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# Housing Bubble or Shelter-Safe Haven?

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## Executive Summary

If there were a Presidential Award for Most Valuable Economic Sector, the current recipient would undoubtedly be housing. After the national economy faltered in the aftermath of the collapse of the late 1990s high-technology capital investment bubble, it was the sheer strength of the housing market that kept us afloat. However, the Federal Reserve, in pushing interest rates to 45-year lows in order to support housing and consumer spending, may well have created another bubble—this time in home prices. During the past four years, New Jersey and the Tri-State Region (Connecticut, New Jersey and New York) served as one of the epicenters of the nation's surging housing market. So strong have home price gains been in the region that concern has been raised as to whether we have experienced a spate of “irrational exuberance” in housing markets rivaling the stock market mania of the late 1990s. Are we destined to experience the same type of aftershock?

Our conclusion is that the price surge evident to date in New Jersey and the Tri-State Region does not yet represent an excessive, unsustainable advance, at least when assessed at the statewide level, and that the combined effects of rising interest rates, advancing incomes, and a stronger economy will lead to a soft landing, i.e., a slowdown in home price appreciation rather than a painful housing price correction. A brief summary of the key findings leading to this conclusion follows.

- The standard for a housing bubble is probably the 1980s home-price boom in New Jersey. Extraordinary price gains far in excess of inflation, combined with vast differentials between the rates of house appreciation in the state versus the nation, led to unsustainable excesses.
- New Jersey house prices rose by 109.5 percent between 1983 and 1988, with 1988 standing as the market peak, as measured by the House Price Index of the Office of Federal Housing Enterprise Oversight. For five consecutive years, prices of New Jersey homes grew by almost 16 percent per year on a compound annual basis.
- In contrast, over this same time house prices nationally rose by only 37.4 percent, or by a compound annual growth rate of 6.6 percent. Thus, New Jersey's house price gains on both measures were nearly two and a half times that of the nation. This type of sustained relative performance—or excess—certainly qualified as a “boom” and, as events would ultimately show, a bubble.
- New York State and Connecticut also both experienced large overall price increases relative to the nation as well as double-digit annual rates of growth. New York's five-year boom was somewhat smaller (76.1 percent, or 12.0 percent annually) than that of New Jersey, while Connecticut's was somewhat larger (120.3 percent, or 17.1 percent annually). Thus, there was a sustained price surge throughout the Tri-State Region compared to the nation.
- But these rates of increase did not prove to be sustainable. New Jersey house prices peaked in 1988 and then declined through 1991, with a total price decline of 7.8 percent, or -2.7 percent on a compound annual basis.
- Since housing markets are “sticky” on the way down, at least compared to equity markets, this decline may not have fully revealed the scale of correction. In contrast, home prices for the country as a whole continued to rise, although slowly. During this period, national prices increased by 8.7 percent, or 2.8 percent on a compound annual basis.
- New York's house price index fell by 4.4 percent (or -0.9 percent annually), somewhat less than that of New Jersey, while Connecticut's tumbled by a very considerable 18.3 percent over a longer period (or -3.0 percent annually). The punch bowl was definitely removed from the regional housing party.
- House values began to recover very slowly as the national and regional economies emerged from the early 1990s recession. But housing in the region faced a long road back. It actually took until 1998 for New Jersey to return fully to its nominal price

peak of 1988. Thus, the recuperation period constituted a full decade.

- This recuperation was in nominal dollars. After adjusting for inflation, 1998 home prices in New Jersey were still considerably below those of 1988 since inflation increased by 32.6 percent between 1988 and 1998. In constant dollar terms, the real house price in New Jersey in 1998 was still 32.6 percent less than in 1988—or nearly one-third lower!
- The lesson to be learned is that bubbles can cast very long shadows. Connecticut and New York had similarly long recovery periods in nominal dollar terms. During their recoveries, all three states registered price increases less than half that of the United States.
- However, by 1998, a number of factors were building in the Tri-State Region and in the nation that would contribute significantly to the next surge in house values. New Jersey's home prices jumped by 51.7 percent between 1998 and 2003, or by 8.7 percent per year. This was nearly four times faster than the annual increase in the CPI (2.4 percent). This was also considerably above the comparable national rates of house price increase (38.0 percent and 6.7 percent, respectively).
- It took the first four years of this recent period of rapid home price appreciation—between 1998 and 2002—for the inflation-adjusted price index to finally top the peak of 1988. Thus, in real terms, it took a full 14 years, to 2002, for complete price recovery. In this context, the notion of a housing bubble tends to lose credibility, since the post-1998 price surge enabled us only to recover the price declines of 1988–1991 and to compensate for 14 years of inflation.
- So it difficult to designate this recent price surge in New Jersey as a bubble. Another important piece of evidence arguing against a bubble is that the 8.7 percent annual compound rate of growth for New Jersey in the five-year period between 1998 and 2003 is barely half of the 15.9 percent annual growth rate of the 1983 to 1988 boom.
- Moreover, in the earlier period (1983–1988), the annual rate of price increase in New Jersey was more than double the national rate. Currently (1998–2003), it is not even one-third higher. Thus, if the 1980s experience sets the threshold for a bubble—in terms of high general rates of increase and high rates of increase relative to inflation and the nation—then we conclude that the current experience is not a bubble.
- The price surges of New York and Connecticut closely paralleled that of New Jersey. New York had the highest annual rate of price increase over the past five years (8.9 percent) compared to 8.7 percent in New Jersey, while Connecticut had the lowest (7.6 percent). All three clearly outpaced the nation (6.7 percent), but not excessively so.
- In the long run, housing price increases cannot consistently outstrip growth in housing buying power. Surrounding the 1980s housing boom was a period of strong relative income growth, with incomes in New Jersey growing far faster than the nation's. But even this growth ultimately could not sustain the boom years' price gains.
- With housing prices having recently advanced far faster than income growth during our current home price boom, some apprehension again appears to be warranted. However, declining interest rates have transformed the unexceptional recent income gains into much larger increments of housing buying power, justifying part of the home-price surge.
- But interest rate declines to levels not seen in more than 40 years are now themselves history. Thus, all of the gains in housing purchasing power as a result of interest rate reductions in the current market probably have been made. Future income growth from this point forward will be the major determinant of housing-buying power gains. How much this will reduce the rate of increase in prices, or even cause them to sag, remains to be seen because so many other elements are also present.

## Introduction

**A**spiring homeowners today face the usual quandaries about timing their housing purchase. However, these normal concerns recently have escalated in intensity. The five-year surge in housing prices has heightened fears of being left behind as the homeownership train leaves the station. Relentless price increases suggest that delaying the decision to purchase a home means falling ever farther behind, being relegated to the shelter caboose, or perhaps even being immobilized forever. Moreover, this anxiety has been exacerbated by the recent rise in mortgage rates. This “to buy or not to buy” quandary is now challenged by another: the fear of being a peak-of-market purchaser. If prices fall, there is the possibility of getting caught in a negative equity position in which the value of a home falls below the face value of the mortgage.

