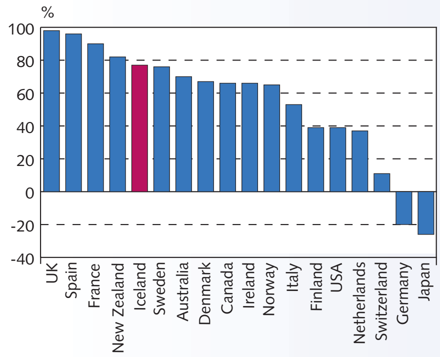
Box IV-2

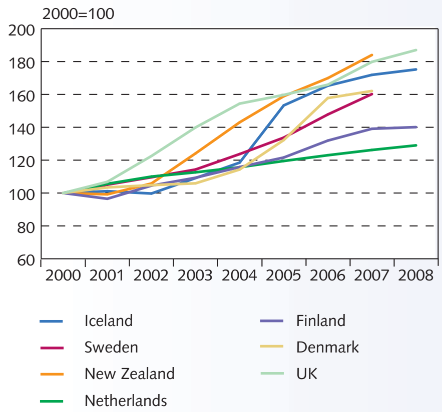
The housing market in a global context

Chart 1
Increase in real house prices from the turn of the century
Percentage change[1]



1. Percentage change from Q4/1999 to year-end 2007.
Sources: Goldman Sachs, Central Bank of Iceland.

Chart 2
Real house price index[1]



1. Data for the year 2007 are averages for available quarters, as data were not available for the year 2007 and figures for 2008 are based on the first quarter.
Sources: Land Registry of Iceland, OECD.

The forecast appearing in the last issue of *Monetary Bulletin*, wherein the Central Bank projected an approximately 30% decline in real house prices, met with vehement response. In the revised baseline forecast, house prices are projected to fall slightly more, or a roughly 19% in nominal terms, from average 2007 to 2010. This corresponds to a real decline of one-third.[1] If this materialises, the past five years' real price increases will be largely reversed. Nonetheless, prices would be close to their estimated long-term equilibrium value.

Iceland is not an island

The steep increase in house prices in the 21st century is an international phenomenon, as Chart 1 indicates. In most countries, housing inflation has been characterised by dramatic increases in real housing prices above what can be explained by underlying fundamentals. In this context, Iceland is not an island. From the turn of the century until year-end 2007, real house prices rose by over 77% (based on the real increase since Q4/1999) and are probably far above their long-term equilibrium. From the beginning of the current upswing in 2002 until 2007, nominal house prices have increased by 104% and real prices by 66%. The decline that is projected for the next three years must therefore be examined in the context of the soaring real estate prices of the past several years.

Where will the housing bust cause the most damage?

In most countries, real estate price increases have slowed considerably in the recent term, and some of the countries that have experienced the greatest increases are now seeing a reversal of that trend. Figures for Q4/2007 and Q1/2008 indicate that house prices have fallen in real terms in countries like the US, Denmark, Ireland, Norway, Spain, and Switzerland.[2]

Economists at Goldman Sachs have assessed the likelihood of a decline in GDP growth and other economic variables in 17 countries. The countries most likely to experience an economic contraction are Spain, Ireland and the US. In all of these countries, house prices have risen steadily in real terms for several years (see Charts 2 and 3), and the increases are considerably greater than the rise in real disposable income. Furthermore, residential investment and employment levels in sectors related to the housing market have deviated far from underlying long-term fundamentals in these four countries. In Goldman Sachs' opinion, Japan, Switzerland, the Netherlands, and Germany need not fear an economic downturn caused by housing deflation. In all of these countries, house prices have risen very little or have actually fallen in real terms. Residential investment has been below its underlying long-term average, and construction sector employment as a proportion of total employment levels has contracted.[3]

Previous experience of housing busts

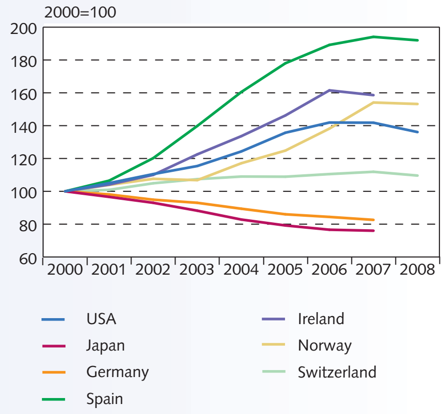
A sizeable deviation of real prices from long-term equilibrium is likely to trigger a sharp correction whose effect on the real economy could vary greatly.[4] A recent study of housing busts in OECD countries since the early 1970s revealed that, in the average bust, real house

1. Real house prices fall by nearly 31% during the forecast horizon, which extends from Q2/2008 until Q2/2011. This is virtually the same decline as was assumed for the forecast horizon of the April forecast.
2. See OECD (2008), *Economic Outlook*, 83, June 2008 (preliminary issue).
3. Real prices have fallen by 20% in Germany and 26% in Japan since the turn of the century.
4. See Goldman Sachs, *Global Economics Weekly*, April 16, April 23, and May 14, 2008.

prices fell around 30%.[5] The average duration of declining real prices was six years. The study revealed a positive correlation between the housing bust, on the one hand, and a negative output gap and a decline in GDP growth, on the other. The decline in GDP growth averaged five percentage points from the peak. Output growth began to wane before real house prices, and it bottomed out seven quarters after the bust began. The output gap bottomed at around the time real prices hit their lows.

Chart 3

Real house price index[1]



1. Data for the year 2007 are averages for available quarters, as data were not available for the year 2007 and figures for 2008 are based on the first quarter.
Source: OECD.

What is hidden behind the average?

There is often an important hidden difference lying behind average figures. The study showed that the severity and duration of the repercussions of a housing bust varied directly with the previous level of imbalance in the economy. The impact on output growth was greater in countries with a wide output gap, strong credit growth, and a wide current account deficit at the time the bubble burst.

Probable developments in Iceland

As Chart 1 illustrates, real house prices in Iceland have risen by more than those in Ireland and the US, but less than in the UK, Spain, and New Zealand, all of which are countries where the after-effects of a housing bust could prove most severe.[6]

The Icelandic credit market has tightened markedly, the supply of housing has increased, and the OMXI15 index has fallen by more than one-fourth so far in 2008. The Central Bank projects that GDP will contract by nearly 3% from the 2007 average to the 2010 average and that the negative output gap will measure just over 4%. The Bank also forecasts that the decline in real house prices will not be over by that time. Nominal house prices will begin to rise again in late 2010, but real prices will not increase until somewhat later.

Although the level of uncertainty is high, particularly as regards developments on the global financial markets, most indicators suggest that the impact on the Icelandic economy could be sizeable, both in international comparison and in a historical context. In view of past housing market crises, and given the pre-existing imbalances in the domestic economy, it is not unrealistic to assume that the after-effects will be even more severe in Iceland. One of the alternative scenarios in Box IX-2 describes the possible turn of events should the domestic housing market contraction prove even deeper than is assumed in the baseline forecast.

5. Goldman Sachs, *Global Economics Weekly*, April 16 and May 14, 2008. The reports examine instances in OECD countries where real house prices have fallen by more than 15% since 1970. See also Chapter II, *World Economic Outlook*, IMF, April 2003 and 2008.

6. The nominal price increase has been greater in Iceland, however, than in the UK, Ireland, and Spain.