

# The rise and fall of the first global real estate bubble

GONZALO BERNARDOS

The key factor to create the first real estate bubble was the existence of great liquidity at global scale between 2001 and 2005. In some countries, this period lasted till August 2007. Liquidity was generated by historically very low interest rates and virtually unbeatable financing conditions. Between 2006 and 2008, the different real estate bubbles burst. This was the consequence of the combination of two phenomena: a sudden change in mortgage financing conditions due to worldwide expansion of the US subprime mortgage crisis, and a large excess offer in housing in some countries.



## Introduction

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The evolution of the residential market has historically been a secondary subject, only followed basically by real estate professionals and those thinking of buying or selling a housing property in the near future. International investment was scarce and there were virtually no indices comparing housing price increases in different countries.

However, the economic situation in the residential market has become a subject of great macro-economic relevance after 2000. The rise of the first global real estate bubble between 2001 and 2005 was to blame for it. After 2006, the reason was its burst, first in the United States, then in Spain, Ireland and the United Kingdom, before eventually reaching Eastern Europe. In many countries, investment in building has evolved from a key driver of economic growth to a mere relict within a few years.

The creation of the first real estate bubble was mainly driven by great liquidity at global scale between 2001 and 2005. In some countries, this period lasted till August 2007. This liquidity was generated by historically very low interest rates and virtually unbeatable financing conditions offered by banks to families and companies. This liquidity created unheard phenomena such as the simultaneous rise of riskier assets (stock and housing) as well as those traditionally considered a haven (bonds and gold). So in 2005, the world economy featured a really paradoxical combination: considerable increase of stock quotations (except in the US), strong rise of housing prices, high market value of government bonds of developed countries and gold price at its maximum level of the previous twenty years. That year, almost all assets increased their value or maintained it at an extraordinarily high level.

Between 2006 and 2008, the different real estate bubbles created in the previous period burst. This was caused by the combination of two phenomena: a sudden change in mortgage financing conditions, and considerable excess housing offer in some countries. Worldwide expansion of the US

subprime mortgage crisis challenged the solvency of some banks and triggered considerable liquidity constraints.

**In some countries such as Spain, the United Kingdom and Ireland, the bubble would have burst even without the financial crisis in the United States.**

After August 2007, lower credit availability reduced considerably demand in housing, which was already in clear decline, leading to considerable agreements on prices and transactions in a large number of countries.

Nevertheless, in some countries such as Spain, the United Kingdom and Ireland, the bubble would have burst even without the financial crisis in the United States. The main reason was considerable excess in offer, a point that was clearly visible in early 2007. If the subprime mortgage crisis had not occurred, the bubble would probably have taken longer to burst and its negative effects would have been less intense and more spread over time.

I will divide the present article into three sections. In the first, I will analyse the main reasons that led to a global real estate bubble between 2001 and 2005. In the second, I will explain how the bubble burst and some features this burst has had in some countries. Finally, in the third section I will point out measures to be implemented at international level to find a way out of the current economic crisis.

## The creation of the first global real estate bubble (2001-05)

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During the first years of this decade, housing adopted a new role: that of a haven asset. This function was shared with other assets such as

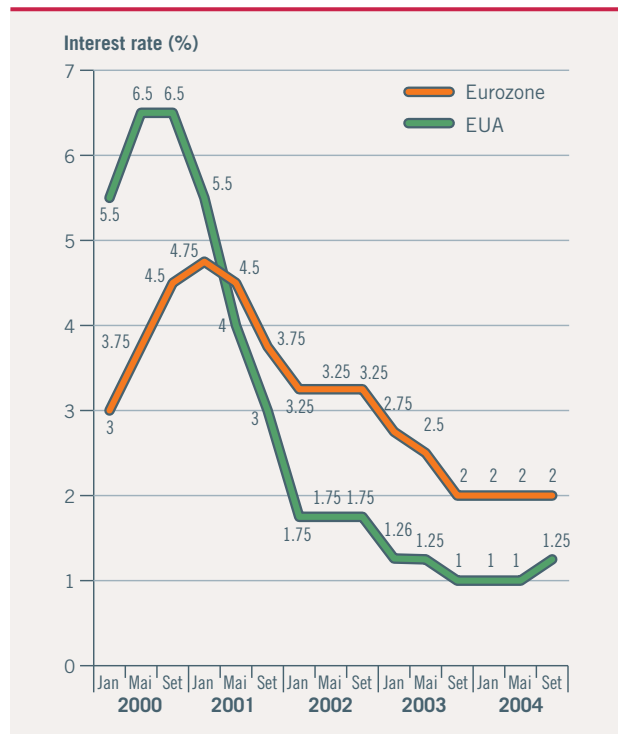
bonds or gold. This situation was largely the effect of the negative development of the main stock markets of the world between March 2000 and 2003. During this period, events of different sort like the burst of the speculative dotcom bubble, 9/11, different corporate scandals (Enron, Worldcom, etc.) and the possible effects of the war against Iraq increased substantially the risk of stock investment and reduced considerably expected profitability.

