No Bubble Trouble?

By PAUL KRUGMAN (NYT) 847 words
Published: January 2, 2006

In spite of record home prices, housing in most of America remains surprisingly affordable, thanks to low interest rates. That fact may seem to say that there's no housing bubble. But it doesn't. To see why, we need to brush up on our economic geography and economic history.

Let's start with the good news. A report in last week's Times summarized the results of a study by Moody's Economy.com, a research company, comparing the cost of home ownership with family incomes.

The study found that for the nation as a whole, the cost of owning the median home is still only 23.7 percent of median family income, which is higher than a few years ago but well below the peak of more than 30 percent reached in the early 1980's.

Now for the economic geography. Last summer I suggested that when discussing housing, we should think of America as two countries, Flatland and the Zoned Zone.

In Flatland, there's plenty of room to build houses, so house prices mainly reflect the cost of construction. As a result, Flatland is pretty much immune to housing bubbles. And in Flatland, houses have, if anything, become easier to afford since 2000 because of falling interest rates.

In the Zoned Zone, by contrast, buildable lots are scarce, and house prices mainly reflect the price of these lots rather than the cost of construction. As a result, house prices in the Zoned Zone are much less tied down by economic fundamentals than prices in Flatland.

By my rough estimate, slightly under 30 percent of Americans live in the Zoned Zone, which comprises most of the Northeast Corridor, coastal Florida, much of the West Coast and a few other locations. So Economy.com's results on affordability aren't surprising: most families live in Flatland, and haven't seen a big rise in the cost of home ownership.

But because Zoned Zone homes are much more expensive than Flatland homes, the Zone looms much larger in the housing story than its share of the population might suggest. By my estimate, more than half of the total market value of homes in the United States lies in the Zoned Zone.

And because home prices have risen much more rapidly in the Zone than in the rest of the country, the Zoned Zone accounts for the great bulk of the surge in housing market value over the last five years.

So if we want to ask whether housing values make sense, data on the median house nationwide are irrelevant. We need to focus on houses in the Zoned Zone. And there the numbers are anything but reassuring.
In the Zoned Zone, the story that rising home prices have been offset by falling interest rates is all wrong: prices have risen so much that housing has become much less affordable. According to Economy.com, the cost of owning a home in the New York metropolitan area went from 25 percent of median income in 2000 to 38 percent today. In Miami, the numbers were 21 percent and 42 percent, respectively; in Los Angeles, 31 percent and 55 percent.

Even so, the current cost of owning a home in the Zoned Zone isn't entirely unprecedented. Roughly similar percentages of median family income were needed to afford houses in the early 1980's.

But that's hardly a comforting comparison, which is where the economic history comes in. You see, the unaffordability of housing in the early 1980's led to an epic collapse in the housing industry. Housing starts fell from more than 2 million in 1978 to only 1.06 million in 1982. And the housing implosion was one of the main factors in the worst economic slump since the Great Depression, which brought the unemployment rate to a peak of 10.8 percent at the end of 1982.

It's also worth noting that the reason housing was so expensive in 1981 and 1982 was that mortgage interest rates were extremely high. That made recovery easy, because all it took to make housing affordable again was for interest rates to return to normal levels.

This time, with interest rates already low by historical standards, restoring affordability will require a big fall in housing prices.

So here's the bottom line: yes, northern Virginia, there is a housing bubble. (Northern Virginia, not Virginia as a whole. Only the Washington suburbs are in the Zoned Zone.) Part of the rise in housing values since 2000 was justified given the fall in interest rates, but at this point the overall market value of housing has lost touch with economic reality. And there's a nasty correction ahead.