For Sale continued from page 1

my prediction fit the future is that house prices will stabilize, remain more normal, and reduce the loan-to-value ratio. I am not expecting the crash in house prices predicted by pundits who interpret the recent past as evidence of a speculative bubble.

Our Goals and Values continued from page 2

UCSD's economics department continues the tradition of a student-centered learning environment where students are exposed to cutting-edge research and practice-embedded learning opportunities. The department's quality and strength is a result of the commitment of our faculty, our graduate students, and our undergraduate students. UCSD's economics department continues to develop programs that will enable students to thrive and succeed, even during turbulent economic times.

Economics RoundTable

The Economics RoundTable presents: Douglas Holtz-Eakin, Former Chief Economist of the White House Council of Economic Advisors, speaking on “Five Steps Toward American Competitiveness.” During his nearly three years heading the Congressional Budget Office, Holtz-Eakin won a reputation for being fair and candid when discussing tough financial issues. Liberal columnist Mark Shields called him “one of the most intellectually honest men in Washington.” And The Washington Post stated “we are lucky to have so many honest men in Washington.” In 2005, Holtz-Eakin left Congress to serve as the Director of the Maurice R. Greenberg Center for Geoeconomic Studies and the Paul A. Volker Chair in International Economics at the Council on Foreign Relations in Washington, DC. In early 2007, he left the Council to serve as the Economic Policy Chair of Senator John McCain’s Exploratory Committee.

For more information, visit http://econ.ucsd.edu/roundtable/index.shtml or contact Edie Munk at (858) 822-0510, emunk@ucsd.edu or visit http://econ.ucsd.edu/roundtable/index.shtml.

Join us on Wednesday, July 18th, 7:30–9:00 a.m. at the UCSD Faculty Club.

For Sale - Reduced Price - Open House - Is the Boom Over?

Marjorie Flavin

It is impossible to ignore the signs that the superheated housing market of the last five years has come to an end. The literal signs – FOR SALE, REDUCED!, OPEN HOUSE SATURDAY – are the most obvious, but the statistical evidence is also unavoidable: inventories of real estate listings substantially greater, and monthly sales volumes substantially lower, than a year ago. The days of double digit annual appreciation in house prices are gone. However, having noted that the recent boom in the housing market is over, the future course of the real estate market is nevertheless an open question.

A prediction of the future path of house prices depends on our interpretation of the dramatic recent run-up in home values. Since a house is a long-lived asset, like equities or bonds, the market price of a house will be strongly by buyers’ expectations, or forecasts, of what a comparable house would sell for in the future, as well as the buyers’ immediate demand for shelter. While it is not the only factor affecting house prices, this dependence of house prices on expected future house prices implies that the housing market is potentially subject to “bubbles”, or speculative swings in the asset price.

Many media pundits seem to identify any dramatic increase in house prices as a bubble. However, economists reserve the notion of a bubble in an asset price to refer to a situation in which the price of the asset has diverged from its value based on economic fundamentals. To an economist, there is no bubble in house prices even if prices double over a five year period, if the fundamental determinants of the supply and demand for housing have changed sufficiently to understand the increase in house prices. If we interpret the dramatic recent appreciation of house prices as a bubble, that is, a result of speculative transactions not grounded in fundamentals, the current high level of house prices will be enough to burst the bubble. If the current high level of house prices is, because of a bubble, in excess of the level of prices consistent with the fundamentals, we would expect house prices to fall, and possibly fall dramatically. If, on the other hand, the current high level of house prices is consistent with the fundamentals, and current slowdown in the housing market is also explained by fundamentals, we would expect house prices to be flat or rise at a more normal rate of 2% to 5% per year.

A super simple model of the fundamental determination of housing asset’s value can be constructed by thinking of the house as an asset that generates, forever, a return in terms of the market value of the housing services it provides each year. Physical structures do not last forever, of course, but land, which accounts for much of residential real estate values in San Diego, does last forever. To account for the fact that physical structures depreciate over time, assume that the owner pays 3% of the value of the structure each year for maintenance and repairs; assuming that the value of the structure contributes half of the value of the property, an owner pays 1.5% of the real estate value per year to repair the ravages of physical depreciation. In addition, the owner pays 1% of the real estate value as property taxes, and incurs interest expenses equal to the mortgage interest rate times the real estate value, denoted r. (All homeowners incur the interest expense, regardless of whether the interest expense is an explicit expense paid to a mortgage lender or, as in the case of homeowners who own their homes free and clear, the opportunity cost of having their wealth tied up in the form of the house.)

With this stripped down model, the asset value of a home that generates $2,000 worth of housing services per month ($24,000 per year) would be: $24,000/(r + .01 + .015). Holding constant the size of the population and the level of per capita income, a decline in the mortgage interest rate from 8% to 5% would increase the value of the house, according to the fundamentals, from $228,571 to $230,080, or an increase of 40%. Any changes in fundamentals that would have the effect of bidding up the price of housing services (e.g., population growth, higher per capita incomes) would also generate an increase in the value of housing consistent with the fundamentals.

What has happened to the fundamental determinants of housing in the past five years? While new structures can be built, the supply of land is essentially fixed, the demand for housing continues to increase, fueled by both population growth and income growth, and mortgage interest rates have been extraordinarily low by historical standards. Given these fundamentals, it is difficult to imagine that anything other than a huge run up in house prices would have occurred over the recent past.