For this reason, capital moved to safer assets offering a better profitability-risk ratio. This move, especially after September 2001, triggered a substantial increase in housing demand for investment and contributed decisively to cause a considerable price increase of housing in many countries.

In 2001, direct and indirect repercussions of the poverty effect, caused by a decline in stock exchange quotations, led to a global economic recession that had not been observed in such terms since 1982. Since 1975, the three main economies (USA, Japan and Germany) had not fallen into stagnation at the same time. This adverse situation caused the main central banks to fear the disastrous combination of recession and deflation. This is what had occurred in Japan after the burst of the speculation bubble created in the second half of the 1980s. In order to prevent this combination, and after considering the mistakes done by the Bank of Japan in the 1990s, the Federal Reserve and the European Central Bank decided a rapid and considerable reduction of nominal interest rates (cf. Graph 1). This reduction was so strong that real interest rates became negative in some countries like Spain and the United States.

Such an expansive monetary policy – especially in the US, where the reduction of interest rates was bigger – was basically aimed at giving incentives to families to increase their leveraging as well as housing demand. If this target was met, the sales increase in the residential market would lead to an increase in building investment, considerable job creation and more dynamism in expenditure of families. Thus the positive

**Graph 1. Nominal interest rate variation**



Source: European Central Bank

▲ The Federal Reserve and the European Central Bank decided a rapid and considerable reduction of nominal interest rates in the 1990s.

evolution of private consumption and investment in building prevented recession and deflation from coming together. In some countries such as the United States and Spain, these variables not only managed to prevent a crisis but also became the key drivers of a period of high economic growth.

**Housing assets as a haven, reduced interest rates, high liquidity and investors' preference for residential market assets created a global real estate bubble in 2001-2005.**

As opposed to earlier periods, the new capital flows reaching the real estate sector in the international market did not target the purchase of

office buildings and hotels but rather residential buildings instead. The economic recession created by the burst of the speculation bubble meant increasing vacancy rates in office buildings mainly due to bankruptcy of many companies related to the new economy.

These vacancy rates reduced profitability expectations, increased the risk of investing in such assets and rendered commercial use of such properties less attractive. In the case of hotels, their profitability went down due to reduced economic activity, especially in the United States, following the decline of tourism.

However, the market value of hotels and office buildings located in the city centres increased substantially. The explanation of this seeming paradox has to do with their possible conversion into residential buildings and their appraisal as such. Low interest rates, together with scarce attraction by alternative assets, caused a great increase in demand of investment in luxury housing located in the prime areas of the most important cities of the world. Given the scarce offer, many developers decided to purchase office buildings and hotels at prices unthinkable of just some years earlier. The sums paid were in no case justified by income from rent (office buildings) or operating results (hotels).

The aim of such purchases was conversion into flat buildings and separate sale of each dwelling to cater for insatiable demand out of investment purposes. Given the lack of alternatives and the great financing capacity available, demand was rather driven by the location and symbolic character of the building than its real value. This fact contributed decisively to a spectacular housing price increase in the centre of the main cities (except in Germany and Japan) that was generally higher than in surrounding areas.

To summarise, housing assets as a haven, reduced interest rates, high liquidity and investors' preference for residential market assets created a global real estate bubble in

2001-2005. Its scope and size can be perfectly observed on Charts 2 and 3.

