think piece

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Deflation threats & insurance premiums: a long, deep recession means greater cuts?

Vanessa Rossi and Nora Burghart

Summary

- House prices are continuing to fall due to the deep recession and deteriorating jobs outlook as well as damaged sentiment regarding the property market in general – this has hurt the UK but some countries, such as the US, Spain, Ireland, are even worse hit.
- Hopes for a speedy recovery from the property slump are being reassessed as the recession has deepened in the first half of 2009 and the general risk of persistent price deflation has become greater.
- There is a strong risk that the US could mirror the experience of Japan's "balance sheet trap" – where the impact of deflation on balance sheets and the burden of debt curbs spending growth, which in turn creates continuing downward pressure on wages and prices, exacerbating deflation and the debt trap.
- This vicious cycle of deflation and unemployment may encourage a dangerous worldwide "race to the bottom", heightening and prolonging the risks from high debt levels and falling assets.
- If weak home values and building costs persist and expectations of recovery fade, tough competition will mean greater – potentially permanent – cuts in premiums.

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CHATHAM HOUSE

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CII Introduction: The property market has been hit hard by the recession, and impacts of the decline have seen deflation reach new levels. Many assume that recovery is around the corner – but what will happen if prices continue to fall? In this fourth instalment of our international series of Thinkpieces, Vanessa Rossi and Nora Burghart of Chatham House explain the implications of a prolonged recession, focusing on how insurance premiums in particular might succumb to ongoing market pressure.

While everyone has experience of rising prices, with economies typically geared to annual increases of 2-3% in consumer price indices, few people have ever witnessed an extended period of flat, let alone falling, prices. Many households - and businesses – are likely to be poorly prepared for the consequences should lower price levels persist. House prices have already seen a substantial decline in the US, UK and Spain – many other housing markets are following suit – but these are not the only prices to have weakened.

Deflation has also hit consumer durables including household equipment and furnishings as well as vehicles. While the general assumption has been that “fire sale” conditions will peter out once the global economy starts to pull out of recession – with prices quickly recovering to pre-recession levels – this relatively benign interpretation of current trends should not be taken for granted. The current dip into deflation in the US has raised fears that prices may well remain weak and even fall further as wages are dragged down by the deep recession.

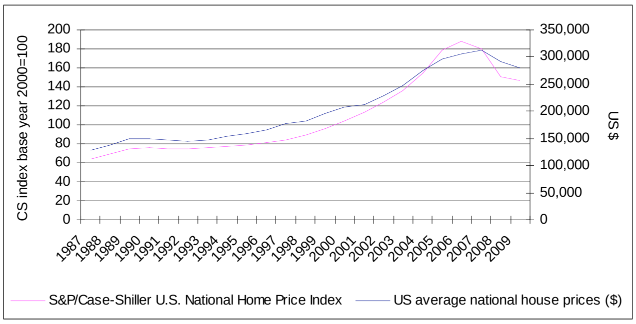
“lower price levels for home and durables would have important implications for…valuations of property insured and insurance premiums…”

Persistently lower price levels for homes and durables would have important implications for an ever wider range of goods and services. Valuations of property insured and insurance premiums would be impacted, putting further pressure on the sector’s revenues and profits at a time when weak asset prices are already causing stress in the financial sector. Adjusting to deflation is much harder to cope with than adjusting to moderately higher inflation, especially given the implications for household debt and company balance sheets, and the impacts would prolong the recession.

House prices are still falling – consumer price deflation breaks out

Although there has been a worldwide boom-bust cycle in property, the US epitomizes the woes of the housing market. As the housing boom picked up steam in the 2003-2005 period, US house starts also rose sharply from around 1.5 to 1.6 million units per annum to 2.1 million by early 2006. But as stresses built up, including over capacity, house prices began to fall in the US in 2006 according to the widely quoted Case-Shiller index (a little later based on national average prices) and are now down by about 30% from the mid-2006 peak. They are still falling as we approach mid-2009, although there has been a slowdown in the rate of decline. House starts have slumped but excess stock remains.

Figure 1: US Case-Shiller index and national average house prices



Source: Standard & Poor’s and US Census Bureau *Note: 2009 S&P’s Case-Shiller estimates are based on January-March data*

This has been an exceptional experience for the US economy and property market. While house prices failed to keep up with inflation in the mid 1970s – leading to lower “real” house prices for a few years – prices still rose and continued to rise during recent recessions such as the early 1980s and 2001. Unsurprising given the savings and loans crisis in the early 1990s, prices dipped during the 1990-92 recession but only very slightly. Most US home buyers saw an absolute fall in prices as a near impossible event although a period of stagnation was generally expected after prices soared way above trend in 2006.

