Chapter 5

Bursting of the Twin Bubbles

I. Introduction

The previous chapter examined the interplay of forces that produced the twin bubbles in house prices and the volume of credit. This chapter looks at the events that transpired as these bubbles deflated rapidly in 2007 and 2008 as house prices fell and the process of deleveraging commenced. The following chapter examines the ways in which the popping of the twin bubbles spilled over to create the lengthiest and most severe U.S. economic contraction since the 1930s.

At some point, probably in 2002 or 2003, the persistently robust increases in house prices evolved into what might reasonably be termed a bubble. People began viewing a home as an investment rather than as simply a place to live. Millions of home owners began trading up to bigger homes or purchasing vacation homes. Fueled by low interest rates, easy access to credit, and herd mentality, speculation became rampant. In some parts of the country, homes were being purchased with the intention not of living in them but rather of reselling them, perhaps in only a few months. By the beginning of 2003, house prices in major U.S. cities were rising at double-digit rates, on average, in spite of very low overall consumer price inflation in the country. By 2004, this inflation rate of house prices was escalating toward 15 percent and more.

At the end of the bubble, house prices peaked in most large U.S. cities in 2006, although these prices continued rising in some cities well into 2007. From January 2000 until the peak, house prices more than doubled in such cities as New York, San Francisco, Phoenix, Las Vegas, Washington, Los Angeles, and Miami, nearly tripling in the latter two cities. The Case-Shiller index of house prices in 20 large metropolitan areas increased by 139 percent in this period. This dramatic increase represents the biggest bubble in house prices in U.S. history.
House prices in large coastal cities, along with those in Phoenix and Las Vegas, increased by the largest relative amount during the bubble. Inflation of house prices in the United States exhibits considerable geographic variation resulting from differences in market conditions. The cost of land is a major ingredient in the determination of house prices, and physical limitations on expansion of building space in such cities as San Francisco, New York, and Miami help explain the relatively high and sharply rising cost of houses in those cities. House prices are much lower and have increased more slowly in cities like Dallas and Atlanta, where land is more plentiful and less expensive. In 2010, after the dust had cleared following the housing boom and bust, the real (inflation-adjusted) price of the typical house in New York and Seattle was more than twice its level a decade earlier. In troubled Detroit, it was approximately half of its 2000 value.

Unfortunately, the good times came to an end in summer 2006 as prices began to decline—slowly at first and then more rapidly. They continued to decline in most cities until spring of 2009, falling about one-third in the nation as a whole and much more than that in numerous cities. This wreaked havoc on millions of homeowners and thousands of financial institutions. It spilled over to result in the most severe U.S. recession since the Great Depression of the 1930s, as detailed in the next chapter.

II. Falling Home Prices and Foreclosures: A Vicious Cycle

In the early portion of the first decade of the new millennium, the Federal Reserve slashed interest rates repeatedly in response to the 2001 recession, the terrorist attacks of September 2001, and the stock market crash of 2000–2002. The federal funds target rate reached 1 percent by mid-2003 and was maintained at this level for about a year. In July 2004, nearly three years after the official end of the 2001 recession, the Fed began boosting the rate. In a series of small increments, the target federal funds rate reached 2 percent in November 2004, 3 percent in May 2005, 4 percent in November 2005, and 5 percent in May 2006.

The implications of this increase in rates for many of those unwary or imprudent borrowers who had taken out adjustable-rate mortgages (ARMs) in the rock-bottom interest rate environment of 2003 and 2004 were disastrous. By the spring of 2006, many were seeing their monthly payments bumped up as the ARMs were reset at higher rates, and by the spring of 2007, the number had turned into a flood. A typical subprime