Thus, two scary scenarios confront aspiring homeowners if they make the wrong determination about whether prices will increase further or decline from what will, only in retrospect, turn out to have been a peak. The question of whether we are now in a home price “bubble” is one of the more perplexing current housing market issues, particularly since housing in the aggregate has also been a strong source of growth in an otherwise lackluster national economy.

After being moribund for most of the 1990s, the gains in housing prices in New Jersey and the region over the last five years have been nothing less than spectacular.<sup>1</sup> The median sales price of existing single-family homes in New Jersey increased by a compound annual rate of 10 percent between 1998 and 2003, yielding a total increase of more than 60 percent in five years. In a number of “hot” markets of the state, price gains have eclipsed even these robust

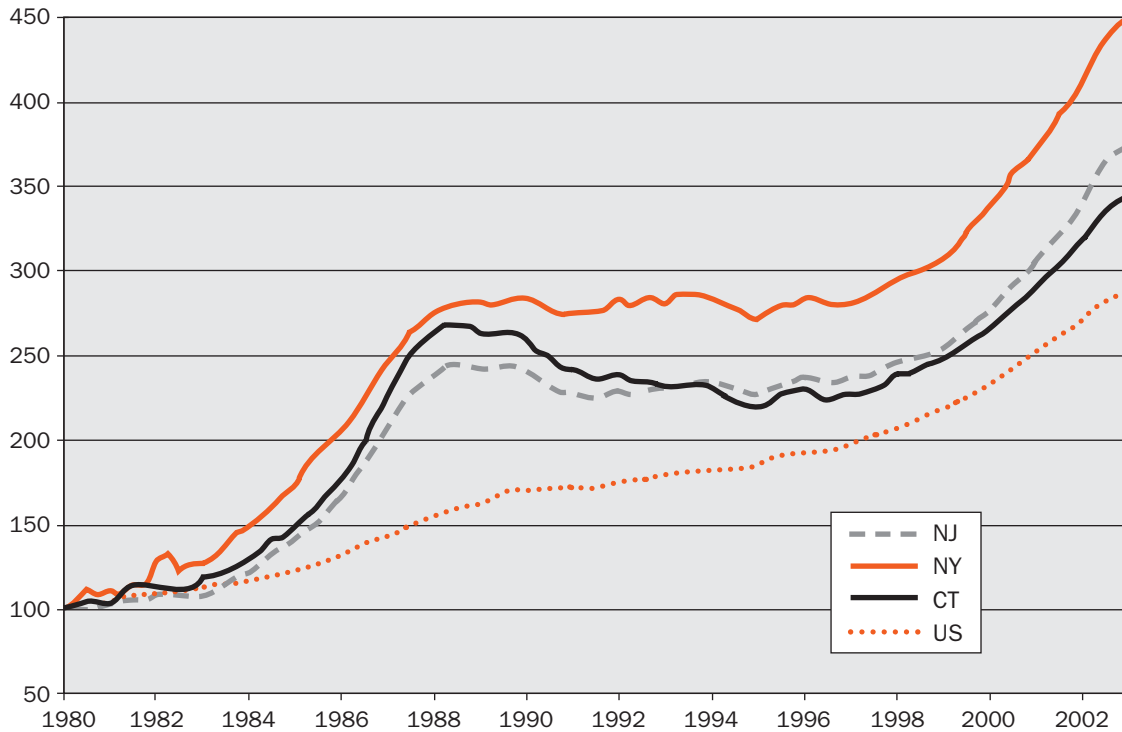
numbers. For many New Jerseyans, buying a house, or trading up in the housing market, became a safe haven as the stock market plunged in value for three years in a row and record-low interest rates made mortgages and refinancing extremely attractive. In fact, the run-up in prices in the current housing market appears to be very similar to the boom years of the 1980s. As shown in figure 1, the escalating slope of the OFHEO House Price Index in the post-1998 period is starting to look ominously like the slope of the 1983 to 1988 period.

Why ominously? It is useful to recall that the housing price surge of the 1980s ultimately burst with a vengeance in 1988, telling us in no uncertain terms that the state and region had actually experienced a true home price bubble. Subsequently, house values declined well into the 1990s and did not regain their 1988 nominal price peak until 1998, a full decade later. Several obvious questions arise. Is the current housing market boom another bubble that is destined to burst? Have we not only reinvented the housing experience of the 1980s, but are we also about to repeat the pattern of the collapse of the high-technology capital investment and stock market bubbles of the late 1990s? Can New Jersey homeowners looking to trade up to larger houses, as well as aspiring first-time homebuyers, anticipate that the gains of the last five years will continue? Or, is 2003 the peak, and is the housing market about to retrench as it did in 1988? Certainly, rising mortgage rates, continued weakness in labor markets, and only modest growth in personal incomes suggest caution. At the same time, demographic trends, stock market uncertainties, and a scarcity of building sites in many areas of the state are strong factors that promote continued housing acquisition and appreciation in house values.

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<sup>1</sup> Three types of house price/value data are used in this report. We rely heavily on the Office of Federal Housing Enterprise Oversight (OFHEO) House Price Index (HPI), which is published quarterly for the nation, states, and metropolitan areas. The HPI tracks house price changes in repeat sales or refinancings on the same single-family properties ([www.ofheo.gov](http://www.ofheo.gov)). The index measures housing appreciation trends but does not provide actual prices. Decennial census house values are also utilized for analysis ([www.census.gov](http://www.census.gov)). These are values estimated by census respondents; each census represents a different mix of units, with substantial new units added and some units lost between censuses. Prices of existing single-family home sales from the National Association of REALTORS® ([www.realtor.org](http://www.realtor.org)) and the New Jersey Association of REALTORS® ([www.njar.org](http://www.njar.org)), the third data source, also represent a different mix of units. The median sales price is that only of units sold during each measurement period.

**Figure 1**  
**House Prices, 1980–2002**  
 (Index 1980=100)



Source: Office of Federal Housing Enterprise Oversight, House Price Index

This report examines the recent large increases in house prices in New Jersey and analyzes these changes within the perspective of national housing trends, current economic conditions, and past experience with other assets that have experienced rapid appreciation. *A key lesson learned from economic excesses of the past is that in most cases you don't know you're in a bubble until it bursts, and then it is too late.*

## Other Bubbles: A Perspective

**D**efining a bubble and its demise is an enigmatic task. Hindsight always brings a morning-after clarity that is elusive when decisions need to be made in the present and the current good times seem likely to roll on forever. Therefore, a review of some other recent boom-and-bust market excesses is instructive.

