

HIGHLIGHTS

A Closer Look at “Bubble Areas”

Overview

There has been much recent discussion in the media regarding the possible existence of a housing bubble. Last quarter OFHEO looked at cycles in the national housing market using the national GDP as a gauge of relative performance. OFHEO concluded that national housing prices would soften as more supply became available, and that large declines were unlikely at the national level. However, housing bubbles are generally recognized as a local area phenomenon, at least historically. In the past (especially the late 1980s and early 1990s) we witnessed bubble phenomena in certain areas along the coasts where supply tends to be slow to respond to changes in demand. The majority of metropolitan areas in the United States have not experienced bubble phenomena.

This quarter, we take a closer look at some of the metropolitan areas that have exhibited bubbles in the past and examine their current status. A few of the most well recognized bubble areas (historically) are San Jose, San Francisco, Boston, and Honolulu. In fact, recent rapid appreciation in the first three of these metropolitan areas has sparked concern regarding future performance. Below we examine the behavior of these markets in detail over the past 20 years.

Silicon Valley

Real housing prices in San Francisco and San Jose (Figures 1 and 2) exhibited bubble behavior in the late 1980s and early 1990s¹. Housing values rose by around 80 percent in both areas between the start of 1984 (late 1983) and the fourth quarter of 1989. Housing values in San Francisco then proceeded to drop by 37 percent over the next six years. In San Jose, housing values bottomed out in early 1995, also declining by 37 percent. Concern about the future of these markets stems from the fact that recent price growth in both areas is comparable to growth during the boom period in the late 1980s. San Francisco values rose 71 percent between the second quarter of 1996 and the third quarter of 2001, while San Jose's increased by a similar 86 percent between the first quarter of 1995 and second quarter of 2001.

Since 2001, house prices in both San Francisco and San Jose have declined. However, declines so far have not matched those of the 1990 bust. By the fourth quarter of 1990, one year after the 1989 peak, housing in San Francisco and San Jose had already lost around 10 percent (give or take a few percentage points) of its value. The current data, however, indicates that San Francisco has simply flattened over the past year (a little below zero growth), and San Jose has dropped by only 3 percent. For the most part, the housing industry has taken the position that declines will be less than those witnessed in historical cycles, and the most recent data for these areas is not inconsistent with that premise.

¹ These numbers are converted to real numbers using the national CPI less shelter, obtained at www.bls.gov.

Honolulu

Honolulu is the only major metropolitan area with significant house price declines in the late 1990s, so it is an interesting case to examine (see Figure 3). Between the second quarter of 1991 and the first quarter of 2001, real housing values in Honolulu dropped by about 30 percent. The most rapid declines took place in the latter half of the decade. Declines in Honolulu are generally attributed to the Asian financial crisis. However, this may simply have triggered and exacerbated a market correction that was likely in any event. Between the fourth quarter of 1985 and the second quarter of 1991, housing prices increased by almost 85 percent. Rapid increases of that magnitude have rarely been fully sustainable, as past experience in other markets such as San Francisco and San Jose indicates. Over the past couple of years, however, housing values have been rising in Honolulu (11 percent real growth since fourth quarter 1999).

Boston

Boston experienced the largest cycle of the 1980s, with 110 percent real house price growth between third quarter 1982 and second quarter 1988 (see Figure 4). Subsequent declines were about 28 percent over the next 7 years, implying that those who purchased housing in 1982 were still doing very well after the market declined. Housing markets in Boston have been performing well throughout the late 1990s and through 2002. Boston has experienced approximately 65 percent real growth over the past 7 years. This is far less than the previous boom, but prices are still rising.

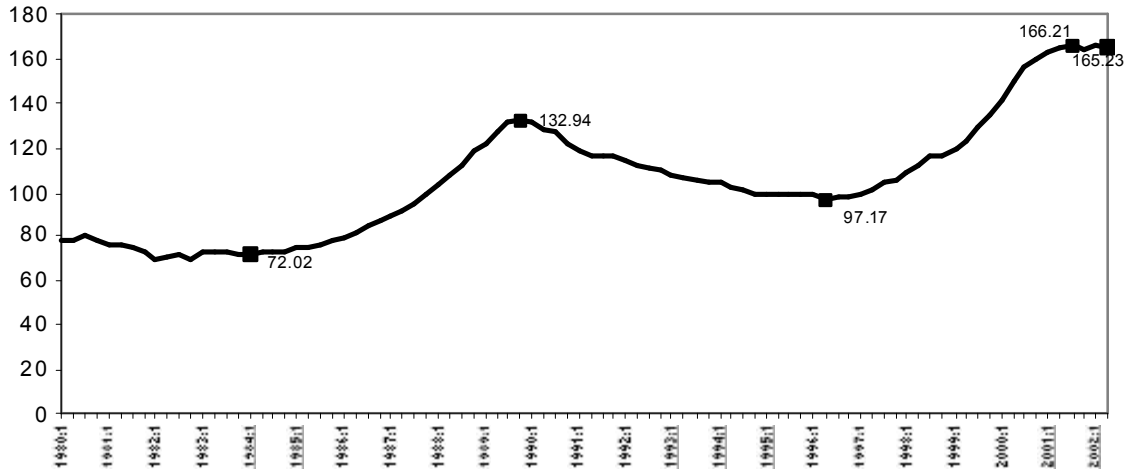
Summary

So what does all of this imply? It is worthwhile to note that while housing values peaked in the Silicon Valley last year, subsequent declines so far are less than they were following the 1989 peak. However, there is insufficient evidence to conclude that larger house price declines are not forthcoming. A number of industry specialists have taken the position that previous cycles were driven by speculative behavior, and that the most recent upward cycle in this market is largely due to supply constraints. Building permits and starts data from the Census, on the other hand, do not support this sentiment. That is, the data do not indicate substantial differences in supply responses between the two boom periods.

Another important observation is that even in these areas that sometimes demonstrate bubble type behavior, cumulative declines have almost always been much smaller in absolute magnitude than preceding increases during the upward portion of the cycle. Over a full cycle during a 12-year period in Boston (1982:3-1995:1), for example, housing appreciated at a healthy annual average rate of more than 4 percent. In San Francisco and San Jose, yearly increases average between 2 and 3 percent annually during a complete up and down cycle (again about 12 years). So regardless of whether or not bubbles occur in given areas, housing has still generally been a good long-term investment.

1995:1=100

Figure 1: Real House Price Growth in San Francisco



1995:1=100

Figure 2: Real House Price Growth in San Jose