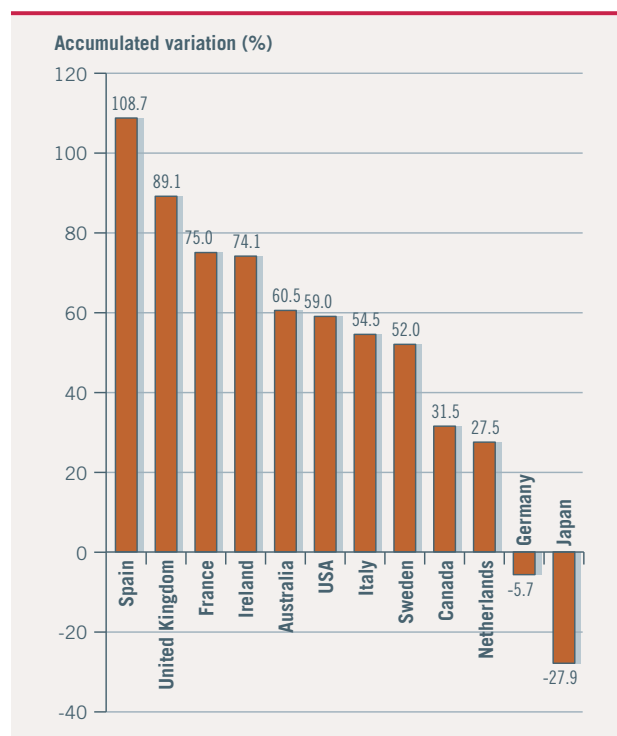
Despite the problems observed in the international economy during the 2001-2003 period, housing prices increased significantly in all analysed countries except Germany and Japan. In some countries, such as Spain, the United Kingdom and Ireland, the price increase was partially supported by according economic development. However, it was much more related with financial rather than macroeconomic aspects in other countries. This is the case of France and Italy. Although their economic growth was rather low, housing prices increased on average an 11.9% and 9.1% respectively during the analysed five-year period.

## The burst of the bubble: different cases

Real estate bubbles usually burst for two reasons: worse conditions for mortgage financing and excess housing offer. The first usually takes place when the central bank believes that there are serious possibilities that the inflation rate on goods and services grows considerably in the next months, eventually reaching too high levels. To prevent such increase, it acts swiftly by raising the guiding rate considerably within a short time. On certain occasions, such action is a crass error and has worse effects (joint deflation and recession) than those created by a relatively high, though occasional inflation rate.

A good example for this is Japan. Fears of increasing inflation led the central bank to raise the guiding interest rate from 2.5% to 6% between May 1989 and August 1990. A few months later, the real estate bubble that had started in 1987 burst. The Bank of Japan made three major errors in this period: it did not take enough into account the evolution of asset prices, thus contributing decisively to the growth of a stock and real estate bubble; it increased the guiding interest rate too fast

**Graph 2. Accumulated variation of housing prices in major countries, 2001-05**



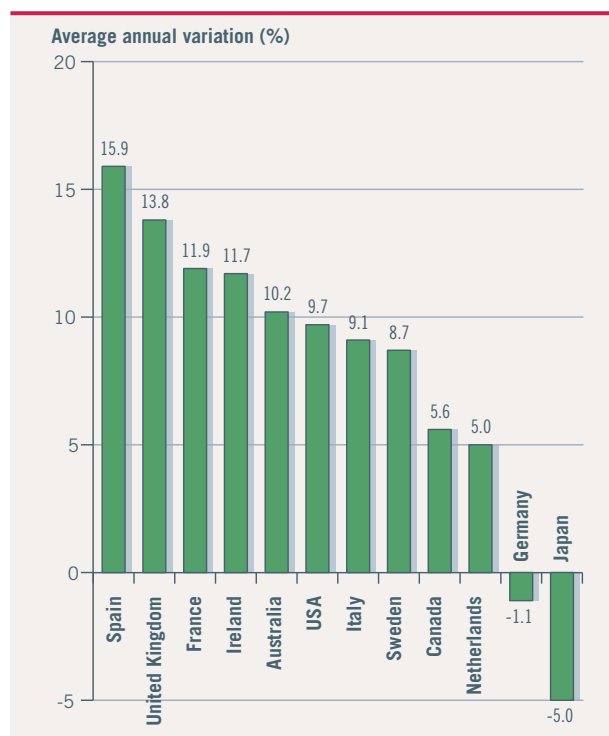
Source: The Economist and own

▲ Housing assets as a haven created a real estate bubble.

when inflation on goods and services started rising; and it took too long to change the trend of its monetary policy when both bubbles burst.

The considerable interest rate increase caused an important reduction in the three main demand categories: use, asset and speculative investment. In the first case, the increase of mortgage instalments turns a portion of a demand from solvent to insolvent, pushing one part to rents and withdrawing the other. In the second, it means that profitability earned through renting out the asset is often below the leveraging cost, thus rendering the purchase of the property hardly attractive. And in the third case, it increases the cost of speculative activity and the risk of any operation. Faced with this new state of mind, a significant number of speculators withdraws from the market.

**Graph 3. Average annual variation of housing prices in major countries, 2001-05**



Source: The Economist and own

▲ Housing prices grew everywhere except in Germany and Japan.