Not only have US house prices been declining for almost three years now but, in contrast to hopes for a renewed pick up, the decline may well continue through this year into 2010. In addition, there is now evidence of deflation creeping in across a wide range of consumer goods and services. On April 15, a milestone was reached as the US reported a 0.4% fall in the overall consumer price index for March versus the same month a year ago – the first such fall since 1955. This rate will drop sharply in coming months.

Together with the impact of fast rising unemployment in 2009, the decline in consumer prices could mark the end of expectations that the housing market will soon see a sustainable recovery and overtake the past peak for prices. Such a shift in expectations would have far reaching implications for the housing market and investment trends – and for other goods and services prices.

"A weak property market is not just a US problem – nor is deflation."

A weak property market is not just a US problem – nor is deflation. The massive overhang of housing stock in Spain suggests a long and painful adjustment for this market while the steep recession and financial sector stress in Ireland also points to a lengthy slump in both the building sector and house prices.

Across the Eurozone, construction is weakening and consumer price trends are also pointing to the likely emergence of deflation. The Eurozone's consumer price index (CPI) registered a year-on-year rise of just 0.6% in March and April, indeed, some countries such as Spain saw prices fall slightly in March compared to a year earlier (-0.1%, following a series of weak monthly figures) while others such as Ireland (-2.6%) clearly face severe deflation problems.

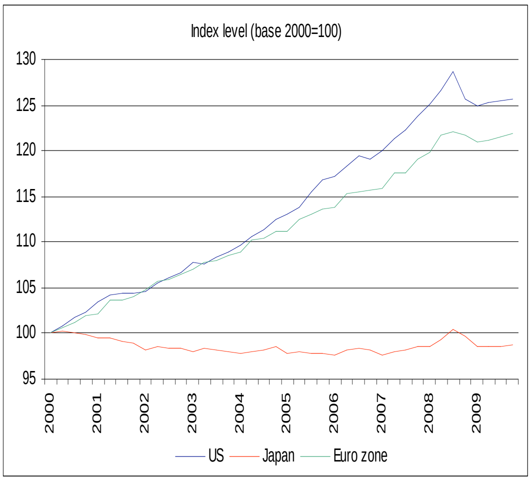
"The UK market could start to firm up again… the outlook may be somewhat better than other badly hit markets…"

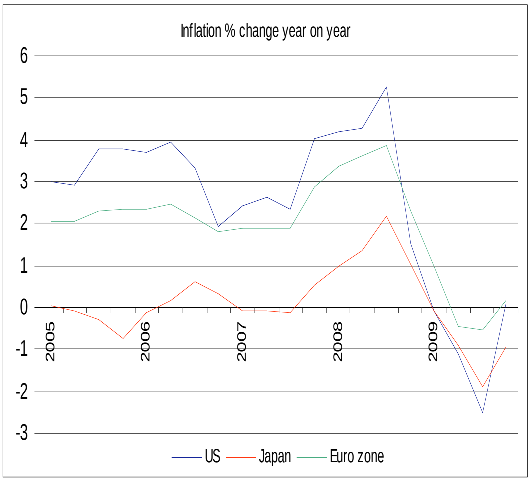
The UK has also seen a substantial fall in average house prices from 2007. However, relatively tight land restrictions and low building rates (at peak, little more than 200,000 new units being built per year versus a peak in Spain of more than 850,000 and in Ireland of around 90,000) have limited the housing overhang and, in principle, the UK market could start to firm up again.

On the other hand, UK land prices were ramped up by previous land hoarding and are now tumbling as forced sellers have emerged in the distressed construction sector. Sentiment regarding the market is also critical and trends will, in part, depend on the US and other markets as well as on the UK's economic performance and the jobs outlook. It would therefore be premature to assume the UK property market is immune to further weakness although the outlook should be somewhat better than other badly hit markets, helped also by the weak pound sterling, which has certainly improved the UK property market's international competitiveness.

While some countries tend to be highlighted more than others in terms of the threat posed by the property slump and the scale of the decline in prices, the reality is that problems are widespread around the world. They stem from similar causes: the tendency to overbuild during the property boom over the last decade; excessive debt-financed speculation in the sector; and, growth in sub-prime, high risk borrowing.

