DEMOGRAPHIA

July 24, 2007

To the Bank for International Settlements
Basle

Re: http://www.bis.org/publ/arpdf/ar2007e.pdf: Annual Report

Dear Sir or Madame:

We note your concern in the Annual Report about the potential long term economic risks arising from the rise in house prices in response to interest rates and more liberal loan products in the United States. However, much of the increase in housing prices may be the result of regulatory factors, rather than financial market factors.

In recent years, the US housing market has developed into two very different sectors --- one sector has the severe overvaluation that rightly concerns you, while the other sector has had minimal housing inflation. This is not always obvious to analysts, because the huge price increases in the escalating markets have bloated the average national house price.

The same differing trends have occurred in Canada, where some markets are severely overvalued, while others continue to exhibit reasonable house prices. However, in Australia, New Zealand and the United Kingdom, the house price run-up has been pervasive, occurring in virtually all major markets.

This does not dilute your concerns in any way. Asset overvaluation in places like California, Oregon and New York pose a risk to the stability of the US economy, while overvaluation in markets like Vancouver presents risks to the Canadian economy.

However, prices have not increased materially in many markets. Perhaps the most important examples are high-demand markets as Atlanta, Dallas-Fort Worth, Houston (the three fastest growing over 5,000,000 population markets in the high-income world), Austin and Ottawa.

In each of the severely escalating markets in the United States, Canada, the United Kingdom, Australia and New Zealand, there is a shortage of land for residential development. This is not a geographical or topographical shortage, it is rather an artificial shortage, imposed by stringent urban planning policies (which may be called “smart growth,” “urban containment” or “urban consolidation”). Development bans apply to large swaths of perfectly suitable land. Further, many of these markets have experienced exorbitant fee increases on new development. Overly lengthy, expensive bureaucratic procedures are also typical. All of these factors raise prices. When the financial market induced demand increase emerged, supply in these inflexible markets was unable to respond sufficiently, and prices rose inordinately.

On the other hand, many US and Canadian markets handled the increased demand in a healthy manner, consistent with historic ratios. These markets generally have more liberal residential development regimes. Where supply has been allowed to respond, the more intense demand has produced little upward pressure on prices.

Kate Barker, a member of the Monetary Policy Committee of the Bank of England has documented the inflationary impact on housing of Britain’s land use regulations (under the “Town and Country Planning Act”). Further, Arthur Grimes, chairman of the board of the Reserve Bank of New Zealand has found that regional land use restrictions has been a principal driver of house price inflation in the Auckland (references to these studies are below).

House cost escalation has been so severe that paying for the median priced house, including interest, will cost between five and 10 years of additional median household income in all Australian markets compared to just a decade ago (including mortgage interest and both inflation and income adjusted). In some California markets, the additional costs range from 10 to more than 15 years (San Diego, Los Angeles, San Francisco and San Jose). Removing this amount of discretionary income from households cannot but have a dampening impact on future economic growth and job creation.

A related demographic shift is already underway in the United States, with more than 3,500,000 domestic migrants moving from the most expensive California and Northeastern markets to less expensive markets, according to US Bureau of the Census estimates for 2000 to 2006

See: http://www.demographia.com/db-intmigra-msa.pdf

There is good reason to conclude that house asset overvaluation in the surveyed nations is more a result of restrictive land use policy than higher demand from financial market factors. More liberal lending environments and the resulting rising demand has impacted all markets. However, inordinate house cost escalation has occurred only in those markets in which there are serious land use restrictions. Where such restrictions are not in place, housing prices have remained under control.

Thus, the issue of development restrictions is deserving of more formal and serious attention by central banks.

These data are outlined in our *3rd International Housing Affordability Survey* which includes Median Multiples (median house prices divided by median household income) in 159 markets in six nations (United States, United Kingdom, Canada, Australia, New Zealand and Ireland).

See: http://www.demographia.com/dhi-ix2005q3.pdf

Please let me know if you have any questions or comments.

Best regards,

Wendell Cox
Co-author, Demographia International Housing Affordability Survey

Cc: Hugh Pavletich, Co-author (Christchurch, NZ)

References:

http://www.hm-treasury.gov.uk/independent_reviews/barker_review_land_use_planning/barkerreview_land_use_planning_index.cfm
Barker Report on Land Use Planning in the United Kingdom

http://www.hm-treasury.gov.uk/consultations_and_legislation/barker/consult_barker_index.cfm
Barker Report on Housing Supply in the United Kingdom

http://www.hnzc.co.nz/chr/pdfs/housing-supply-in-the-auckland-region-2000-2005.pdf: Housing Supply in the Auckland Region

Copies of this letter have been sent to:
Federal Reserve Board of the United States
Bank of England
Bank of Canada
Reserve Bank of Australia