Views on Whether There Is a Housing Bubble

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According to conventional wisdom, a home is not just a place to live, but also a good investment. Currently, however, high home prices make it difficult to commit to home ownership. The high prices also raise fears of a housing bubble. If there is one and it pops, many new homeowners would be left with a home having significantly less value than when purchased, in other words, a bad investment. So the decision on whether to buy a home now might depend upon whether there is, in fact, a bubble in the housing market. Opinions differ among economics writers. An analysis of the opposing points of view reveals that the differing assessments are based on differing assumptions about which economic data offers the best evidence for determining whether or not home prices are overinflated.

Which Evidence Matters?

Among popular economics experts, housing bubbles have been closely tied to the overall health of the economy as indicated by statistics measuring national economic activity. For instance, Kudlow (2006) disputed projections some economists made of a "housing-price crash" as part of his argument against the "grim picture [portrayed by] mainstream media" of the nation's economy. He based his optimism on positive numbers for employment and stock investments. Krugman (2006), writing for *The New York Times*, also linked the state of housing to the bigger economic picture, although he agreed with the "pessimists" forecasting a housing crash, citing a recent drop in the Gross Domestic Product (GDP) and expected rises in unemployment. Also holding a pessimistic outlook, Schilling (2005) cited a variety of potential economic factors that could "burst the housing bubble" and send the economy downward much more quickly, factors ranging from higher interest rates to greater unemployment. While these writers do not all agree about whether the housing market is inflated or not, they seem to agree that the bigger economic picture is tightly linked to the housing industry, which contributes quite substantially to overall economic activity as a source of employment and as a way to invest money.

Aside from those authors writing for mainstream news outlets, writers in academic journals have also sounded off in the debate. Those analyzed here focused less on national economic factors and more on local ones. Smith and Smith (2006), for instance, introduced their extensive research by acknowledging and then discounting less thorough assessments of the housing market: “Evidence of a housing bubble has been suggestive but indirect, in that it does not address the key question of whether housing prices are justified by the value of the services provided by a home” (p. 1). Their study’s findings are based on local value measurements, rather than national economic data. In an article in the journal *Regulation*, Stewart and Brannon (2006) likewise examined local markets, albeit in a more limited manner. Interestingly, both sets of academic authors noted a possibility that housing prices might be inflated in a few local markets, but both also asserted that there should be no general concern of a broad housing market crash (Smith & Smith, 2006, pp. 47-48; Stewart & Brannon, 2006, p. 15). The discrepancy between these more academic studies and some of those published by popular columnists raises an important question: How are financial bubbles defined?

Assumptions About What Defines a Bubble

For those writing for popular news publications, the assessment that there is a housing bubble appears to be based primarily on comparisons between economic trends. As noted above, these writers referenced ups and downs in GDP, stock investments, and employment rates. These macroeconomic measurements were then reconciled with industry trends in housing, in particular, home prices, lending, and investments in home building. Krugman (2006), for example, remarked that home building investment was “abnormally high as a percentage of GDP,” in spite of the fact that more home owners were going into foreclosure. Schilling (2006) also emphasized the disconnection between foreclosures and new home building. For these authors, the apparent expectations of continued profits, which now fuels new investments, ignores the growth of failed mortgage investments (foreclosures). Consequently, they seem to believe a bubble exists when key market players—government regulators (Krugman’s focus) or speculative investors (Schilling’s focus), for instance—dismiss generally discouraging economic trends in order to profit in the short term (politically or financially) from rising home prices.

But the popular economic writers did not all focus on the same broad economic numbers, nor did they interpret them all in the same way. Kudlow (2006), for instance, pointed to other trends that support a more confident view of both housing and the economy as a whole: low tax rates, low unemployment, wage growth, and low inflation. For Kudlow, the current economic measures not only justify optimism, but they are also the key causes of the current economic boom: in other words, there is no bubble because a majority of economic factors reflect a “healthy” economy, even if there are moderate fluctuations in different areas of the economy. Although Kudlow and Krugman (2006) and Schilling (2006) differ in their interpretations of various economic trends, they do appear to agree that bubbles are defined primarily by the likelihood of avoiding *substantial and sharp drops* in future economic activity, in particular, spending and investment. Unfortunately, for those who want a clear answer about housing, the data that Krugman highlighted as likely to worsen Kudlow highlighted as signs of prosperity.

Among the writers contributing to academic journals, the financial rationale of home buying itself has the most important role in assessing the existence of a housing bubble. Smith and Smith (2006) provided an especially complex set of details related to local housing markets, considering the influences of local population and income changes (p. 14), various house features, such as bedrooms and bathrooms (pp. 15-17), and mortgage rates (pp. 30-32), among other factors generally considered when deciding whether to rent or buy and determining what to buy. Holding a similar, but much less thorough, approach, Stewart and Brannon (2006) compared what renters and owners paid per month to what they received in terms of living conditions (p. 16)—in other words, the same kind of data used by Smith and Smith. These authors all used home-buying logic as their bases for dismissing the existence of a bubble. Their underlying assumption about housing bubbles could be restated this way: if purchasing a home remains a sound purchase for informed home buyers, then the current prices must not be inflated.

Conclusion

As the analysis above shows, economics writers have different assumptions about what defines a financial bubble, and so their different views on the current state of housing can better be understood. The optimists focus on the value of what a buyer purchases. When it comes to housing costs, home buying is directly compared with renting. There is no bubble as long as most potential buyers cannot acquire a substantially better home by renting. The pessimists, on the other hand, focus on broad economic factors that determine whether average home buyers even have a choice to buy and, more importantly, an *ability to keep* their home. For the pessimists, a bubble exists when the current ability to buy overshoots the ability to keep a home in the near future, due, for example, to the loss of a job or a rise in interest rates. If many homeowners need to unload their properties in a short period of time, then the supply will overwhelm demand, causing prices to fall—and the bubble to pop. The missing piece of data, then, seems to be an assessment of whether the many buyers contributing to the ongoing housing boom have made sound, rational purchasing decisions. Until we know how many buyers purchased over their means, we cannot assess with certainty whether or not there is a bubble in the housing market.

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