Changes in the fundamentals can cause a dramatic increase in the price of housing; likewise, the fundamentals can cause house prices to fall. The increase in the rates on variable rate mortgages since a year ago is associated with a decline in the value of housing according to the fundamentals. In my view, the recent boom in housing prices is, for the most part, readily understood in terms of the fundamental determinants of housing prices - interest rates, population growth, income growth - and not the effects of a bubble. With this interpretation of the past,
W e owe a debt of gratitude to our colleague Richard Carson for his devoted stewardship of the department during the past four years. The Department can count many accomplishments of its tenure: a new faculty hiring wave -- extraordinary work recruiting top-notch faculty, a dramatic rise in the department's stature in the academic elite, and a strong engagement of students and policy makers and the local community, to name a few. Added to these is a host of accomplishments that did not make the headline news, but are nonetheless critical to the health of the Department and to the Department of Economics family.

The result is truly a remarkable story of success, infused with the contribution of Richard's experience, wisdom, and fine leadership. Our immediate challenge is to further the department's growth in size and stature, and to manage it within the challenging resource constraints that we face. The Economics Department, and the University as a whole, is a complex organization that, in principle, en- richeres the lives of all its participants: students, faculty, staff, and members of the greater community. An organization such as ours functions best when its participants agree on goals, work in concert implement them, and share in the success.

Research and teaching is, of course, at the center of our work. It is important to me, personally, that each of our faculty has the support to conduct the highest quality research at the frontier of the profession and to provide exceptional instruction for undergraduate and graduate students, which includes engaging students in the process of scientific discovery. In addition, we should always look for new ways of attracting the best faculty members and graduate students.

Two aspects of this endeavor are particularly close to my heart and will receive my special attention as Department Chair. First, we need to make sure that the Department's environment is as positive as possible, so that it can be for our junior faculty members. I reaffirm our commit- ment to provide moral support, guidance, and appropriate resources so that the junior faculty can be productive and thrive. UCSD's Economics Department was largely built from the junior ranks during a difficult decade, as it were, and we are constantly reassessing our strategies to improve the environment and to facilitating their transformation into senior members of the department's faculty. This theme is even more important today.

Second, we must continually work to deliver excellence to the great many undergraduates who take our courses and who major in economics and management science. In this regard, I salute Melissa Famulari, our vice-chair for undergraduate education, for leading the department's effort to redesign its undergraduate curriculum. This massive undertaking has relied on her important and tireless work. Dr. Famulari is also working on other creative ways of en- gaging our undergraduates, including initiating the Undergraduate Economic Society.
New Chair, Same Corner: Our Goals and Values

We owe a debt of gratitude to our colleague Richard Carson for his dedicated stewardship of the department during the past four years. The Department can count many accomplishments to its credit during his tenure: a new chair—extraordinary work recruiting top-notch faculty, a dramatic rise in the department's stature in the academic community, better numbers for our faculty recruitment efforts and policy makers and the local community, to name a few. Added to these is a host of accomplishments that did not make the headlines, but no less important to the future of the Department of Economics family. This theme is even more important now that the Economics Department was largely built from the junior ranks (hiring during the past four years). The Department of Economics is a place where the junior faculty can be productive and thrive. UCSD's immediate challenge is to further the department's growth and increased visibility on the national stage, and to maintain it within the challenging resource constraints that we face. The Economics Department, and the university as a whole, is a complex organization that, in principle, en-riches the lives of all of its participants—students, faculty, staff, and members of the greater community. An organization such as ours functions best when its participants agree on goals, work in concert to implement them, and share in the success.

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General correspondence may also be emailed to: economics@ucsd.edu.
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ECOTOMICS in Action

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Our Goals and Values continued from page 2

UCSD’s economics department has come a long way since I was an undergraduate student here in the mid-1980s. It is gratifying to see that the department’s quality and strengths are more and more being recognized in the rankings. We do face the difficult challenge of trying to increase the number of faculty to keep pace with our rapidly growing undergraduate population, but I look at this as an opportunity to further strengthen the department. In the least, it helps perpetuate the department’s lean-and-hungry spirit, which is one reason why UCSD is such an exciting place to be.

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Of the housing services it provides each year. Physical structures can be constructed by thinking of the house as an asset that generates income, and its value is determined by the present value of that income, discounted at the market interest rate. In mathematical terms, the present value of the future stream of income generated by the house, discounted at the market interest rate, is equal to the market price of the house. This income is composed of the rental income generated by the house and the capital gains realized by the owners as they sell the house at a higher price at a later date.

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With this stripped down model, the asset value of a home that generates $2,000 worth of housing services per month ($24,000 per year) would be: $320,000(1 + r + .01 + .015). Holding constant the size of the population and the level of per capita income, a decline in the mortgage interest rate from 8% to 5% would increase the value of the house, according to the fundamentals, from $228,571 to $320,000, or an increase of 40%. Any changes in fundamentals that would have the effect of bidding up the price of housing services (e.g., population growth, higher per capita incomes) would also generate an increase in the value of housing consistent with the fundamentals.

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