Consider, for example, the commercial office space bubble of the 1980s. The Economic Recovery Tax Act of 1981 instituted an accelerated cost recovery system (e.g., it allowed a 15-year depreciation period for commercial buildings) to stimulate capital investment. The Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St Germain Depository Institutions Act of 1982 deregulated savings and loan associations and allowed them, for the first time, to finance nonresidential buildings. These major regulatory and tax code changes, in combination with an expanding economy, led to the enormous speculative growth of commercial property in New Jersey and other parts of the nation. Between 1980 and 1990, the state added more than 100 million square feet of office space to a 1980 base of only 25 million square feet. Eighty percent of all the office space ever built in New Jersey was constructed in the 1980s! In ten years we built a twenty-year supply of

space, a scale of overdevelopment reflecting an extraordinary absence of market discipline.

But beginning with the stock market collapse of October 1987 and followed by the deep 1989–1992 regional recession that struck the financial and construction sectors in the Northeast, the extent of the overbuilding was gradually, but forcefully, exposed. The office development overhang led to such dark humor as “see-through office buildings” (i.e., devoid of tenants and fixturings) littering the landscape and “three years’ free rent on a two-year lease” (i.e., securing tenants at any cost). By 1990, the office arena had a dramatic “over” and “under” problem: overbuilt, overleveraged, and underleased—a situation that would not be fully rectified until the second half of the 1990s. The commercial real estate bubble of the 1980s had clearly burst, and the classical signals of overexpansion—the speculative building of offices at a time when demand was soon to decline—was recognized and soberly acknowledged only in retrospect. Ultimately, the Resolution Trust Corporation was established by the Financial Institutions Reform, Recovery and Enforcement Act of 1989 to dispose of the assets of more than 500 failed thrift institutions nationwide as the New Jersey experience was repeated in many other markets throughout the country.

America’s high-technology capital investment boom of the late 1990s provides a second boom–bust example. Spending on new equipment and software surged at an average annual real growth rate of approximately 12 percent between 1995 and 2000. However, the collapse of the dot-com sector, which had become highly leveraged on the strength of promises, not profits, and the echo effect of reduced technology demand after major expenditures to cope with Y2K requirements, led to a sharp decline in technology spending. Real expenditures declined by 6.4 percent in 2001 and 1.7 percent in 2002 as the scale of overcapacity was finally realized. A few examples prove illustrative here. By some estimates, more than 90 percent of all the fiber-optic cable laid

during the second half of the 1990s is not now being used—it is sitting dark! The amount of investment in fiber-optic cable was staggering. According to *The Wall Street Journal*, by the end of the 1990s, an estimated 40 million miles of fiber-optic capacity had been put in place, enough to go to the moon and back 80 times!<sup>2</sup> The volatile swing from rapid growth to a sustained decline in high-technology capital spending was a major cause of the recession of 2001.

The parallel bubble to the technology-spending spree of the late 1990s was, of course, the accompanying stock market boom, which provided the capital for the technology investment boom. This was a heady time—everyone’s a genius in a bull market—and the promise of “Dow 30,000” attracted enormous numbers of new investors and new money into the equity markets. Between February 1997 and the peak in January 2000, the Dow Jones Industrials average rose from 6,989 to 11,722 (68 percent), while the technology-based Nasdaq index zoomed from 1,165 in September 1996 to 5,132 in March 2000 (340 percent). The realization that few dot.coms would ever show a profit and the sharp reversal of technology investment, along with rising unemployment in the financial and information sectors, abruptly reversed the market run-up. By September 2001, the Dow had lost 30 percent of its peak value, and in October 2001 the Nasdaq dropped to below its previous low! The Dow and Nasdaq indices fell for three consecutive years (2000, 2001, and 2002). Only since March 2003 have both these averages, and the broader Standard & Poor’s index, shown positive gains in year-to-date performances, offering the prospect of a positive annual increase for the first time since 1999.

*In all three of these examples—commercial real estate in the 1980s, technology capital investment spending in the second half of the 1990s, and the equity markets from 1997 to 2000—a bubble was apparent only after painful corrections and collapses occurred, with accompanying significant damage to individuals and the*

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<sup>2</sup> Dennis K. Berman, “Telecom Investors See Big Potential in Failed Networks,” *The Wall Street Journal*, August 14, 2003, p. 1.

economy as a whole. But nowhere is the impact of a potential bubble as great as in housing, simply because of the sheer number of Americans, and New Jerseyans, that would suffer direct exposure to it.

## Housing: The American Dream

**H**omeownership is a dominant contour on the American social landscape. Owning one's own home is *the* American dream, one of the glues holding our society together. We have been transformed from a nation primarily of renters before World War II to a nation primarily of homeowners today. The nation's current 68 percent rate of homeownership is the envy of the world. The American middle class has moved from the modest shelter accommodations of a generation ago to the virtual finished living machines of today, packed with arrays of amenities that at one time only the very rich could aspire to have.

As a result, housing has become a major part of the financial worth of most Americans. Indeed, in the post-World War II era, homeowners have been richly rewarded just for living in their own houses! As reported in table 1, the median home value in the United States in 1950 according to the decennial census was \$7,354. By 2000, the value had increased by 1,526 percent to \$119,600!<sup>3</sup> This represents an annual compound growth rate of 5.6 percent for a fifty-year period! Such is the power of compound interest.

Thus, housing has been a financial engine, a savings vehicle, a means of forced savings (and tax savings), and a mechanism for painless capital

accumulation. It has been the super piggy bank that ultimately would provide the wherewithal to pay for children's education and ensure a retirement nest egg. Housing did all this while providing instant gratification, pleasure, and service on a day-to-day basis. Moreover, housing was and is one of the few leveraged investments available to most Americans. A homeowner can leverage a relatively modest down payment into a much larger asset upon which annual gains are made. For example, assume a household purchases a dwelling for \$100,000 with a down payment of \$10,000 and a \$90,000 mortgage. If the dwelling increases in value by 5.6 percent in one year, the house is then worth \$105,600. This represents a 56 percent return (\$5,600) on the household's initial investment of \$10,000! Few, if any, alternative investments can offer such safe competitive returns. So the power of compound interest is boosted by the power of leverage, and both dynamics serve as foundations for the financial advantage of homeownership. This advantage is further and significantly extended by allowable federal and state income tax deductions for mortgage interest payments. It is not surprising that there has been a willingness of housing consumers to devote extraordinary shares of their income to homeownership, ratcheting up demand and propelling housing prices.

Moreover, leverage also provides a buffer from inflation. Table 1 also provides the inflation-adjusted constant 2000-dollar values back to 1950.<sup>4</sup> Viewed in this perspective, housing's long-term appreciation has been much more modest, with the national median home value increasing by 166.9 percent over the 50-year period, or by a real 1.03 percent annual compound rate of increase. While this rate of return seems somewhat paltry, it does not reflect the leverage elements or the tax advantages discussed

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<sup>3</sup> It is important to stress again that the data do not represent the same housing units over time but those housing units in existence at the time of each census. Thus, the value can change over time due to additions to and subtractions from the housing inventory as well as to appreciation or depreciation of units in existence at the time of the previous census.

