Notations

Who Saw The Housing Bubble Coming?

Bruce Bartlett 01.02.09, 12:00 AM ET

The current economic crisis is raising many legitimate questions about the failure of economists and financial analysts to foresee the housing bubble and warn of its collapse.

There were, in fact, many warnings dating back more than seven years--but in the euphoria of rising home prices, no one listened. As time went by and no crash occurred, many of those doing the warning lost credibility or decided that perhaps they were wrong and moved on to other issues.

I first created a folder on the housing bubble back in 2001 and began collecting material on the subject. The very first piece I filed was an article from a September 2001 issue of *Forbes* called "What If Housing Crashed?" by Stephane Fitch and Brandon Copple. Read today, the article was remarkably prescient.

Federal Reserve Chairman Alan Greenspan first addressed the question of a housing bubble in testimony before the Joint Economic Committee on April 17, 2002. He dismissed the idea--or, for that matter, any comparison to the stock market, which had recently gone through a high-tech bubble--on the grounds that housing was different because of substantial transaction costs and more limited opportunities for speculation.

Greenspan also argued that there really wasn't a single national market for housing, but rather a collection of many local markets. Even if a bubble emerged in one market, he said, there was no reason to think it would spill over into other markets.

In June 2002, I filed a report by economist Ed Leamer of UCLA noting that the ratio of home prices to rent was rising rapidly and that this represented a kind of price to earnings ratio for the housing market.

Like the stock market's P/E ratio, when it rises rapidly above historical norms in a short period of time, it's is a good sign that there is a bubble--and that it could burst quickly.

But in March 2003, Greenspan continued to deny the possibility of a housing bubble. In a speech to the Independent Community Bankers of America he said that any comparison between the housing market and a stock market bubble was "rather a large stretch."

Greenspan repeated his view that one could not generalize about the national housing market from other possible bubbles in a few isolated markets. He went on to argue that there was no evidence of excess supply in newly constructed homes and that the rate of housing starts was consistent with the growth of incomes and population.

Despite Greenspan's assurances that there was nothing alarming, it was apparent that a number of local markets, especially in California, were experiencing bubble-like conditions, with prices rising to clearly unsustainable levels. UCLA's Leamer proclaimed that a bubble definitely existed in the Los Angeles and San Francisco real estate markets in a June 2, 2003 report.

In September, economists Karl Case and Robert Shiller presented a very detailed analysis of the housing market to the Brookings Institution's panel on economic activity.

While conceding that economic fundamentals were favorable to rising home prices, they also noted that there were elements of bubble psychology in the housing market. Case and Shiller pointed to an increase in the buying of real estate for investment purposes and high expectations of housing price increases.

They also observed an increasing sense of urgency and opportunity among home buyers, who were plunging into real estate for fear of being left behind as they perceived their friends and neighbors growing richer--classic signs of a bubble.

By 2004, concerns about a housing bubble were pervasive throughout the popular media. But responsible authorities continued to throw cold water on them.

For example, in February, the Federal Deposit Insurance Corporation denied the existence of a housing bubble. It noted that there had not been a decline in national housing prices since the Great Depression. Advances in the structure of mortgage finance since that time, the FDIC concluded, made any repeat very unlikely.

The first report I have pointing to the potentially disastrous effects of a collapse in housing on financial institutions came from economist Paul Kasriel of Northern Trust on July 30, 2004. He noted that 60% of banks' earning assets were mortgage-related--twice as much as was the case in 1986.

If the housing market were to go bust, Kasriel warned, the banking system would suffer significant damage. And since the banking system is the transmission mechanism between the Fed and the economy, any serious downturn in that sector could make monetary policy impotent, thus pulling down the entire economy.

That same day, however, I received a report from Bear Stearns economist David Malpass arguing that the housing market was healthy and that much of the rise in prices simply represented a "catch-up" because they had lagged behind the rise in equity prices since the mid-1990s.

The Bear Stearns report also noted that rising household formations, declining unemployment, low interest rates, a decline in the inventory of unsold homes and the 1997 cut in capital gains taxes on owner-occupied homes as other reasons for its continued optimism.

In September, the International Monetary Fund called attention to the highly synchronized movements in housing prices internationally in its World Economic Outlook.

This suggested that there was greater liquidity in the housing finance market than others had generally assumed. The IMF further noted that interest rates were unusually low and bound to rise at some point as central banks necessarily tightened monetary policy to fend off inflation.

Indeed, the interest rate increases that had already occurred in 2004 were expected to sharply reduce the growth of housing prices in 2005, the IMF predicted.

But in October, Greenspan was still saying that the housing market was nothing to be concerned about. In a speech to America's Community Bankers, he pointed out that the vast majority of homeowners lived in their own homes--so if they sold one, they would have to buy another.

Consequently, there was little possibility of a general downturn in housing prices. While Greenspan acknowledged that there had been some increase in home buying for investment purposes, this represented only a small portion of the overall housing market. And while there was evidence of a rise in debt service ratios, he nevertheless saw household balance sheets as being in good shape.

Greenspan's view was shared by economists at the Federal Reserve Bank of New York. In December, they directly addressed the housing bubble question. Their report's bottom line? There was no bubble; housing prices were rising due to positive fundamentals and not from expectations of rapid price appreciation. And even if fundamentals turned negative, there was little likelihood that prices would drop significantly.

I published my first column on the housing bubble on Dec. 15, 2004. In hindsight, I see that I was overly impressed by the views of Alan Greenspan and the New York Fed. But I did raise red flags about loans becoming too easy, the decline in down payments and the spread of adjustable rate mortgages.

I concluded it would be "unwise to buy a house in the expectation of future price increases like those we have seen." I advised every homeowner to get out of adjustable-rate mortgages and into a fixed-rate mortgage as soon as possible.

I'm ending my discussion of this issue in 2004, but throughout the years since, a number of analysts have emerged on both sides of the housing bubble question. So I do not claim to be comprehensive in my review. I just wanted to call attention to a few of the more prominent analyses that crossed my desk when the housing bubble first caught my attention.

There were many economists who did see it coming, but there were many others of equal or greater prominence and authority who repeatedly insisted that there was nothing to worry about. Under the circumstances, ordinary investors can hardly be faulted for taking actions that unwittingly fueled the bubble and are now having disastrous consequences for themselves and the nation.

Unfortunately, it is in the nature of economic and financial forecasting that being right too soon is insignificantly different from just being wrong. And forecasters that are wrong when most of their community is also wrong never suffer for it. The trick is to be right just a little bit sooner than everyone else--but only a little bit.

Bruce Bartlett is a former Treasury Department economist and the author of Reaganomics: Supply-Side Economics in Action *and* Impostor: How George W. Bush Bankrupted America and Betrayed the Reagan Legacy. *This is the first installment of his new weekly column for Forbes.com.*