(32) Labonte, Marc :U.S. Housing Prices: Is there a Bubble?" Report for Congress, Congressional Research Service, 2003.

The report analyzes whether there is a bubble in the housing market, especially that housing prices increased by 38.3% from 1997-2002, which outstripped the general increase in prices of 8.5% over this period. In addition, these increases look small in comparison to the behavior of house prices in certain regions of the country. Analyzing the housing data reveals that the housing markets are local as there is a wide diversity in recent price behavior from market to market, and that the growth in housing prices is even more geographically concentrated.

There is evidence suggesting that the demand for housing has increased recently due a decline in interest rates and large increases in income, which placed upward pressure on prices. However, the author argued that a bubble can be ruled out if movements in income, inflation and interest rates can explain the movement in house prices, without even considering the full array of fundamentals. The data suggested that there is no housing bubble in the nation as a whole, but by comparing the behavior of house prices in two of the fastest appreciating regions in the country against the behavior of income and population in those regions, the data reveals that unlike the nation as a whole, income and population have not risen as quickly as prices in these regions providing support to the bubble hypothesis in these areas.

The author uses another approach to determine whether a bubble is present in housing prices by statistically estimating the historical relationship between house prices and variables that affect housing supply and demand before 1997, and then uses these relationships to forecast what house prices would have been afterwards if the historical relationships had held constant. If the forecast is similar to the actual behavior of house prices then a bubble can be ruled out, otherwise a bubble may be present. Comparing actual housing prices to the forecast results generated by five different models, find that all of the models except one predicted housing prices that were 12.7-22.9% lower than actual prices over the past 5 years, and actual housing prices were outside the 95% confidence interval in each case.

Though there are reasons to believe that bubbles are less likely in housing markets than stock markets, as it is the intangible nature of certain assets that makes their pricing difficult, there are intangible attributes to any given house that open the possibility for a bubble, and these could be thought of as a bundle of services attached to the house. Also, since a house is considered as a consumption and an investment good, the expected price in the future should be a factor in determining the value of the house today, and the expected price is uncertain especially at the local level. Another difference between housing and stock markets is the high transaction costs to buying or selling a home which means buying or selling solely in response to mispricing is less likely to occur. The effect of these transaction costs is unclear as they reduce the opportunity for rational traders to correct the mistakes of others as economic theory would

suggest, but also reduce the opportunity for rational traders to bid up prices in order to profit before a bubble bursts.

The author also argues that if prices were to fall, it would be an independent cause for concern to policymakers only if the fall were due to the deflation of a bubble which might cause consumption expenditures to decline because of a negative wealth effect, but if the fall was due to an external factor, the effects should be attributed to the source of the price decline.