Figure 2: Consumer prices in the US and Europe could follow Japan's flat trend

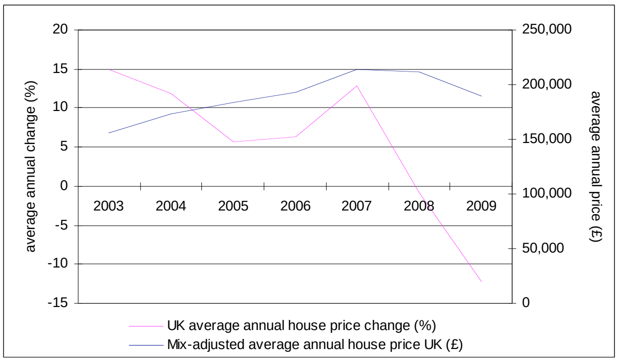




Source: US Bureau of Labor Statistics, Eurostat, Statistics Bureau of Japan and own forecasts

Hopes are still pinned on a short-lived decline in the market will be followed by a fairly rapid recovery. However, as the recession has deepened through the first half of 2009 and the general risk of persistent deflation has become greater, these hopes for a speedy recovery in property markets are being reassessed. The US's economic and financial situation is increasingly compared to that of Japan in the 1990s, while Europe is becoming more pessimistic about its economic prospects, with forecasts pointing to a very late recovery. Such concerns are illustrated in the latest IMF forecasts, which highlight the potential for the recession to be extended into 2010 – delaying recovery to 2011-2012. This is especially worrisome as it would have further implications for consumer and business sentiment, exacerbate the risk of deflation and prolong weakness in the housing sector.

Figure 3: UK house price changes (2003-2009)



Source: Communities and Local Government UK (base Feb 2002=100) *Note: 2009 estimate is based on first quarter data*

Learning from the Japanese experience?

Many analysts expected the fall in US house prices (Chart 1) to gradually taper off as prices returned to the old long term trend, estimated to be fairly close to present levels. However, this relatively comforting view of a short-lived correction in the market followed by a smooth return to trend could be very misleading. As an example of what might go wrong, Japan's real estate values (Chart 4) have been eroding for 17 years and are now far below the level previously estimated as the long-term trend for prices.

"As an example of what might go wrong, Japan's real estate values have been eroding for 17 years and are now far below the level previously estimated…"

Arguably, the trend for Japanese house prices was poorly estimated in the 1990s and did not accurately reflect the underlying long-run sustainable level. For example, assuming that the rise in prices during the 1980s represented a large but unsustainable digression from normal behaviour, the alternative estimate would be a very flat long run trend, putting prices roughly where we see them today (about three times the level in 1970-1972).

However, many see Japan's long standing problem of weak property prices as the result of an inability to deal effectively with what is called the "balance sheet trap" (a view expressed by Keiichiro Kobayashi at the Chatham House – Japan Economic Foundation Symposium, 4 March 2009). This "trap" is caused by the damaging impact of deflation on balance sheets and the burden of debt. Indebtedness curbs spending growth, which, in turn, creates continuing downward pressure on wages and prices, exacerbating deflation and the debt trap.

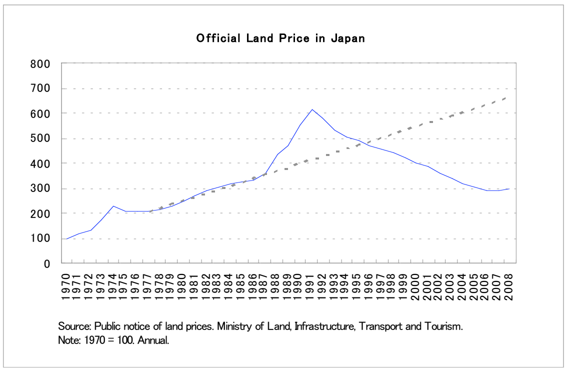
There is a serious risk that the US, which has seen household debt delinquency rates soar, could experience the same vicious cycle as Japan. Deteriorating household balance sheets (rising debt/income and debt/wealth ratios) are already weakening consumer spending, impacting on corporate balance sheets through the effects of both falling demand and lower prices. This will cause bad debt to spread and escalate in the corporate sector – with yet more negative consequences for the banking sector.

In addition to these pressures on balance sheets and banks, wealth losses in the residential sector have been compounded by declining asset values in commercial property, where prices also began to fall at the end of 2007, and by the collapse in stock market wealth. Estimates for the total loss in financial and housing wealth in the US vary, but it may well be as high as $20 trillion, more than the annual GDP of about $15 trillion, which puts into perspective the scale of debt adjustment required to restore balance.

"The possibility of a negative debt-inflation situation occurring in the US – and probably in Europe as well – raises the risk that the global recession will be very prolonged indeed."

The US balance sheet trap may assume even greater proportions in the months to come. As the vicious circle continues, property values will continue to fall and, contrary to previous expectations, prices could eventually slide far below the trend level established before the bubble burst – mirroring the experience of Japan (Chart 4).

