Opinion

Bubble Talk

By Raymond E. Owens

It’s easy to understand the widespread attention to the nation’s sharp run-up in housing prices. If indeed we’re witnessing a “housing bubble” — and higher prices aren’t supported by economic fundamentals — then a collapse would seem both inevitable and detrimental. A drop in prices could result in extensive economic fallout if increasingly leveraged consumers don’t expect the decline and fail to make adjustments ahead of time. In this worst-case scenario, household wealth would take a big hit and consumption would be reduced, thus producing a relatively strong, negative macroeconomic impact. Nobody wants that.

But I think some of this concern may be overblown. To be sure, housing prices in many parts of the nation and Fifth District have risen rapidly over the last few years. Homes in Washington, D.C., fetch nearly double what they did five years ago, and Baltimore prices aren’t far behind. Those areas are not necessarily experiencing a bubble, however.

In many places, economic fundamentals — supply and demand conditions — tend to explain at least part of the rise in housing prices. Even though the supply of houses has increased markedly in recent years, builders and developers in the hottest markets say that limited availability of lots has kept housing production short of demand. Against this, a variety of factors has boosted demand. Population growth in Washington has been rapid, for example, helping to drive up housing prices. And mortgage rates have dropped to historically low levels. In addition, we have seen improvements in personal income growth and a much more solid job picture since the country emerged from recession in 2001. Tax treatments also continue to be favorable to home buyers, with married couples able to make as much as $500,000 in gains on their house sales with no accompanying tax liability.

There has been some worry that new forms of financing are pushing up housing prices to unsupportable levels. Interest-only and negative amortization loans, plus the increased use of adjustable-rate mortgages, have widened the pool of potential home buyers. What if consumers don’t really know how to use these vehicles and aren’t aware of the risks? That’s a question to consider, but also remember that financial market innovations usually yield real benefits. A big shock to the economy might indeed catch users of interest-only loans unprepared, but at the same time there are likely significant benefits that such loans have provided in the short-term. I think it’s still up for debate whether these products provide benefits to consumers which offset new risks.

The price-to-rent ratio is an oft-cited statistic by analysts who believe we’re in a housing bubble. It has spiked by 30 percent in the last five years. But before jumping to conclusions about what that means, consider that the demand for house ownership has increased and with it a big group of people has left the rental ranks. That means rental demand has diminished, so it’s not surprising that rental prices haven’t kept up with sale prices in the short run.

Finally, the national housing market actually flattened somewhat during the 1990s. Some of the recent price gains, then, might be viewed as making up for previous stagnation.

Which brings me to the question that everyone seems to be asking: Are we in a housing bubble? The answer is: I don’t know. Even in hindsight, it can be difficult to identify a true bubble. Just because prices in a sector rise rapidly and then fall does not necessarily mean that a bubble has existed and popped.

When weighing the likelihood of a bubble, though, it’s important to keep in mind that in today’s housing price appreciation we see some accompanying improvement in the economic fundamentals underlying housing prices. To assume that the current level of housing prices must be a bubble is somewhat dicey, given the mixed evidence.

The same couldn’t have been said, by the way, about the run-up of stock prices in the late 1990s. In that episode, we saw companies spring up virtually overnight with no earnings and no viable products but enormous market capitalizations. My view of the 2005 housing market is that it is not strictly analogous to the stock market of the late 1990s. This is not to say that the housing market is without risk, but it appears to be less risky than the late 1990s stock market.

Does this mean that housing prices will remain at their current levels? All bets are off on that question because it depends on how future events unfold. One thing we know about the future is that we know we don’t know much about it. But I think it’s fair to say that there are many sound reasons why housing prices have risen — and that recent increases do not appear to be the result of rampant speculation alone.