<sup>4</sup> The nominal values for 1980 and 1990 are converted to year 2000 dollars using the Bureau of Labor Statistics' Consumer Price Index Research Series (CPI-U-RS). The nominal values for 1950, 1960, and 1970 were based on derivations of the CPI-U-RS by the Census Bureau.

**Table 1**  
**Median House Value**  
**United States, New Jersey, New York, and Connecticut: 1950–2000**  
*(Current and constant dollars)*

		<b>Current Dollars</b>	<b>Change from Previous Census</b>	<b>Constant Dollars</b>	<b>Change from Previous Census</b>
<b>United States</b>	1950	\$ 7,354		\$ 44,817	
	1960	11,900	61.8 %	58,986	31.6 %
	1970	17,000	42.9	65,683	11.4
	1980	47,200	177.6	93,916	43.0
	1990	79,100	67.6	101,562	8.1
	2000	119,600	51.2	119,600	17.8
	Change 1950–2000 Compound Annual Rate	\$112,246	1,526.3 % 5.60 %	\$ 74,783	166.9 % 1.03 %
<b>New Jersey</b>	1950	\$ 10,408		\$ 63,428	
	1960	15,600	49.9 %	77,326	21.9 %
	1970	23,400	50.0	90,411	16.9
	1980	60,200	157.3	119,783	32.5
	1990	162,300	169.6	208,388	74.0
	2000	170,800	5.2	170,800	-18.0
	Change 1950–2000 Compound Annual Rate	\$160,392	1,541.0 % 5.62 %	\$107,372	169.3 % 1.06 %
<b>New York</b>	1950	\$ 10,152		\$ 61,868	
	1960	15,300	50.7 %	75,839	22.6 %
	1970	22,500	47.1	86,933	14.6
	1980	45,600	102.7	90,732	4.4
	1990	131,600	188.6	168,970	86.2
	2000	148,700	13.0	148,700	-12.0
	Change 1950–2000 Compound Annual Rate	\$138,548	1,364.7 % 5.37 %	\$ 86,832	140.3 % 0.68 %
<b>Connecticut</b>	1950	\$ 11,862		\$ 72,289	
	1960	16,700	40.8 %	82,778	14.5 %
	1970	25,500	52.7	98,525	19.0
	1980	65,600	157.3	130,527	32.5
	1990	177,800	171.0	228,290	74.9
	2000	166,900	-6.1	166,900	-26.9
	Change 1950–2000 Compound Annual Rate	\$155,038	1,307.0 % 5.28 %	\$ 94,611	130.9 % 0.54 %

Source: U.S. Census Bureau, Census of Population and Housing for given years

above. Conversely, it does not consider the costs to homeowners of long-term capital improvements and upgrading.

Whereas New Jersey's inflation-adjusted 50-year compound rate of appreciation (1.06 percent) was barely higher than that of the nation, New York's (0.68 percent) and Connecticut's (0.54 percent) were significantly lower—and certainly sobering. While this long-term perspective certainly challenges some of the assumptions about housing as investment, it should be stressed that housing transactions are conducted in nominal dollars, not in inflation-adjusted dollars. Nonetheless, constant dollar analyses suggest that annual real price/value increases significantly greater than 1 percent per year may not be sustainable in the long run and may be one of the indicators of a bubble.

What is also significant over the half-century period is the striking similarity in long-term annual gains across the United States (5.6 percent), New Jersey (5.6 percent), New York (5.4 percent), and Connecticut (5.3 percent). Despite differences in absolute median home values—with Census 2000 showing New Jersey (\$170,800) far higher than the United States (\$119,600)—housing's uniform broad-based advance in value is evident. However, within this long-term consistency in the rate of increase in home values, there is much more short-term (decade-by-decade) volatility at the state level. The highest and lowest inflation-adjusted growth rates are in New Jersey, New York, and Connecticut, with the 1980s standing as the peak and the 1990s as the nadir. This suggests that despite national uniformity, at the level of local and regional markets there is a tendency toward more extreme booms and busts, perhaps even bubbles. This is the case even when decade census benchmarks are used, which mute actual intra-decade peaks and troughs.

Nonetheless, the record after a long half-century jaunt is that New Jersey's relative home value gains were virtually identical to those of the nation (1,541 percent versus 1,526.3 percent). *This strongly suggests that the long-term home-value growth in the state certainly has not been excessive,*

*and that home values in New Jersey in 2000 were at appropriate market levels.*

## Shelter Eras and Housing Production

**T**he performance of housing markets—output, supply, sales, and pricing—results from the interplay between the demand for shelter and the supply of dwelling units. A brief review of the demographic determinants of demand in the context of long-term housing production provides a framework for interpreting current housing markets.

New Jersey—as well as much of America—is now in the third distinct demographically defined housing period since World War II. The *first* era emerged in the immediate post-war years and lasted through 1970. It can be labeled the *Post-World War II Nesting Generation*, or the Original Levittowners. It followed a 15-year drought in housing production and the resulting large accumulation of pent-up demand—both effects of the Great Depression and World War II. Housing production, household formation, and family rearing all had been postponed. But immediately after the war, GI Joe and Rosie the Riveter quickly got together; nine months later, the baby boom erupted. The boom ultimately lasted 18 years, stretching from 1946 to 1964 and producing the largest generation in American history—over 78 million strong nationwide. Housing in this era was shaped by the requirements of child rearing. The baby boom roared and tract house suburbia was born—and this housing type, in turn, contributed to the record size of the population boom.

Starting in 1950, young families in New Jersey moved into Levittown-genre and similar-style dwellings at the rate of 1,000 per week for 1,000 straight weeks, yielding almost 1 million housing units between 1950 and 1970. As shown in table 2, 497,000 dwelling units were authorized by building permit in the decade of the 1950s, and nearly

501,000 in the decade of the 1960s.<sup>5</sup> These peak housing-production levels were not to be seen again. In retrospect, this was New Jersey's golden housing-production era, a period driven by unprecedented backlogs in demand, the long sweep of post-World War II prosperity, and a seemingly endless supply of cheap, developable land. There was additional demand stemming from massive suburbanization out of New York City and Philadelphia. Between 1950 and 1970, net domestic in-migration into New Jersey exceeded 1 million persons, most seeking the new suburban American housing dream. But, as the state matured over the ensuing decades, all of these factors would change, and housing production would steadily decline from the heights of this era.

The *second* era can be labeled *First-Generation Baby-Boom Housing Demand*. By the time the decade of the 1970s unfolded, the baby boom itself began to enter the housing market directly and in full force. Thus, the second era was powered by the offspring of the first, and it lasted through the mid-1980s, when most baby boomers had become full housing participants. But this generation affected the housing market far differently than did their parents. Emerging new social values and new lifestyle aspirations produced an eclectic mix of household configurations, and these segmented the formerly homogeneous mass middle market of the first housing era. New shelter alternatives to detached single-family dwellings emerged to satisfy changing demand profiles that were no longer dominated by the imperatives of child rearing.