Big excess in offer seems to be caused by a considerable increase in the number of dwellings built. The first factor determines the rise of interest rates and deterioration of economic perspectives. The second occurs as a consequence of high benefits earned in the past by developers, which induces them to increase the pace at which they purchase land and to plan to build a higher number of new dwellings. Their expectation is that profitability earned with previous developments will be equalled or even surpassed by future ones.

These companies very often are not aware in time of adverse change in the economic situation nor of its negative effects on the residential market. So if the economy does well, they almost always think the current real estate hype will go on for at least some more years when

planning new developments. On numerous occasions, reality catches them by surprise and they observe how in a new economic situation, a significant part of dwellings are not sold after completing a new building. Excessive leverage leads sooner or later to the need of eliminating or considerably reducing the current stock, causing a dramatic price fall that contributes decisively to the burst of the bubble.

**In the last two years, the burst of real estate bubbles having occurred in different countries had one common feature: the global financial crisis generated indirectly by the real estate recession affecting the United States since the second half of 2006.**

An example of what we are explaining could be seen over the last years in the Spanish residential market. During the second half of 2006, the selling pace went down in many cities, while housing prices were still increasing. Some developers did not notice this reduction and others simply denied it. The outcome was that in that year, 920,199 new housing units were planned, an all-time record. The number of new dwelling units to be sold (including those in the hands of speculators) is above a million right now.

In the last two years, the burst of real estate bubbles having occurred in different countries had one common feature: the global financial crisis generated indirectly by the real estate recession affecting the United States since the second half of 2006. This crisis has affected considerably the capacity of raising credit for housing demanders, reduced transactions significantly and triggered important price falls in many countries.

The negative effects on banks could have been avoided, or at least mitigated, if the Federal Reserve and the US Department of the Treasury had taken existing links between the real estate market and the finance sector into more consideration. If they had done so, they probably

would have used other incentives apart from lowering the guiding interest rate (such as partial surety for newly given credits, additional tax exemptions, etc.) to avoid a continuous fall of housing transactions and prices. If they had succeeded, they would have stabilised the residential market and implicitly set a relatively high minimum price for bonds linked to subprime mortgages in the fixed-interest market. Thus bank losses due to the decline of the value of their assets would have been smaller and their deterioration could have been prevented.

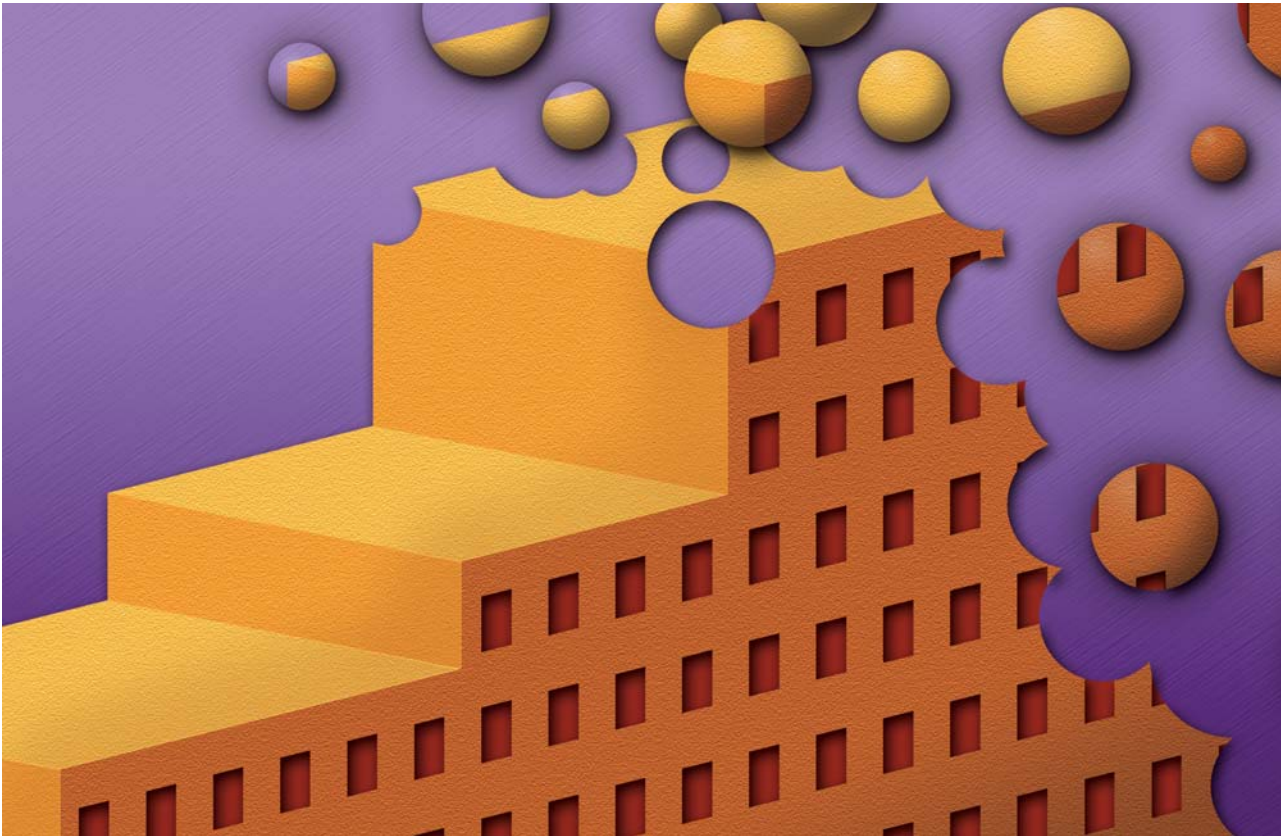
For this reason, their total needs of new own funds would have been easily quantifiable instead of being a complete uncertainty. If it had been done this way, doubts on present solvency of many banks all over the world would probably not exist.

