Since 1970, residential investment—new home construction—has averaged 4.5% of GDP. Since 1991, its share of GDP has increased 2.5 percentage points. Recent increases in home prices seem to be reflected in this sector’s greater share of output in the past 10 to 15 years. If higher home prices reflect a bubble or changes in demand, then a sharp fall in home prices may cause a sharp fall in investment in this sector and possibly in overall GDP as well.

Is there a bubble in home prices? One sign is the ratio of home prices to income. A rise in this ratio indicates that homes are less affordable, suggesting that a bubble does exist. Since the late 1990s, home prices have indeed risen relative to per capita personal (disposable) income.

Another sign is the ratio of implicit rents to home prices. A low ratio suggests that housing is being held because expected home price appreciation is above average. The fall in the rent/home price ratio since 1995 is consistent with a bubble.

Neither measure accounts for interest rate movements. In the first half of 2000, the 30-year fixed mortgage rate was 8.3%; in the first half of 2005, it fell to 5.7%. Such a drop makes a larger mortgage more affordable at a given income level. The affordability index captures the effect of interest rates, home prices, and income on affordability. The index shows that homes are far more affordable than in the 1980s, although it held fairly constant during the recent run-up in housing prices.

This has caused some to suggest that higher home prices should be expected given the rise in income and the sharp decline in mortgage rates. But the jury is still out on whether home prices are experiencing a bubble.

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**Home Prices**

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**RESIDENTIAL INVESTMENT AS A SHARE OF GDP**

**HOME PRICE/INCOME RATIO AND RENT/HOME PRICE RATIO**

**MORTGAGE RATES**

**HOME AFFORDABILITY INDEX**

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*a. Not seasonally adjusted.*

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