Economic Environment

Housing Bubbles: No National Bubble, Some Regions Vulnerable

by Al Schuler

Everyone is talking about the threat of a "housing bubble," but does anyone really know what that really means?

Since 2001, a combination of low mortgage rates and "boring" equity markets have helped to fuel record-setting home sales, contributing to substantial price increases in the U.S. and many other parts of the world (see Table 1). Economists are concerned about riskier mortgage financing and the increasing incidence of speculative demand in some regions. According to the National Association of Realtors (NAR), 23 percent of all home sales in 2004 were for investments (not owner occupied), and another 13 percent were bought as second homes. In this article, we will analyze housing bubbles—how they are defined, why they happen, how they usually end, and their implications for the economy. No one knows for sure if we are currently in the midst of a housing bubble (or boom), but we will provide you with some tools to analyze the situation.

	1st Qtr 2004 - 1st Qtr 2005	1st Qtr 2003 - 1st Qtr 2004	1997- 2005
South Africa	23.6	28.1	244
Hong Kong	19	17.4	(43)
Spain	15.5	17.2	145
France	15	14.7	87
New Zealand	12.5	23.3	66
USA	12.5	8.4	73
China	9.8	7.7	Na
Britain	5.5	16.9	154
Canada	5.2	5.7	47
Australia	0.4	17.9	114
Germany	(1.3)	(0.8)	(0.2)
Japan	(5.4)	(6.4)	(28)

Table 1. Percentage change of house prices. (*The Economist,* 2005)

What is a Housing Bubble?

A recent Federal Deposit Insurance Corporation study (FDIC 2005) defined a housing bubble as any region where inflation-adjusted home prices increased at least 30 percent over three years or less. While other definitions may exist, much of California and New England fit the FDIC's description during 2000-2003, as well as metro areas like Washington, DC; Philadelphia; New York City; and southern Florida from 2002 to 2003. Most of these regions also have inelastic supply due to developable land shortages. The same study defined busts to be a 15 percent decline in nominal prices over five years or less. The study found that booms typically end in stagnation, not busts in home prices and are caused by economic downturns. If the economic downturn is severe enough, a bust in home prices can occur.

In the past two decades, there have been only two regional busts in the United States: the Oil Patch in the 1980s and the 1990s bicoastal (California and New England). In each case, the drop in home prices were caused by severe economic shocks affecting major employers in their region (Oil Patch—severe downturn in oil

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at a glance

- Twenty-three percent of all home sales in 2004 were for investments (not owner occupied).
- Today, U.S. interest rates depend as much on the global economy as national conditions.
- If interest rates remain low, house prices will continue to appreciate until they surpass "ability to pay" by prospective buyers.

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prices in mid-80s; Bicoastal—1990s recession and the end of the Cold War leading to massive defense downsizing, and downturn in population growth). In other words, regional busts don't necessarily follow booms; there are mitigating factors involved.

Causes of Today's House Price Inflation

Many analysts believe the current housing boom is caused by a worldwide savings glut—the result of low business investment, recycling petro dollars, loose monetary policy, low interest rates, demographics and sluggish stock markets resulting in excess savings throughout the world (*Business Week,* 2005). This money has to go somewhere, so real estate has become the most attractive option for many investors. Much of the excess money is flowing into real estate located in "borrowing countries" such as the U.S., Britain, Spain and Australia from "big savers" like Japan, Germany, Saudi Arabia and Switzerland. Excess liquidity is pushing house prices up too fast in the "borrowing" parts of the world (see Table 1). It's not happening in the saving part of the world. The world's two largest savers, Japan and Germany, have seen house prices actually fall during the past two years.

Today, U.S. interest rates depend as much on the global economy as national conditions. For example, we have a large budget deficit and huge trade deficit that are usually inflationary and normally lead to higher interest rates. The Federal Reserve has raised short-term rates 275 basis points (from 1 to 3.75 percent) in the past 18 months to stave off potential inflation as the U.S. economy strengthens. Normally, we would expect long-term rates to follow, but they haven't. Long-term rates have remained low, either because long-term inflation expectations are low or as a consequence of foreign purchases of U.S. securities, fueled by our trade deficit. In addition, cheaper goods from China and other low wage countries have made it easier for the FED to achieve their inflation goals without needing to push up interest rates up (*The Economist,* 7/28).

What might change the status quo? A dollar crisis caused by cessation of recycling excess dollars into U.S. securities, political turmoil (terrorism and trade protectionism), or a return of general inflation. The current energy crisis is a case in point.

Inflation in U.S. House Prices: Where Are We Headed?