Significantly, baby boomers, delaying both marriages and families, spawned the baby-bust generation—that unusually small population cohort born between 1965 and 1976. Thus, only a limited pool of future homebuyers emerged to purchase the “used” peak-of-market baby boom housing, i.e., the “McMansions,” in the post-2000 years. Moreover, the rise of the Sunbelt caused population and jobs to move to the South and West on a massive scale during this era. As a result, net domestic migration to New Jersey turned negative. Because of this, as well as the exhaustion of earlier pent-up demand, housing

production fell from the 50,000-unit annual average of the 1950-to-1970 period to the 40,000-unit level during the decade of the 1970s, and to less than 38,000 units in the 1980s (table 2).

*Maturing Housing Demand* is the *third* and current housing era, but it too is driven by the maturing baby boom. After blazing new and revolutionary paths to first-time household formation and then to first-time homeownership, the now middle-aged baby boom generation created a huge web of trade-up markets during the 1990s, moving to family-rearing accommodations appropriate in scale, amenity, and ingenuity to a population cohort now in its peak earning and peak child-rearing years. The baby boom produced a replica of itself—the baby boom echo—a huge, 70-million-person cohort born between 1977 and 1995 that falls just below the size of the original baby boom. This generation will be the source of escalating entry-level housing demand as the current decade matures.

Housing production during the 1990s continued the pattern of decade-by-decade decline, with the annual average building permits dipping to under 24,000 units (table 2). This is less than half of the average of the 1950s and 1960s. One particular reason was the decline in household formation and hence in entry-level housing demand as the baby bust thinned the ranks of the “twenty-somethings.” The baby bust proved to be far too small a replacement cohort for the voids formed in the age sectors and housing markets vacated by an aging baby boom. Another reason for reduced housing production was the sustained pattern of net domestic out-migration from the state. The end result was that housing demand experienced its lowest growth since World War II.

In summary, each housing era of the second half of the twentieth century was driven by the life-cycle stages of the baby boom and its shelter requirements: (1) birth and adolescence, (2) young adulthood, and (3) middle-aging and maturation. In 2004, the baby boom will be between 40 and 58 years of age and will be moving rapidly into the post-child-rearing stage of the family life cycle. The baby boom will continue to

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<sup>5</sup> For simplicity of presentation, we equate building permits with housing production.

**Table 2**  
**Dwelling Units Authorized by Building Permits: 1940–2002**  
**State of New Jersey Total**

Year	Total	Year	Total	Year	Total
1940	16,135	1950	72,657	1960	41,166
1941	18,046	1951	49,816	1961	46,963
1942	13,948	1952	48,213	1962	46,655
1943	7,073	1953	48,310	1963	54,488
1944	4,857	1954	52,728	1964	68,078
1945	6,945	1955	55,126	1965	64,933
1946	16,907	1956	44,276	1966	50,163
1947	36,471	1957	37,492	1967	46,958
1948	37,982	1958	39,738	1968	43,661
1949	49,796	1959	48,674	1969	37,887
<b>Decade Total</b>	208,160	<b>Decade Total</b>	497,030	<b>Decade Total</b>	500,952
<b>Annual Average</b>	20,816	<b>Annual Average</b>	49,703	<b>Annual Average</b>	50,095
Year	Total	Year	Total	Year	Total
1970	40,143	1980	22,270	1990	17,524
1971	58,360	1981	20,676	1991	14,856
1972	64,979	1982	21,297	1992	19,072
1973	52,743	1983	35,857	1993	25,188
1974	26,171	1984	43,787	1994	25,388
1975	23,313	1985	55,027	1995	21,521
1976	31,355	1986	57,353	1996	24,173
1977	34,920	1987	51,462	1997	28,018
1978	38,756	1988	40,909	1998	31,345
1979	34,868	1989	30,337	1999	31,976
<b>Decade Total</b>	405,608	<b>Decade Total</b>	378,975	<b>Decade Total</b>	239,061
<b>Annual Average</b>	40,561	<b>Annual Average</b>	37,898	<b>Annual Average</b>	23,906
Year	Total				
2000	34,585				
2001	28,267				
2002	30,441				
<b>Total</b>	93,293				
<b>Annual Average</b>	31,098				
<p>Source: New Jersey Department of Labor</p> <p>Note: Shaded areas indicate peak production period of each decade.</p>					

dominate the housing market through 2020 and beyond, but the specific shape of its demand will evolve as it passes through its final life-cycle stages. The baby boom will be numerically stronger than any other mature generation in history. Boomers are destined to remain the key housing market dynamic as they transition into empty-nesters in the years ahead.

## House Production Patterns

**T**here have been six major decade peaks in housing activity in New Jersey since World War II (highlighted entries in table 2), interspersed with cyclical production slowdowns and secondary peaks. Every boom period ultimately came to an end, and every trough yielded to renewed growth. Since 1950, however, each succeeding peak has been lower than its predecessor, and each intervening downturn has deepened. For example, the all-time peak of the 1950s (72,657 units) was more than double the peak production year of the 1990s (31,976 units).

New Jersey has also experienced a long-term decline in residential building activity when measured by decade-long permit totals. Housing traditionally has been one of the most cyclical of industries, highly sensitive to interest-rate shifts, with new construction surging during booms and retreating with recession. But superimposed on business-cycle swings is a pattern of secular decline in housing output decade by decade since 1960. The production level of 500,952 in the 1960s fell to 405,608 units in the 1970s, to 378,975 units in the 1980s, and to 239,061 units in the 1990s. Rarely are economic trends so emphatic and apparent. However, since new housing has been increasing steadily in size, the actual square footage produced has not exhibited an equivalent decline, and quality and amenity levels have experienced major gains. *Nonetheless, the state's housing market has reached advanced middle age, with unit production greatly diminished from its "more formative" market years.*

Still, there has been a surging potency of housing demand in the current era: Building permits (34,585 units) in 2000, the first year of the current decade, already have eclipsed the peak year of the 1990s. The three-year (2000–2002) annual average (31,098 units) is 30 percent above that of the annual average (23,906 units) of the 1990s, although this increase took place from a half-century low. Also, this has been the first time in a national recession when housing production did not dip markedly. In fact, permits averaged over 31,000 units during the past five years, when the housing market soared. Is this production level “as good as it gets” in a mature market such as New Jersey? Does it reflect a housing market bubble? To answer this question, it is useful to try to learn from the experience of the 1980s, when a true regional housing bubble emerged and ultimately burst.

