The Housing Bubble Fact Sheet

BY DEAN BAKER

Since 1996, house prices have risen by more than 45 percent after adjusting for inflation.

Every week, approximately 140,000 U.S. families buy a house, a majority of them at bubble-inflated prices.

Center for Economic and Policy Research
1611 Connecticut Ave, NW
Suite 400
Washington, DC 20009
tel: 202 293 5380
fax: 202 588 1356
www.cepr.net

1. The unprecedented rise in house prices has dangerous implications for the economy.

The generalized bubble in housing prices is comparable to the bubble in stock prices in the late 1990s. The eventual collapse of the housing bubble will have an even larger impact than the collapse of the stock bubble, since housing wealth is far more evenly distributed than stock wealth.

2. The housing bubble has created more than $5 trillion in bubble wealth, the equivalent of $70,000 per average family of four.

Through the post-war period 1950 to 1995, house prices grew at approximately the same rate as the prices of other goods and services, like cars, gas, and healthcare. Since 1996, however, house prices have risen by more than 45 percent after adjusting for inflation. This unprecedented run-up in house prices has generated more than $5 trillion in housing bubble wealth, which is the difference between the current market value of housing and the value if house prices had followed their historic trend and kept pace with inflation.[1]

3. The increase in house prices is not being driven by fundamental factors in the housing market, such as income and population growth.

The increase in home prices cannot be explained by fundamental factors, such as rising incomes and population growth. The growth in income over this period has not been especially rapid. The rate of income growth is considerably slower than in the years from 1950 to 1973, when the rise in home prices just kept pace with the overall rate of inflation. The growth in population over this period has not been especially rapid. The most rapid growth in the number of new households actually took place in the 1970s and early 1980s, when the huge baby boom cohort was first forming their own households.

Dean Baker is co-director of the Center for Economic and Policy Research.

Most importantly, there has been no significant increase in rents, which would be expected if the run-up in house prices were explained by the fundamentals of the housing market. Rents and home sale prices have always moved closely together, since families can freely switch between renting and owning depending on the relative prices, and landlords can sell off rental property if home sale prices rise substantially relative to rents. Rents had increased somewhat more rapidly than the overall rate of inflation from 1998 to 2002, but actually have been falling behind inflation in the last two years. This indicates that the run-up in house prices is not being driven by fundamental factors in the housing market.

The economy is building over 2 million housing units annually, while the number of households is growing by about 1.4 million a year.

4. The housing bubble regions are large enough to have a major impact on the national economy.

There are many areas of the country in which house prices have not diverged far from their historic patterns, increasing only slightly more than the overall rate of inflation. However, the bubble regions -- some of which have seen home prices increase more than 60 percent after adjusting for inflation -- are large enough to have a major impact on the national economy. These regions include most of the East Coast north of and including Washington, DC, especially New England; much of the Pacific Coast region; and many pockets in between. Not all of the run-up in prices in these regions will necessarily be reversed in the downturn (there are reasons why these areas have become more attractive places to live), but most of the run-up in house prices will likely be reversed in most areas. The bubble areas are far too large to be explained merely by the fact that they have become more attractive relative to other regions.

Ratio of home equity to home value stands at near-record lows.

In assessing whether house prices in a particular area make sense, it is useful to think of higher-than-average house prices as comparable to a tax. Cities like San Francisco, Los Angeles and New York City have features that make them more desirable than other places, so people are willing to pay a premium to live there. However, there is a limit to how much people will pay. Housing costs comprise approximately 30 percent of the average family's spending. So if house prices are twice as high in bubble areas as in the rest of the country, it is equivalent to a tax of 30 percent on residents of these regions. If house prices go even higher in these areas, then the effective tax rate becomes even higher.

At some point, the economies of these bubble regions will not work -- the rest of the country and the world will pay no more for the legal services, financial services, apparel, or whatever else is produced in these areas than it will for the same items produced in Peoria, Illinois or Bangalore, India. House prices that are too disproportionate with the prices elsewhere will simply make the economies in the bubble areas uncompetitive, leading these regional economies to contract until house prices fall back to a level where these regions can again be competitive in a national and world market.

5. The collapse of the housing bubble will throw the economy into a recession, and quite likely a severe recession.

Housing construction is equal to approximately 5 percent of GDP. Construction of new homes has been going on at a near-record pace over the last few years, in response to the run-up in housing prices. Home construction could easily fall back 40 percent (this was the drop off in the 1981-82 recession), which would imply a direct loss in demand equal to 2 percentage points of GDP.

The market in mortgage-backed security currently exceeds $6 trillion.

In addition, the large wealth effect associated with the housing bubble, which has spurred a consumption boom in the last few years, will go into reverse as housing prices plummet. Research from the Federal Reserve Board shows that a dollar in additional housing wealth leads to 4 to 6 cents of annual consumption. This implies that a loss of $5 trillion in housing wealth would lead to a decline in annual consumption of between $200 billion and $300 billion. This loss in consumption is equivalent to 1.6 to 2.5 percentage points of GDP.

The housing bubble collapse could lead to a loss of 3.6 to 4.5 percentage points of GDP due to a drop in *housing construction* and reversal of the bubble's *wealth effect*.