Figure 4: Land prices in Japan have dropped far below estimated trend



Source: Keiichiro Kobayashi, Chatham House – JEF Symposium 4 March 2009

The possibility of such a negative debt-deflation situation occurring in the US - and probably in Europe as well - raises the risk that the global recession will be very prolonged indeed, just as the IMF has warned in its April update of the World Economic Outlook.

One of the aims of government policy is to tackle the debt problem head on in order to escape the debt trap and regenerate growth as quickly as possible – but the scale of this task and the rising threat of persistent consumer price deflation will make the target hard to achieve.

Deflation will encourage prolonged recession

Deflation is no longer a forecast risk but reality in both the US and within the Eurozone (Spain, Ireland, Portugal and others). While housing and consumer durables prices have been falling for some time, the phenomenon of generally falling consumer prices is now official, confirmed by the 0.4% drop in the US's CPI in March. Although the UK has so far avoided deflation, largely thanks to the sharp fall in the pound, there may well be a dip later in the year.

The more the deep recession depresses economies and raises unemployment, the greater the likelihood that annual pay rises will come to a halt, exacerbating the downtrend in prices and threatening to create a worldwide competitive "race to the bottom". Although many fear that easy monetary policy could spark inflation later, and there is concern that economic recovery could also reignite the phenomenon of soaring energy and commodity prices, the more immediate problem is turning around an even more dangerous downward lurch in wages and prices. A sharp decline is dangerous because it would serve to heighten and prolong the risks posed by high levels of debt and falling asset prices.

"Rising unemployment and halting annual pay rises will exacerbate the downward trend in prices, threatening to create a worldwide 'race to the bottom'."

Illustrating how difficult it can be to exit such a situation, especially once it is embedded in wage settlements, Japan has battled for many years with persistently low or negative consumer price inflation. In spite of efforts to boost growth and restore inflation, including the central bank's "zero rate" policy and quantity easing, there has been little success in re-establishing a firm uptrend in prices, as shown by the present rapid relapse into deflation.

Towards the end of the troubled 1990s, Japan set about radically reducing debt and repairing balance sheet damage, eventually producing a modest economic recovery in 2004-2007. According to Japanese opinion, it is essential to directly address balance sheet problems in order to exit from the debt trap and recession – they found that fiscal and monetary stimulus alone did not work. However, in spite of the vaunted success in restoring a period of positive economic growth up to 2007, prices remained virtually flat (Chart 2) and only saw a temporary rise in 2008 on the back of soaring world commodity prices. Japan's inability to avoid persistent deflation undoubtedly prolonged the debt trap and hampered recovery, but it has also proved impossible to eradicate.

Insurance premiums still reflect hope of a rapid recovery?

Growth in life insurance accelerated in all advanced economies in 2008, except Continental Europe and Japan. IFSL (International Financial Services London) report that non-life insurance and life insurance premiums grew in advanced economies in 2008. But evidence from the Japanese insurance company Mitsui Sumitomo suggests that long-term economic decline can have significant negative effects on insurance premiums. For example, Japanese consumers are switching increasingly from discretionary insurance to statutory required minimums, especially for automobile insurance and fire insurances. In addition, weak demand for cars and other household products is also affecting premiums. Figures from Mitsui Sumitomo show that even compulsory insurance business is falling.

"Japanese consumers are switching increasingly from discretionary insurance to statutory required minimums..."

So far, the US and UK have not been as badly hit as Japan. For example, in the UK, home insurers reportedly succeeded in increasing premiums in 2008, despite the cost of claims dropping sharply. Buildings insurance rose by 7.5% during 2008 and by a staggering 5.3% between October 2008 and January 2009 alone, according to the UK's AA (Automobile Association). At the same time, not only house prices but also rebuilding costs are falling in the recession ridden construction sector. The Royal Institution of Charted Surveyors reports a 1.2% drop in construction costs for the UK in late 2008.

If weak home values and building costs persist and expectations of recovery fade, tough competition will mean greater cuts in premiums. The longer the recovery process, the more likely it will be that companies cave in to pressure to offer permanent premium cuts rather than temporary discounts and incentives.

"The longer the recovery, the more likely it will be that companies cave in to pressure to offer permanent cuts..."

If the global economy begins to turn around by late 2009, quickly restoring consumer price inflation, then it may be plausible to expect house prices and building costs to recover to previous peaks over the following two to three years.

However, with consumer price deflation creeping into many economies, continuing financial stress and the risk of a long drawn out recession, then it could be a decade before house prices stand a chance of regaining their recent peaks. And even this outlook would be far better than that actually seen in Japan.

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