In most Eastern European countries, the burst of the bubble has been the result of quick withdrawal of foreign real estate investors, apart from the effects caused by the international financial crisis. In the final stage of the bullish period, a large number of speculators from many countries thought that the real estate El Dorado was located in Eastern Europe. For this reason, they bought countless property and a huge number of housing units at unheard prices for developers and families living there.

Speculators went there attracted mainly by four factors: the perspective of continuously high economic growth, the expectation of relatively quick integration in the eurozone, relatively low real estate and property prices compared to most Western countries and abundant liquidity.

The first was based on the perception of EU structural and cohesion funds, company offshoring to these countries and the implementation of economic liberalisation policies. The second implied expectations of a significant risk decrease as a hardly reputed currency would be replaced quite quickly by one with great international pedigree (the euro). The third meant progressive homogenisation of





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housing prices between Eastern and Western Europe and thus expectations of higher value increase in Eastern European countries. Finally, the fourth made it relatively easy to raise credit under good conditions from a bank in a developed country to purchase property abroad.

Initially, most investors thought of selling purchased or built housing to the local population. However, high prices and purchasing pressure from second, third and fourth-generation speculators had that property bought mainly by foreigners. The demand, which had been almost inexhaustible up to August 2007, collapsed when the financial crisis became global. The excess offer is impressive right now, transactions are almost non-existent and prices are plummeting. Nevertheless, almost nothing of all this is certified by real estate statistics, which are hardly rigorous anyway.

## Solutions

During the period stretching from 2004 to September 2008, global economic policy management was extremely deficient and the main cause for the present crisis.

Countless mistakes were made, but the biggest were keeping an extraordinarily low guiding interest rate in the US over a too long period; underestimation by American authorities of existing links between the residential market and the finance sector; the belief that it was reduced liquidity what was causing solvency problems of some banks, when the exact contrary was the case; confusion between a demand and an offer crisis (ECB); and an erratic policy of bank rescues (why did not the Federal Reserve save Lehman Brothers?).

The main problem in the world economy was duly identified towards the end of 2008: existence of an international financial crisis. In this respect, most measures taken are adequate. From my point of view, the roadmap towards recovery should initially look for stabilisation of residential markets of the world's leading countries to ultimately quantify losses suffered by banks from asset deterioration in an adequate manner. Then, public capital should enter banks with the aim of increasing own funds and offering fast and appropriate liquidity for families and businesses. To make up for the loss in demand of goods from the private industry, public authorities should go on implementing a very expansive tax policy till the end of 2010 in order to prevent further deterioration of the economic situation.

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Finally, in some countries like Spain, where the GDP increase depends heavily on the development of the building industry, a set of structural reforms (corporate tax reduction, collective agreements at company level, etc.) should be tackled to allow the implementation of a new economic growth model.

#### GONZALO BERNARDOS

Full professor of Economics and commissioner of Economic Resources at the University of Barcelona.

A researcher of the Research Centre of Welfare Economy, director of the GRUPQUALITAT-Universitat de Barcelona real estate report and director of the Master course in Real Estate Consulting of the University of Barcelona.

He created the Degree in Real Estate and Building Studies at the University of Barcelona.



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