Rapid rise of Australian house prices have created disagreement between economists on whether a housing bubble currently exists. Brian Birdwell/flickr, CC BY-NC-ND

The b-word is doing the rounds, barely a decade after the United States house price bubble burst spectacularly, setting in motion a global financial crisis. As Australian real estate prices continue to break records, many wonder whether this is sustainable.

Economists disagree on how to define a bubble, or even whether bubbles exist. Intuitively, a bubble (and this applies to any asset, not just real estate) exists when the price of an asset is over-inflated relative to some benchmark. And here's the rub: no one can agree on what that benchmark should be.

The benchmark could be an estimate of the asset's value based on a collection of variables that plausibly affect its supply, demand and price, so-called fundamentals. For houses, these fundamentals include population growth, tax policy, household size, household income, and many others.

But economists cannot agree on what fundamentals determine an asset price, or how important each fundamental is. As well, the value of these fundamentals can only be estimated, not observed. It's subjective to the point that someone will always be able to concoct a story based on fundamentals to rationalise why house prices are at the level they are.

Some economists propose alternative benchmarks to measure a bubble, such as historical long-run averages or an estimate of the underlying value of a trend. If asset prices are greater than these averages or the trend, then we have a bubble. However, this definition is too simplistic because the economy is dynamic, ever evolving, and both long-run averages, as well as trends, do change.

Price hikes and bubbles

It's only when asset prices reach outrageous heights that a majority of people, economists

included, agree that it is overpriced and due for a major correction (a bubble burst). Even then some economists will deny the existence of a bubble.

One of the earliest examples of an asset price bubble was the frenzy in the market for Dutch tulip bulbs in the seventeenth century — the so-called “Tulipmania”. Although the data is patchy and many historians have not exercised great care in retelling the story, there’s little else to explain how prices for Witte Croonen bulbs rose 26-fold in January 1637 and fell to one-twentieth of their peak value in the first week of February.

Yet, well-respected scholar Peter Garber argued that :

The wonderful tales from the tulipmania are catnip irresistible to those with a taste for crying bubble, even when the stories are so obviously untrue. So perfect are they for didactic use that financial moralizers will always find a ready market for them in a world filled with investors ever fearful of financial Armageddon.

Soldiers destroy tulips to reduce supply and stabilise prices following the sudden collapse of tulip prices in seventeenth century Holland. The Tulip Folly (1882) by Jean-Léon Gérôme.Jean-Léon Gérôme/Wikimedia Commons

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Assuming bubbles are a significant gap between the observed asset price and some appropriate benchmark value, the mere existence of this gap begs the question of how it came about. The answers mostly rely on psychology, which is why many economists (looking to represent the world in a mathematical model) struggle with the concept.

Bubble frenzy

Bubbles are ultimately a confidence game, in which the vendor sells the asset to a buyer at a profit, with the latter hoping to do the same in the future. This game relies on a powerful narrative that captures people's imagination and persuades them their turn will be different.

As George Soros, the famous US-Hungarian multi-billionaire hedge fund manager once remarked:

[…] Bubbles don't grow out of thin air. They have a solid basis in reality, but reality as distorted by a misconception.

This misconception is the consequence of human behaviour and traits that depart from the fully rational paradigm so often assumed in formal economics. Instead, as behavioural economists argue, people exhibit a number of biases.

These include, for example, the desire to find information that agrees with their existing beliefs (called confirmation bias) or the tendency to form decisions based on the most readily available information (called availability bias). People experience and seek to resolve their discomfort when they have two or more contradictory beliefs, ideas, or values and they also employ simple abstractions in thinking about complex problems and events (framing).

People are poor intuitive statisticians and care more about avoiding losses than about experiencing gains (called loss aversion). The list of flaws in human behaviour goes on. Moreover, humans, social animals that we are, compete with and emulate our peers, herd like sheep and act on rumours.

Occasionally, all these traits and biases re-enforce each other and send the prices of houses, or shares or whatever, into the stratosphere.

Who's afraid of a bubble?

The bubble itself is rarely a major cause for concern, although young Australian households

looking to purchase their first home will disagree. The problem, of course, is that every bubble eventually pops and this correction is typically violent and painful, for two reasons.

First, asset prices often fall faster than they rise, so the downward correction can destroy value in a very short space of time. And second, most bubbles are fuelled by debt, because the only way a bubble can expand in the later stages is if the demand for the asset is bolstered by debt.

This combination – high debt and falling asset prices – generates a vicious cycle in which distressed debtors scramble to repair their balance sheets and sell their asset. This in turn pushes the price of that asset even lower, causing further distress to similar owners of the asset, and so on.

The pain associated with a bursting bubble varies considerably. Sometimes economies rebound rather quickly from a burst bubble, as was the case after the breath-taking collapse of the dotcom bubble.

However, housing bubbles are in a league of their own. Historically, they have always led to severe recessions, and there is no reason to believe this should change. The next time is not different.

The answers on how to deal with a bubble range from “nothing” to “whatever it takes”. The problem is that no-one (policy makers included) can reliably identify a bubble.

If there is such a thing as a bubble, we will only know for sure when the bubble is already popping. Acting early to prevent a bubble expanding further is risky and unpopular. It’s a brave central banker who raises interest rates in anticipation of an increase in asset prices when the rest of the economy is humming along just fine, or even showing signs of weakness.

So, is Australia in the midst of a housing bubble? I will go out on a limb and answer in the affirmative. There are plenty of arguments why current house prices are exactly where they should be, based on the fundamentals.

But in my opinion these explanations do not pass the smell test: double digit increases in house prices, combined with unprecedentedly high household debt (more than 120% of GDP , the third highest in the world) and household debt servicing ratios (also the third highest in the world), make for a precarious situation. All it takes is a modest change in investor sentiment, a few interest rate hikes, or a noticeable increase in unemployment, and the whole scheme unravels. I hope I'm wrong, but history is on my side.

Timo Henckel received funding from the Centre for International Finance and Regulation. He is chair of CAMA's RBA Shadow Board at the Australian National University.

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