

**BRIEF ANALYSIS**

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## The Bicoastal Housing Bubble

by **Bruce Bartlett**

Speculative “bubbles” can appear in various sectors of the economy when the Federal Reserve eases monetary policy by lowering interest rates. Generally speaking, when the Federal Reserve tightens monetary policy, the sectors of the economy that went up the most during the easing phase will fall the hardest as the bubble bursts. For instance, stocks went up the most from 1995 to 1998, when the Federal Reserve eased the money supply; stocks fell the most after the Federal Reserve tightened the money supply in 1999 and 2000.

The principal impact of the last easing phase, which began in January 2001, was on housing. When the Federal Reserve began tightening monetary policy in June 2004, the Federal Funds rate, charged to member banks to borrow funds overnight, stood at just 1.0 percent. But after a series of increases, this key interest rate stood at 3.5 percent by the end of August 2005.

**Today’s Housing Market.** Over the last five years, housing prices nationwide rose by an average of just over 50 percent. [See the figure.] But in some areas, prices have risen much more.

- In 13 states and the District of Columbia, home prices have climbed more than 60 percent. All of these states, except Nevada, border either the Atlantic or Pacific oceans.
- Home prices in California and the District of Columbia are up more than 100 percent.

A new study by National City Bank found 53 cities in which home prices were in real estate bubble territory

— defined as prices 30 percent above where they should be based on local income growth, population density and other factors. Santa Barbara, Calif., ranks as the city with the most overpriced real estate — home sales prices are 69 percent above fundamental value.

However, housing prices have not increased significantly in the rest of the country — in 32 states they have risen less than the national average. In Utah, prices have gone up just 17.5 percent in the last five years — little

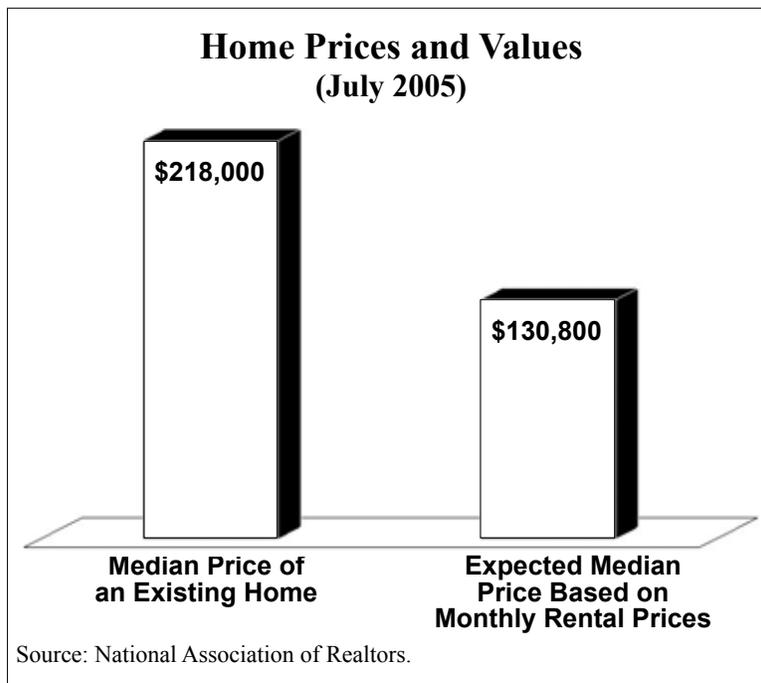
more than the 12.8 percent increase in the Consumer Price Index. Other laggards include Indiana (19.8 percent), Mississippi and Nebraska (both 21.8 percent). Almost all of the below-average states are in the nation’s heartland.

Based on the ratio of monthly rent to home sales prices, purchase prices nationally are now almost 40 percent above where they should be. This abnormal price-to-rent ratio is driven partially by falling rents, not just rising home prices. Rents are falling because investors

are purchasing many properties in hopes of rapid appreciation, increasing the supply of rental housing. And since much of this real estate has been purchased with interest-only or negative-amortization loans, investors don’t need much rent to cover their payments.

Last year, according to the National Association of Realtors, 23 percent of homes were sold as investments and another 13 percent were vacation homes. A prime motive for both types of purchases is rapid appreciation; thus, any falloff in housing prices could cause many of these properties to be dumped on the market quickly, potentially turning a housing downturn into a crash.

**Risky Homeowner Practices.** Today, many of the economists who correctly predicted the stock market



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bubble would burst are saying that the housing market is in a bubble. If it collapses as the stock market did, the impact could be even more painful. That is because homeowners are much more leveraged than they used to be:

- According to the Federal Reserve, home equity — the portion of a home's value not covered by a mortgage or equity loan — has fallen from 75 percent of home values a generation ago to 56.3 percent today.
- In the first half of 2005, two-thirds of homebuyers financed more than 80 percent of their purchase, and 38.1 percent borrowed more than 95 percent, according to SMR Research. Historically, loans with less than 20 percent equity have been considered risky.
- According to the Federal Home Loan Mortgage Corporation (“Freddie Mac”), in the last four years homeowners have taken \$559 billion in equity out of their homes by refinancing.

Additionally, many homebuyers are making larger mortgage payments than their incomes will support, according to financial experts:

- According to the Federal National Mortgage Association (“Fannie Mae”), 28 percent is the most one ought to pay.
- Almost 40 percent of California homeowners — compared to 29 percent nationally — pay at least 30 percent of their income for housing, according to the Public Policy Institute of California.
- In California, 15.4 percent of homeowners pay as much as 50 percent of their income for housing, including mortgage, taxes, insurance and utilities; this includes 20 percent of recent homebuyers — nearly twice the proportion of homebuyers nationally (10.6 percent).

Furthermore, homeowners are increasingly buying and refinancing with unconventional loans, such as adjustable rate, negative amortization and interest-only mortgages, rather than traditional fixed mortgages. Such loans have lower initial payments, but rise automatically with interest rates. The Federal Reserve says that 47 percent of all residential mortgages by dollar volume are now nontraditional.

Negative-amortization loans are especially dangerous, both for borrowers and those making such loans. This type of loan is a bit like a credit card, where the full amount need not be paid every month. As long as a small minimum payment is made, the balance can be rolled over. In this case, the unpaid balance is added to the outstanding mortgage.

This reduces the buyer's cash flow expense, but also reduces the profit when the property is sold. Unless prices rise fairly rapidly, investors can easily end up with a mortgage that is greater than they can clear at closing. Consequently, even if prices simply level off, a lot of investors may find themselves with mortgages they cannot pay back after a sale.

**Conclusion.** Owning one's own home is still the best investment that anyone can make. And if you plan to stay put for a few years, you shouldn't worry about a bust in the housing market. But those buying investment properties on either coast should be very, very careful. It may take a lot longer than they think to make money and they should be sufficiently well capitalized to ride out a market dip.

Thus far, there is little evidence that the Federal Reserve's interest rate increases have had any effect either on financial markets or the real economy. Market interest rates, especially for mortgages, remain low while economic growth continues at a steady, if unspectacular, pace. However, it takes time for the Federal Reserve's policy changes to have their full impact and these lags vary.

Furthermore, just because the Federal Reserve is raising rates gradually doesn't mean that the impact will be gradual. It could come quite abruptly. Think of a balloon. Whether you blow it up slowly or fast, at some point it is still going to burst. The same thing oftentimes occurs with monetary policy. It may appear that nothing is going on for a long time and then, suddenly, something dramatic happens.

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