## The Big Boom and the Big Bust

**A**n auspicious alignment of economic and political conditions converged in the 1970s and early 1980s to set the stage for the extraordinary housing boom between 1983 and 1988. First, significant inflation dominated this period, beginning in the early years of the 1970s when Vietnam War expenditures led to higher prices, followed by two major oil price spikes and the recessions that followed (the harsh downturn of 1974–75 and the rolling recession of 1980–82), as OPEC used oil as a political weapon in a complex struggle with Western nations. For the entire decade of the 1970s, prices (as measured by the Consumer Price Index) increased by 87 percent, the highest decade increase in the twentieth century. Prices continued to rise into the early 1980s, increasing by 17 percent between 1980 and 1982. Second, the stock market had a rocky and weak performance in the 1970s. The Dow Jones Index began the decade at a value of 744 and ended it at 836, only 12.4 percent higher. But its decade peak was 1,018 in 1972 and its low was 616

in 1974, indicating significant volatility. It is noteworthy that by the end of the decade, the Dow Jones index was 18 percent below its 1972 peak. Thus, for individual investors considering housing versus stocks as an investment, the equity markets in the 1970s were both risky and weak. Third, the Federal Reserve focused on fighting inflation and painfully began to wring inflationary expectations out of the economy even as economic growth stagnated in the first years of the 1980s. Interest rates increased steadily and significantly, and mortgage rates rose to 17 percent early in the 1980s. As a result, the national economy struggled in the beginning of the 1980s. Real Gross Domestic Product (GDP) fell by 0.2 percent in 1980, rose weakly by 2.5 percent in 1981, and declined again in 1982 by 2 percent. This weakness reduced the growth in personal incomes and spending as unemployment rose from an already high level of 7.1 percent in 1980 to 9.7 percent in 1982.

Housing had been the safe haven for investment in the 1970s as an alternative to the weak stock market and as a hedge against inflation. As shown in table 1, the median house value in the United States between 1970 and 1980 increased by 177 percent in nominal dollars. Even though inflation was rampant, house values still increased by 43 percent in real inflation-adjusted terms. Housing was seemingly the only inflation-proof investment. Nonetheless, in the early years of the 1980s, as a result of prohibitive mortgage rates and weak income growth, housing affordability plummeted. Housing starts fell precipitously from 2.02 million in 1978 to 1.06 million in 1982. These were years of housing disaster—the Dark Ages of America’s housing markets.

However, the national economy began to recover by 1983, spurred by large federal tax cuts. Real GDP increased by 4.3 percent in 1983, by 7.3 percent in 1984, and it continued to grow at or above 3.4 percent annually for the rest of the decade. *This strong economic growth and the accumulation of*

*significant pent-up housing demand from the early 1980s set the stage for a burst in housing demand, production, and prices. Nationally, between 1983 and 1988, private unsubsidized housing construction records were set. Single-family-unit production exceeded 1 million units per year for seven straight years. At the time, it was one of the greatest production runs in housing history.*

Table 3 provides a perspective of the changes in house values from 1983 to date for New Jersey, the United States, New York, and Connecticut. The OFHEO data in table 3 are particularly informative since they measure the change in house prices of the very same single-family properties over time expressed as a House Price Index (HPI). Four periods are defined for each of the three states. For New Jersey, the first is the five-year period of rapidly increasing prices that defined the boom of the 1980s—1983 to 1988. The second measures the price declines from the 1988 peak to the trough of 1991, the low point following the bursting of the housing bubble. The third is the slow and lengthy recovery period between 1991, when home prices started to recover, and 1998, when they finally regained their previous peak value. The final period is the current five-year housing boom from 1998 to 2003. (We have defined both booms as five years in length, leading to the peak housing value, for purposes of comparison across booms and across states.)

To provide a base of comparison for New Jersey, we have used the same benchmark years (and quarters) for the United States. For New York State and Connecticut, the benchmark years are those specific to the house-price movements in those states. The first period for these two states is defined as the five years leading to their peak housing price of the 1980s. The second period measures the price peak to the subsequent trough, while the third starts with the trough and ends with the beginning of the current five-year boom. The five-year boom itself is the final period.<sup>6</sup> Thus, we employ the exact same periods for New Jersey and the United States—

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<sup>6</sup> We have defined the first quarter of 2003 as the end of the most recent five-year boom period. By the second quarter of 2003, all three states had shown a deceleration in the rate of price increase. Second-quarter annual growth rates fell to the lowest level since the fourth quarter of 2000.

**Table 3**  
**House Price Index: New Jersey, United States, New York, and Connecticut**  
**1983–2003**  
*(1980 = 100)*

	Year	Index	Inter-Period Percent Change		
			Period	Total	Compound Annual Rate
<b>New Jersey</b>	3Q 1983	116.57			
	3Q 1988	244.23	1983–1988	109.5 %	15.9 %
	3Q 1991	225.30	1988–1991	-7.8	-2.7
	1Q 1998	247.05	1991–1998	9.7	1.4
	1Q 2003	374.84	1998–2003	51.7	8.7
<b>United States</b>	3Q 1983	116.04			
	3Q 1988	159.41	1983–1988	37.4 %	6.6 %
	3Q 1991	173.21	1988–1991	8.7	2.8
	1Q 1998	209.08	1991–1998	20.7	2.9
	1Q 2003	288.61	1998–2003	38.0	6.7
<b>New York</b>	4Q 1984	161.51			
	4Q 1989	284.37	1984–1989	76.1 %	12.0 %
	1Q 1995	271.78	1989–1995	-4.4	-0.9
	1Q 1998	295.92	1995–1998	8.9	2.9
	1Q 2003	452.65	1998–2003	53.0	8.9
<b>Connecticut</b>	2Q 1983	122.24			
	2Q 1988	269.25	1983–1988	120.3 %	17.1 %
	1Q 1995	219.85	1988–1995	-18.3	-3.0
	1Q 1998	239.05	1995–1998	8.7	2.8
	1Q 2003	344.78	1998–2003	44.2	7.6

Source: Office of Federal Housing Enterprise Oversight, House Price Index

boom, bust, recovery, and boom. The actual peaks and troughs unique to New York and Connecticut define the benchmarks for those states.

It should be pointed out that the United States as a whole encompasses the entire national housing market and can be viewed as the average of the entire array of regional, state, and local submarkets. Thus, the national price index is much less susceptible to the volatility of its individual component submarkets: Increases in one part of the nation are counterbalanced by slowdowns in others. Consequently, the House Price Index rose continuously for the United States over the entire 24-year period.

