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Briefing Paper

The Housing Bubble in New England

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The Housing Bubble in New England

In the last eight and a half years, the country has experienced an unprecedented run-up in home prices. Over this time, the rise in home sale prices has been more than 40 percentage points higher than the overall rate of inflation. Typically home prices have risen approximately in step with the overall rate of inflation. Neither the great boom of the sixties, nor the demographic surge created by the baby boomers forming their own households in the seventies and eighties, led to any substantial increase in home prices, adjusting for overall inflation.

The New England region has been at the center of this run-up in home prices, experiencing an increase in home sale prices that exceeded the overall rate of inflation by more than 70 percentage points over this period. The run-up in home prices in New England over this period was more rapid than in any other region of the nation. The table below shows the increase in home prices (adjusted for the overall rate of inflation) in the United States as a whole, the New England region, the Pacific Coast region (which had the second largest run-up in prices), and each of the six New England States.

Table 1
Inflation Adjusted Increase in Home Prices 1995-2003

United States	34.7%
New England	59.6%
Pacific States	49.4%
Connecticut	36.4%
Maine	44.9%
Massachusetts	73.5%
New Hampshire	67.8%
Rhode Island	53.3%
Vermont	26.1%

Source: Office of Federal Housing Enterprise Oversight and Bureau of Labor Statistics.[2]

While the most obvious explanation for this increase in home prices is that it is due to a real estate bubble that paralleled the stock bubble – as happened in Japan -- some analysts have attributed this run-up in home prices to fundamental factors affecting the supply and demand for housing. This list of factors includes:

1) an increasing population due to immigration,
2) limited supplies of urban land,
3) environmental restrictions on building,

[2] This table uses the OFHEO House Price Index (HPI) data for home prices for the regions and states listed over the period from the first quarter of 1995 to third quarter of 2003. The data is deflated by the non-shelter index from consumer price index. These numbers almost certainly understate the actual increase in home prices, because the HPI only included homes with mortgages of less than $320,000. This would exclude the upper segment of this market, which probably experienced the most rapid run-up in home prices.

4) growing incomes of homebuyers.

The problem with these explanations is that none of them are new to this period – if these factors explain the current run-up in home prices, then they should have also led to rising real home prices in prior decades, when many of the factors (e.g. rising incomes) would have played a larger role in pushing up home prices.

At a more basic level, if these fundamentals were to explain a run-up in home prices, then they should also be driving up rental prices. If higher home prices are due to an insufficient supply of housing, then the effects in the sale and rental market should be comparable. While rents did originally outpace overall inflation in the period from 1995-2002, they did not rise anywhere near as much as home prices, increasing approximately 10 percentage points more than the overall rate of inflation. More recently, rental inflation has slowed. In the last year and a half rents nationwide have risen slightly less than the overall rate of inflation. In some bubble markets, such as San Francisco and Seattle, rents are actually falling. This pattern is completely inconsistent with a run-up in home prices that is driven by fundamental factors, rather than by a speculative bubble.

If the run-up in home prices in New England and elsewhere is attributable to a speculative bubble, then it will inevitably burst. Like the stock market crash, a collapse of the housing bubble is likely to be a serious blow to the economy. It will virtually ensure a second dip to the recession. It is also likely to be devastating to the personal finances of millions of families, whose home is their largest financial asset.

Unfortunately, few families realize that much of the wealth in their homes could disappear in a collapse of the housing bubble. As was the case with the stock bubble, the vast majority of economic analysts have failed to recognize the housing bubble. Families have been encouraged to treat housing as a secure investment that can only appreciate in value. This view from experts has led homeowners to borrow in record amounts – the ratio of equity to value is at a post-war low among homeowners, in spite of the record appreciation in home prices.[3]

If home prices move back toward their pre-bubble levels, many families will find that their mortgages equal or exceed the market value of their home, leaving them with no equity. For aging baby boomers who are nearing retirement, many of whom have recently lost much of their savings in the stock market crash, such a blow may destroy any hopes of a financially secure retirement.

While some of the increase in home prices is likely to be real – just as some "new economy" stocks have survived the crash, it is likely that the regions experiencing the largest run-up in home prices will see the largest fall during the crash. For this reason the New England region is especially vulnerable to a downturn in the housing market.

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[3] At the end of the second quarter, the ratio of equity to value stood at just 54.3 percent (Federal Reserve Board, Flow of Funds Accounts, table B.100, line 52). This compares to an average of close to 70 percent in the sixties, seventies, and eighties.

Table 2 shows the real increase in home sale prices over the last five years in the major metropolitan areas in the New England region. The last row shows the real increase in rent in the Boston metropolitan area, the only metropolitan area in the region for which the Bureau of Labor Statistics publishes a rent index. As can be seen, the real increase in home prices vastly exceeds the increase in rents in Boston in every city on the list. As is the case nationally, the rate of increase in rental prices has slowed dramatically in the Boston area. Over the last year, rent in the Boston area has increased by 3.6 percent, compared to increases of more than 7 percent in the prior two years. This pattern of slowing rental inflation is consistent with the run-up in home prices being explained by a speculative bubble instead of underlying factors in the regional housing market.

Table 2
Inflation Adjusted Increase in Home Prices 1998-2003

Barnstable-Yarmouth, MA	79.2%
Boston, MA-NH	55.0%
Bridgeport, CT	40.9%
Brockton, MA	63.3%
Burlington, VT	26.3%
Danbury	34.3%
Fitchburg-Leominster, MA	55.3%
Hartford, CT	25.1%
Lawrence, MA-NH	53.4%
Lowell, MA-NH	54.2%
Manchester, NH	54.9%
Nashua, NH	61.8%
New Haven-Meriden, CT	33.3%
New London-Norwich, CT-RI	36.4%
Portland, ME	41.1%
Portsmouth-Rochester, NH-ME	50.2%
Providence-Fall River Warwick, RI-MA	52.0%
Stamford-Norwalk	42.8%
Waterbury, CT	24.5%
Worcester, MA-CT	51.1%
Boston – Rent Index	12.0%

Source: Office of Federal Housing Enterprise Oversight and Bureau of Labor Statistics.[4]

The public should be calling on presidential candidates to address the issue of the housing bubble. The failure to recognize the stock market bubble was the major cause of the current recession and the resulting job losses. While it may be too late to prevent a sharp decline in house prices, the next president should be prepared to offer a program of economic stimulus to counter-act the recessionary effects of the bursting of the housing bubble.

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[4] This table uses the OFHEO House Price Index (HPI) data for home prices for the regions and states listed over the period from the third quarter of 1998 to the third quarter of 2003. The data is deflated by the non-shelter index from consumer price index.