Combining the 2 percentage point drop in demand due to a falloff in *housing construction* with the 1.6 to 2.5 percentage point drop in demand due to the reversal of the housing bubble's *wealth effect* leads to a falloff in demand of between 3.6 and 4.5 percentage points of GDP. If employment fell in the same proportion, this would imply the loss of between 5.0 million and 6.3 million jobs. Since the federal government is already running a large deficit, and the country is running a very large trade deficit, the government's ability to use fiscal and monetary policy to boost the economy out of the recession will be severely restricted.

6. The collapse of the housing bubble is likely to put major strains on the financial system and require a federal bailout of the mortgage market.

The collapse of the housing bubble is likely to lead to record levels of mortgage defaults. The ratio of home equity to home value stands at near-record lows, even though the run-up in home prices translates directly into additional equity. The reason for the low ratio of equity to value is that many homeowners have been quick to borrow against the new equity created by the housing bubble. This means that when home prices fall, many homeowners will find that their mortgages equal or exceed the value of their house, giving them a strong incentive to default on their mortgage and simply turn over their house to the mortgage holder.

Of course, if the economy is in a recession, then many homeowners will have no choice but to default on their mortgages. Rising house prices have led many homebuyers to stretch themselves as far as possible to be able to afford monthly mortgage payments. Losing a job or being forced to take a new job at lower pay will leave many recent homebuyers unable to make their payments. Similarly, if interest rates rise, as virtually all economists expect, homebuyers with adjustable rate mortgages will find themselves paying much more on their monthly mortgages. Many homeowners will be unable to make these higher payments.

If there is a large increase in the rate of mortgage defaults, then the mortgage holders will experience big losses. While many banks and financial institutions still hold large amounts of mortgage debt, most mortgages become the basis for mortgage-backed securities, a market that now exceeds $6 trillion. This market will be put in danger by a large wave of defaults following the collapse of the housing bubble. It is likely that the federal government will have to bail out the market in mortgage-backed securities to prevent a cascading series of defaults.

7. The sooner house prices drop, the less economic damage there will be.

Given how far out of line house prices have grown from fundamentals, there is no way to avoid enormous economic damage when the bubble collapses. However, the quicker house prices revert to more normal levels, the less damage there will be.

As long as prices remain high, more people will buy into homes at bubble-inflated prices. Every week, approximately 140,000 families across the country buy a house. Most of these home purchases occur in the bubble regions. Homeowners who see the price of their home soar in the bubble and then fall back in the crash are not harmed (although they may be unhappy that they didn't sell at the peak). On the other hand, people who buy a home at a bubble-inflated price - and then see the price plummet in the crash - may lose much or all of their savings. The sooner the bubble bursts, the fewer the number of people who will be in this situation.

In addition, if people are borrowing against the bubble-inflated value of their homes, they may come to regret the level of debt they have acquired once they realize that the equity in their home is less than they thought. The baby boom cohort, currently ages 41 to 59, is nearing retirement. Many baby boomers have done very little saving because they believe that they have a large amount of equity in their home. The sooner the bubble bursts, the less borrowing will occur, leaving people better prepared to pay for their retirements.

Rents increased slightly faster than the overall rate of inflation from 1998 to 2002, but have been falling behind inflation in the last two years.

Nationwide vacancy rental rate is at all-time high.

Also, the longer the bubble persists the greater the number of questionable mortgage loans. The future rate of mortgage defaults will be higher the longer it takes to burst the bubble. For these reasons, and others, it would be better for the economy if house prices adjusted quickly to more normal levels.

8. The housing bubble could pop from higher interest rates, but it could also deflate even if interest rates stay low.

Some regions of the U.S. have experienced a 60 percent increase in real home prices.

The fact that mortgage rates fell to a fifty-year low, and have stayed low, has been an important factor in propelling the bubble. The low mortgage interest rates of 2003 were largely the result of deliberate action by the Federal Reserve Board to prop up the economy in the wake of the stock market crash. However, mortgage rates have remained low, even as Alan Greenspan has raised interest rates, primarily because the Japanese and Chinese central banks have intervened in the U.S. treasury market to offset the Fed's actions. By purchasing hundreds of billions of dollars worth of long-term bonds, these central banks have completely offset the Fed's efforts to affect the mortgage market. If the Japanese and Chinese central banks reduce their intervention, or other factors put substantial upward pressure on long-term interest rates, then the housing bubble is likely to unwind.

However, the bubble could begin to deflate even if interest rates do not rise appreciably. The economy is building over 2 million new housing units annually. The demand for housing from new households or second home purchases is probably in the neighborhood of 1.5 million a year. As long as house prices remain at their bubble-inflated levels, construction will stay at its current level or possibly even increase. At the moment, the excess supply of housing is being absorbed by speculators who are convinced that the prices will rise in the future and also by a record nationwide rental vacancy rate. Both sources of demand are limited. There is a limit to the number of people who are willing to speculate in real estate. Also, as excess rental capacity develops, it will put more downward pressure on rental prices, leading more potential homebuyers to rent and causing many landlords to sell off rental units.

It is impossible to say what set of events will cause housing prices to turn (in the absence of a rise in mortgage interest rates), just as it was impossible to determine the set of events that finally led to the bursting of the stock bubble in 2000. However, with supply persistently outstripping demand, it is only a matter of time before house prices eventually adjust.

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[1] The value of residential housing is taken from the Federal Reserve Board's Flow of Funds, Table B102, line 4. The increase in house prices is taken from the Office of Federal Housing Price Oversight's House Price Index, with the CPI-URS being the measure for overall rate of inflation. (June 2004)