*The magnitude of the 1980s boom in New Jersey home prices is readily apparent from the 109.5 percent home price increase that occurred during the five-year period between the third quarter of 1983 and the third quarter of 1988, the market peak. On a compound annual basis, New Jersey home prices grew by almost 16 percent per year for five consecutive years. In contrast, home prices nationally rose by only 37.4 percent over this same time span, representing a compound annual growth rate of 6.6 percent. House values in New Jersey over the entire period grew by more than twice the national rate of increase! That type of sustained relative performance certainly qualifies as a "boom" and, as events would ultimately show, a bubble.*

New York and Connecticut both experienced similarly large total increases as well as double-digit annual rates of growth. New York's five-year boom was somewhat smaller (76.1 percent, or 12.0 percent annually) than New Jersey's, while Connecticut's was somewhat larger (120.3 percent, or 17.1 percent annually). These data convey how much faster the Tri-State Region's home prices grew compared to the nation. Housing became the ultimate asset, providing the valuable daily service of shelter and a spectacular and sustained annual rate of return to its owner-occupants. People who owned their own homes during this period seemingly made more money going to sleep at night than they did going to

work during the day. Dual-income households (both spouses working) became three-income households, with the house itself transformed into potent "earner."

But these rates of increase simply were not sustainable. Speculative building, particularly in the condominium market—not reflected in the House Price Index—created significant overcapacity as the decade matured. The stock market collapse of 1987 and the spreading deep recession in the Northeast, centered in the financial, commercial real estate, and construction sectors, brought the good times to a painful end. The developing recession began in the Northeast and was a steeper and longer decline than the national slowdown. *The housing bubble was about to burst. New Jersey home prices peaked in the third quarter of 1988 and then declined through the third quarter of 1991, with a total loss of 7.8 percent, or -2.7 percent on a compound annual basis (table 3). In contrast, national prices continued to rise during this period, although slowly, by 8.7 percent, or by 2.8 percent on an annual basis. New York's House Price Index fell by 4.4 percent (or -0.9 percent annually), while Connecticut's tumbled by a very considerable 18.3 percent (or 3.0 percent annually).*

## Boom Déjà Vu?

**H**ouse values began to recover slowly as the national and regional economies emerged from the 1991 recession. The initial period of economic recovery was weak, as real GDP grew by only 3 percent in 1992 and 2.7 percent in 1993. Moreover, the regional recession lasted until 1992, when a jobless economic recovery ensued. *Consequently, housing faced a long road back. It actually took until the first quarter of 1998, an entire decade later, for New Jersey to fully regain its nominal price peak of 1988!* Table 3 indicates that in the recovery period, from 1991 to 1998, New Jersey's House Price Index grew by only 1.4 percent a year, for a total increase of only 9.7 percent in seven years. *The lesson is that wild*

*housing parties are inevitably followed by prolonged housing hangovers.*

Nationally, house prices increased by 2.9 percent annually over this same time, or by 20.7 percent in total—double the price increases in New Jersey. According to data not presented here, New York regained its previous peak sooner than New Jersey (by the second quarter of 1997), while Connecticut lagged significantly behind both of its neighbors and did not return to its 1989 peak value until the second quarter of 2000. As shown in table 3, however, the total percentage changes for these states during the economic recovery but pre-boom period were less than half that of the United States.

By 1998 a number of factors were converging in the Tri-State Region and in the nation that would contribute greatly to the next surge in house values. First, a significant change in federal tax law in 1997 exempted the first \$500,000 for married couples (\$250,000 for single taxpayers) in realized capital gains from the sale of a primary residence (without buying a unit of greater value). This change injected much-needed liquidity into the housing market. Second, the 1990s stock market boom accelerated in 1997, and high annual capital appreciation in equities occurred for the next three years. During this time, many investors realized significant capital gains, and these gains became another large source of income to support the demand for housing. Then, when the equity markets faltered badly in 2000 and the next several years, the expression “safe as houses” took on new meaning, as investment in housing became a secure refuge from battered capital markets. Third, the Federal Reserve, by aggressively reducing interest rates, bolstered housing following the collapse of both the equity markets and the high-technology capital spending that had sent the national economy into a recession in 2001. This recession, unlike every other post-World War II downturn, was caused by a sharp decline in investment spending rather than the typical cycle of inflation, rising interest rates, and reduced consumer and housing spending. The Federal Reserve reduced interest rates thirteen times

over a two-year period, driving mortgage rates to 45-year lows. As a result, housing helped keep the economy afloat during and after the recession. Finally, the supply of building sites in mature states like New Jersey became more constrained and exerted upward pressure on house prices from the supply side of the market.

All these factors led to strong growth in house prices in New Jersey and the region. *Table 3 shows that New Jersey's home prices rose by 51.7 percent between 1998 and the first quarter of 2003, or by 8.7 percent per year.* This was above the comparable national rates of increase (38 percent and 6.7 percent, respectively, for the same periods). The question, then, is whether the New Jersey price surge is a bubble. There are several reasons that indicate it is not. Certainly, the 8.7 percent annual compound rate of growth for New Jersey in the five-year period between 1998 and 2003 is considerably below the 15.9 percent annual growth rate reached during the five-year boom from 1983 to 1988. In fact, it is barely half. Moreover, in the earlier period, the annual rate of price increase in New Jersey was more than double the national rate. Currently, it is less than one-third higher. *Thus, if the 1980s experience sets the threshold for a bubble—in terms of high general rates of increase and high rates of increase relative to the nation—then the current experience is not a bubble.* What proves elusive is the necessary scale of excess—and, of course, even small bubbles can burst!

The experiences of New York and Connecticut closely paralleled that of New Jersey. New York had the highest annual rate of price increase over the past five years (8.9 percent) compared to 8.7 percent in New Jersey, while Connecticut had the lowest (7.6 percent). All three states outpaced the nation (6.7 percent), but not excessively so.

Table 4 provides annual rates of change over this five-year period. Acceleration in home prices is evident between 1999 and 2003 for the nation as well as for the three states. During that four-year period, the average annual increases in both New Jersey and New York increased to slightly more than

**Table 4**  
**Annual Percentage Change in House Price Index**  
**1998–2003**

	1998–1999	1999–2000	2000–2001	2001–2002	2002–2003
<b>New Jersey</b>	3.6 %	8.6 %	9.7 %	11.2 %	10.5 %
<b>United States</b>	4.6	6.9	8.2	7.1	6.5
<b>New York</b>	4.4	9.3	10.5	10.2	10.1
<b>Connecticut</b>	4.0	7.2	9.3	9.2	8.3

*Note:* Changes measured from first quarter of each year.

*Source:* Office of Federal Housing Enterprise Oversight, House Price Index

10 percent, a rate still far below that of the boom period of 1983–1988.

Further confirmation of the strong housing market during this time is documented in table 5, which provides data on the median sales price of existing single-family homes in New Jersey. The data indicate that the median price rose by 68.8 percent between 1998 and 2003 (second quarter), a figure somewhat greater than that measured by the House Price Index shown in table 3 (51.7 percent). The sharp differences in the level of prices within regions of New Jersey is also apparent, with the median price of existing single-family home sales in the Northern region 118 percent greater than that of the Southern region (\$342,800 versus \$157,300) by the end of the period. Moreover, Central New Jersey had the highest rate of increase (73.7 percent), a pace perhaps somewhat closer to bubble rates of increase.

