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Running Out of Bubbles

By PAUL KRUGMAN

Remember the stock market bubble? With everything that's happened since 2000, it feels like ancient history. But a few pessimists, notably Stephen Roach of Morgan Stanley, argue that we have not yet paid the price for our past excesses.

I've never fully accepted that view. But looking at the housing market, I'm starting to reconsider.

In July 2001, Paul McCulley, an economist at Pimco, the giant bond fund, predicted that the Federal Reserve would simply replace one bubble with another. "There is room," he wrote, "for the Fed to create a bubble in housing prices, if necessary, to sustain American hedonism. And I think the Fed has the will to do so, even though political correctness would demand that Mr. Greenspan deny any such thing."

As Mr. McCulley predicted, interest rate cuts led to soaring home prices, which led in turn not just to a construction boom but to high consumer spending, because homeowners used mortgage refinancing to go deeper into debt. All of this created jobs to make up for those lost when the stock bubble burst.

Now the question is what can replace the housing bubble.

Nobody thought the economy could rely forever on home buying and refinancing. But the hope was that by the time the housing boom petered out, it would no longer be needed.

But although the housing boom has lasted longer than anyone could have imagined, the economy would still be in big trouble if it came to an end. That is, if the hectic pace of home construction were to cool, and consumers were to stop borrowing against their houses, the economy would slow down sharply. If housing prices actually started falling, we'd be looking at a very nasty scene, in which both construction and consumer spending would plunge, pushing the economy right back into recession.

That's why it's so ominous to see signs that America's housing market, like the stock market at the end of the last decade, is approaching the final, feverish stages of a speculative bubble.

Some analysts still insist that housing prices aren't out of line. But someone will always come up with reasons why seemingly absurd asset prices make sense. Remember "Dow 36,000"? Robert Shiller, who argued against such rationalizations and correctly called the stock bubble in his book "Irrational Exuberance," has added an ominous analysis of the housing market to the new edition, and says the housing bubble "may be the biggest bubble in U.S. history"

In parts of the country there's a speculative fever among people who shouldn't be speculators that seems all too familiar from past bubbles - the shoeshine boys with stock tips in the 1920's, the beer-and-pizza joints showing CNBC, not ESPN, on their TV sets in the 1990's.

Even Alan Greenspan now admits that we have "characteristics of bubbles" in the housing market, but only "in certain areas." And it's true that the craziest scenes are concentrated in a few regions, like coastal Florida and California.

But these aren't tiny regions; they're big and wealthy, so that the national housing market as a whole looks pretty bubbly. Many home purchases are speculative; the National Association of Realtors estimates that 23 percent of the homes sold last year were bought for investment, not to live in. According to Business Week, 31 percent of new mortgages are interest only, a sign that people are stretching to their financial limits.

The important point to remember is that the bursting of the stock market bubble hurt lots of people - not just those who bought stocks near their peak. By the summer of 2003, private-sector employment was three million below its 2001 peak. And the job losses would have been much worse if the stock bubble hadn't been quickly replaced with a housing bubble.

So what happens if the housing bubble bursts? It will be the same thing all over again, unless the Fed can find something to take its place. And it's hard to imagine what that might be. After all, the Fed's ability to manage the economy mainly comes from its ability to create booms and busts in the housing market. If housing enters a post-bubble slump, what's left?

Mr. Roach believes that the Fed's apparent success after 2001 was an illusion, that it simply piled up trouble for the future. I hope he's wrong. But the Fed does seem to be running out of bubbles.

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