The Office of Federal Housing Enterprise Oversight (OFHEO) tracks average house price changes in repeat sales or refinancing of same single family residences. According to OFHEO (2005), national average nominal home prices increased 12.5 percent between the first quarters of 2004 and 2005, surpassing any four-quarter increase in the past 25 years. Furthermore, prices have increased a total of 50 percent in the past five years. Although this seems high, it is skewed by housing activity in regions with great price appreciation. If interest rates remain low, house prices will continue to appreciate until they surpass "ability to pay" by prospective buyers. Ability to carry a mortgage depends primarily on the relationship between income growth and mortgage rates. This means that prices could continue to increase until the mortgage cost affects the ability to pay for many potential buyers. Lower or stagnant demand would force builders to eventually curtail production. Not rocket science, but plain old demand and supply adjustments are the way most price inflation deflates.

Indicators to Watch

Some good measurements of price appreciation are: home price to income ratio (see Figure 1); home price to rent ratio (see Figure 2); evidence of burdensome mortgage debt (mortgage debt to income ratio); NAHB's housing affordability index (HOI), and the inventory of homes for sale. (See **Support Docs** at www.sbcmag.info for more information on **Indicators to Watch**.)

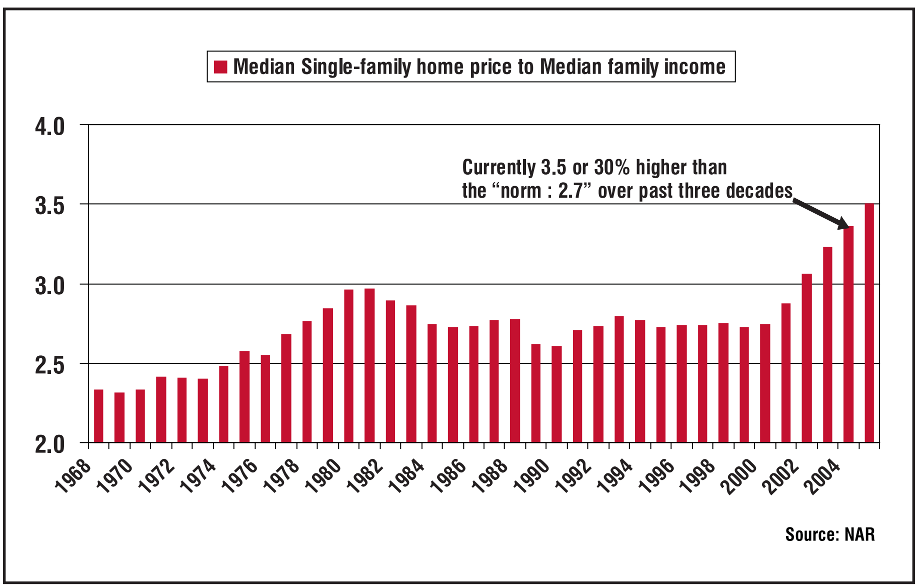

Figure 1. Ratio of home prices to income. (Source: NAR and U.S. Census)

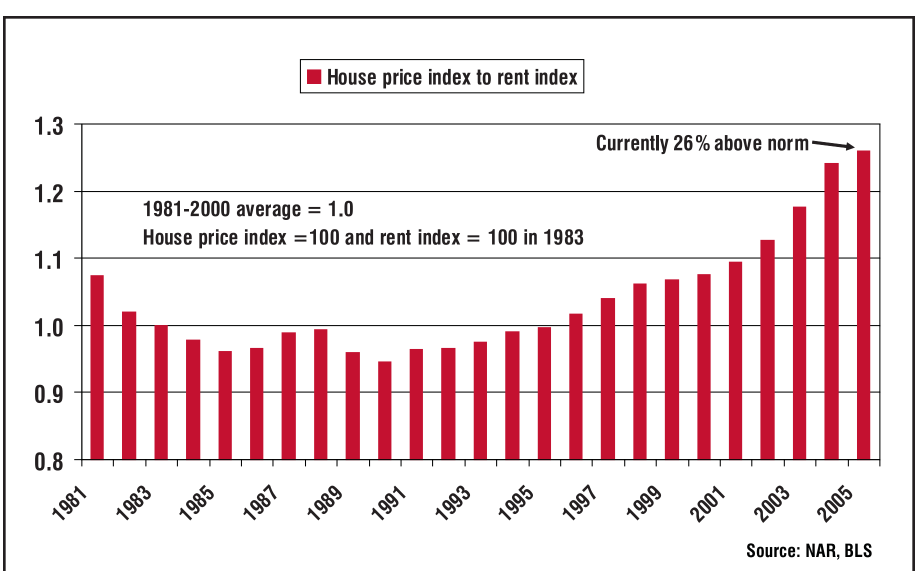

Figure 2. Ratio of Home Prices to Rents (Sources: NAR and Bureau of Labor Statistics)

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Comparison with 2000 Technology Bubble Collapse

There has been some discussion comparing the recent run-up in house prices with the late-1990s rise and subsequent collapse in technology stock prices. During the tech bubble collapse, investors saw a 75 percent drop in average technology stock price, from the 2000 peak to the low point in 2002. David Lereah, chief economist for NAR, said this wouldn't happen in housing for several reasons. First, it takes more time and money to sell and buy real estate. Second, most of us live in our home so there are additional values involved. Third, there are tighter lending standards for real estate. And finally, there hasn't been a national decline in house prices since the Great Depression in the 1930s (see Table 2).

