequences. First, it makes housing demand sensitive to expectations and social narratives about future house prices. Often the fear of missing out can lead people to buy homes at high prices if a narrative takes hold that tomorrow's prices will be even higher.

The Nobel Prize–winning economist Robert Shiller is famous for spotting bubbles in the housing market driven by unrealistic expectations of future prices. In 2003, Shiller noted that US house prices were substantially out of whack with people's incomes and with rents, suggesting prices were not supported by economic fundamentals. House price bubbles form, Shiller argued, from narratives and societal beliefs, often amplified by word of mouth, creating a powerful collective expectation of ever-increasing prices.

A second consequence is that housing demand is sensitive to the availability and cost of mortgage credit. A relaxation in lending standards can impart a strong boost to house prices, as happened in the run-up to the global financial crisis in 2008–09. But even without changes in lending standards, there can be amplification effects related to credit availability. As house prices climb, the value of properties pledged to lenders as collateral also increases, which can lead banks to extend more credit, further inflating the housing market. Shiller noted that the misconception that house prices always rise led to risky lending and investment. These practices, combined with the sale of high-risk loans as securities, exacerbated the impact when the reality of the market's instability was exposed.

Supply constraints

Amplification of demand goes a long way toward explaining soaring house prices, but supply constraints play an equally important role. Building a house requires financing, permits, and approvals, followed by a lengthy construction period. Even under the best circumstances, it takes some time before housing supply catches up with housing demand.

Canada, for instance, must construct 500,000 houses every year to keep

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pace with the growing demand, as an IMF assessment noted. Yet for the past two decades it has built only between 150,000 and 250,000 houses annually. To increase housing supply, the authorities are reducing permitting times, freeing up unused government land for homes, and addressing a shortage of construction workers. It will, however, take time for these measures to yield results.

A host of other regulations and zoning requirements add considerably to the supply lag. Economists Edward Glaeser and Joseph Gyourko show that land-use restrictions limit density, curbing the supply of housing and driving up prices. So in heavily regulated cities like New York, house prices soar beyond construction costs. Cities such as Houston, by contrast, have plenty of affordable homes thanks to light regulations and ample land availability.

Global forces

Housing markets are increasingly shaped by forces beyond country borders. Capital inflows from foreign buyers are boosting housing demand in many countries. These inflows are driven by several factors: an increase in wealth, particularly in emerging markets; historically low interest rates between 2008 and 2021, which prompted investors to search for yield by putting their savings into property; and capital flows to safe haven housing markets. Researchers have, for instance, shown that prices in London's high-end housing market tend to increase with geopolitical risks.

While these global trends benefit some wealthier property owners, they often make it more challenging for local residents to get a foot on the housing ladder, leading policymakers to place restrictions on foreign property buyers and regulate short-term rentals to tourists. In 2018, New Zealand passed a law barring foreigners from buying some residential properties. Canada followed five years later with a similar ban and stiff fines for those who breach the rule.

Market management

In short, while not backing away from demand and supply as a framework for explaining housing markets, economists do recognize that the amplification of demand—because of price expectations, credit availability, and capital flows—combined with stringent supply constraints can lead to substantial imbalances between demand and supply. The policy response to help housing markets work better likewise must be multifaceted.

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To manage credit availability, regulators use microprudential policies such as the risk weighting of mortgage assets, which requires banks to keep a certain amount of capital against risky mortgage loans. Increasingly, such policies are complemented by macroprudential policies to ensure the safety of the financial system as a whole. Often-used policies include setting limits on debt-service-to-income ratios, which keeps households from taking on mortgages that are too large relative to their income, and limits on loan-to-value ratios, which restrict the size of mortgage loans relative to property values and thus effectively require a minimum initial payment.

Central banks also manage housing markets by raising policy interest rates, leading to increases in mortgage rates and more expensive housing loans. But since policy rate hikes would affect all other sectors of the economy, not just housing, monetary policy is considered a blunt tool for managing housing markets.

Authorities may need to consider additional policies to manage increased housing demand from foreign buyers, many of whom use cash rather than mortgages to finance their purchases, thus bypassing any regulations imposed by the local banking regulator. In such cases, a surcharge on nonresident buyers can reduce demand from cash-rich foreigners who are not covered by local lending rules. In Singapore, for instance, the authorities in 2013 doubled the rate of stamp duty paid by foreigners to 60 percent to ease housing pressures in the city-state.

In the end, however, the basic principle of supply and demand still holds. High house prices can be largely explained by the simple fact that there are too few houses for sale. When this happens, just trying to help people buy homes—using demand-focused policies such as debt-to-income ratios, loan-to-value ratios, or changes to interest rates—will not work. The solution must come from supply-focused policies. Above all, we must build more homes. F&D

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