*In 2001–2002, sales prices in New Jersey increased by 16.6 percent, and by 19.1 percent in Central New Jersey. These rates are certainly comparable to the extreme pace of the 1980s boom. But during the 1980s, such high rates of increase lasted for a full five years. This adds another quandary to the task of bubble determination: How long must the excesses persist? Certainly one year, or even two, does not in itself a bubble make. But if excesses continue beyond some limited time frame, then very real problems may be imminent. Although only second-quarter data are currently available for 2003, it appears that the 2002–2003 rates of increase are starting to decelerate, except for the Southern region.*

The median sales price data further emphasize that there is significant variation across housing submarkets. Just as the Tri-State Region had a bubble within a national “non-bubble” context

**Table 5**  
**Median Price: Sales of Existing Single-Family Houses in New Jersey by Region**  
**1998–2003**

<b>Year</b>	<b>New Jersey</b>	<b>Northern</b>	<b>Central</b>	<b>Southern</b>
1998	\$162,400	\$206,100	\$153,000	\$115,100
1999	166,800	217,800	163,200	115,700
2000	186,700	247,900	172,800	116,100
2001	211,200	273,800	202,200	127,700
2002	246,300	313,398	240,900	137,000
2003 2 <sup>nd</sup> Quarter	274,200	342,800	265,800	157,300
<b>Change: 1998–2003</b>				
Number	\$111,800	\$136,700	\$112,800	\$ 42,200
Percent	68.8 %	66.3 %	73.7 %	36.7 %
<b>Compound Growth Rate</b>				
1998–2003	11.0 %	10.7 %	11.7 %	6.4 %
<b>Annual Growth Rates</b>				
1998–1999	2.7 %	5.7 %	6.7 %	0.5 %
1999–2000	11.9	13.8	5.9	0.3
2000–2001	13.1	10.4	17.0	10.0
2001–2002	16.6	14.5	19.1	7.3
2002–2003 2 <sup>nd</sup> Quarter	11.3	9.4	10.3	14.8
<i>Note:</i> All changes and rates calculated by the authors.				
<i>Source:</i> National Association of REALTORS®				

during the 1980s, so too can local markets within states experience bubbles even when overall state price gains may not be excessive. This possibility still looms large even though we do not have adequate local market data for appropriate evaluation.

## The Sobering Reality of Inflation Adjustment

**A**n additional perspective is secured by adjusting the HPI to account for inflation. By 1998, as shown previously, the HPI finally surpassed the peak it had achieved in 1988 (in nominal dollars).

However, inflation increased by 32.6 percent between 1988 and 1998, according to the CPI-U-RS. (This index calculates past rates of price changes using the current methodology of measuring inflation.)

*Thus, in constant dollar terms, the real house price in New Jersey in 1998 was still 32.6 percent less than in 1988—or nearly one-third lower! It then took four years of strong home price appreciation—between 1998 and 2002—for the inflation-adjusted index to top the peak of 1988, a full 14 years. In this context, the notion of a housing bubble tends to lose credibility, since the post-1998 price surge enabled us only to recover the price declines of 1988–1991 and to keep pace with 14 years of inflation.*

The inflation-adjusted reality of the OFHEO data is reinforced by the census data presented earlier in table 1. New Jersey (-18.0 percent), New York (-12.0 percent) and Connecticut (-26.9 percent) all registered real, constant dollar, home-value declines in the 1990 to 2000 period. All had significant economic ground to recover—Connecticut (\$61,390), New Jersey (\$37,588), and New York (\$20,270)—before their values would match the 1990 real census value peak. This affirms not only the severe regional housing market swings of the past two decades but also the lack of plausibility that the current price advance will turn out to have been a bubble.

## The Uncertain Future

It has often been cynically observed that when your hairdresser or barber gives you tips on what shares to buy during a surging stock market, you can be pretty certain this is a reliable sign that the market has peaked and is ready for a major correction. Similarly, in a time of surging housing prices, a signal of a peaking market is when households observe that they couldn't afford to own the home they're living in if they had to purchase it today. Such anecdotal indicators have a ring of truth to them, but they certainly do not stand as the most reliable of benchmarks.

Nonetheless, our vision of what is to come is still constrained by history. The foundation for most forecasting is overwhelmingly based on historical experience, whatever its level of quantitative sophistication. So even though we have not yet fully invented our housing future, this report's historical review concludes that we are not experiencing a housing bubble at this time, but we may soon be close to approximating one in some local markets.

*Housing nationally is still experiencing the greatest single-family home-production run in history. Between 1992 and 2002, we had 11 straight years in which single-family-unit starts surpassed 1 million units annually, with 2003 destined to extend the "streak."* We have totally obliterated the previous record: the seven straight years set during the 1980s. Our current extraordinary period is still being bulwarked by the baby boom's seemingly insatiable demand for more housing—demand that is not likely to abate soon.

*However, in the long run, housing price increases cannot consistently outstrip growth in housing buying power.* Surrounding the 1980s housing boom was a period of strong relative income growth. Between 1980 and 1988, per capita income in New Jersey surged by 88.0 percent compared to 70.9 percent nationally. In 1980, the state's per capita income was 16 percent higher than that of the nation. By 1988,

it was fully 27 percent higher. Nonetheless, this growth ultimately could not justify the 169.6 percent gain in median house value measured by the Census Bureau between 1980 and 1990 (table 1).

During the 1998 to 2002 period, per capita income grew by 17.5 percent in New Jersey compared to 15.0 percent nationally. While this pushed the state's per capita income to 28 percent higher than the nation, the 17.5 percent increase was only one-third of the 51.7 percent increase in the HPI between 1998 and 2003 (table 3). With housing prices having advanced far faster than income growth during the current home price boom, some apprehension appears to be warranted. *However, declining interest rates have transformed modest income gains into much larger increments of housing buying power, justifying at least part of the home price surge.* Thirty-year fixed-rate mortgage rates were above 8 percent in 2000; by their low point in 2003, they approached 5.5 percent, a 31 percent decline. This translated, by itself, into a 31 percent increase in housing buying power.

But interest-rate declines to levels not seen in 40 years are now themselves history. Even if the recent increase in rates is reversed, there is little possibility of new mortgage-rate lows being broached. Thus, all of the gains in housing purchasing power as a result of interest-rate reductions in the current market probably have been made. From this point forward, income growth will be the major determinant of housing buying power gains. Upward pressure on prices is bound to diminish. How much this will reduce the rate of increase in prices, or even cause them to sag, remains to be seen because so many other elements are also present. These include the strength of the economy and job growth, the potential supply of homes as determined by input costs and the availability of sites, and the rate of household formation. Our conclusion is that the regional housing market is not about to suffer a collapse. The bursting of the housing bubble in 1988 will remain a subject of history, not a predictor of our housing future.

That leaves the question of whether to buy or not to buy. We retreat to the time-proven admonition: Let the buyer beware! ■

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