Feature	Stocks	Homes
Buy & Sell	Easy, quick	Time-consuming
Transaction cost	$7 to $200	$ thousands
Benefits	Purely financial	Financial and intangibles (a place for life experiences)
Investment funds from where?	No questions asked	Mortgage lender scrutiny
Price Declines	Some years, months, days, hours, seconds	No national price decline since the 1930s

Table 2. Comparing "apples and oranges"—stocks and homes (Source: NAR)

My Conclusions

I offer four conclusions: regional housing bubbles are possible; with the exception of the Great Depression, there has never been a national housing price collapse; housing bubbles are less likely than equity bubbles; and there are usually mitigating circumstances. That's why we can have low national mortgage rates causing booms in some regions, but no boom in slower growth regions. The "localized nature" of real estate is the main reason arguing against a national real estate bubble (*Kiplinger's,* 2005). Component manufacturers should monitor economic trends for any signs indicating a shift in their local economies (see August **Support Docs** at www.sbcmag.info for list of useful web sites).

Some economists, including me, believe even with no bubble, housing and the nation's economy could be in for an adjustment. Just a flattening of housing prices could trim U.S. economic growth by as much as one percent. For example, housing is said to be generating about a full percentage point of stimulus to the economy by reinforcing a construction boom and strong consumption (Wolk 2005). Although residential construction makes up about five percent of the GDP, it accounted for over 12 percent of average yearly growth since 2002. Construction jobs tally five percent of all payrolls, but accounted for 16 percent of all new jobs in past two years (*Business Week,* 4/11/05). Both the economy and housing are expected to pull back in 2006 in response to rising interest rates. This will slow the rate of house price appreciation and consumer spending growth will be impacted via reduced mortgage refinancing activity. Homeowners cashed out equity worth one percent of GDP in 2002 and 1.3 percent in 2003, but that is expected to pull back in 2005-2006 (see Figure 3). Some of these funds were used to pay down debt, but 25 percent went to discretionary spending and 40 percent to home renovations. Thus, any slowdown in housing could affect the economy more than in the past due to the impact on overall consumer spending. More likely than not, this slowdown will probably be accentuated in those regions where house prices have inflated the most. SBC

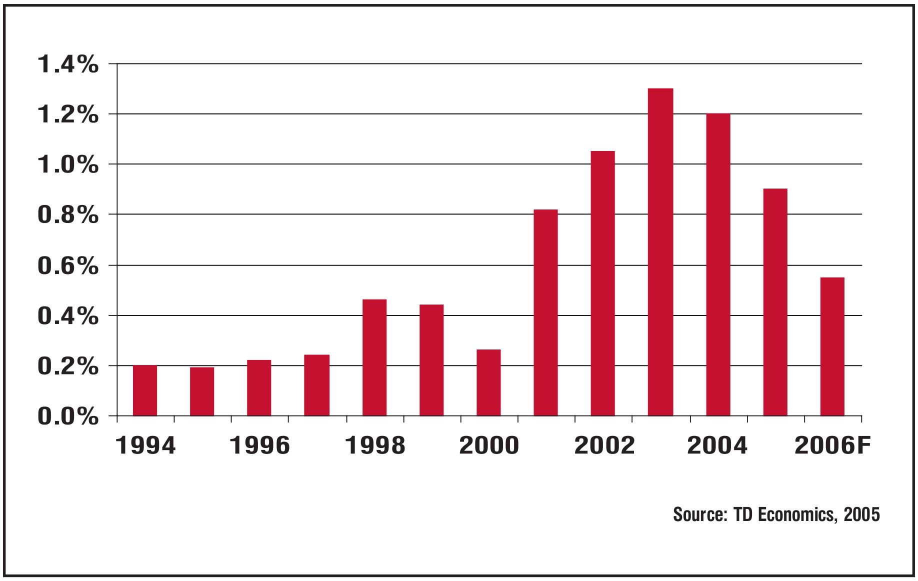

Figure 3. Home equity cashed out as a share of U.S. GDP (Source: TD Bank, 2005)

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