University of Aberdeen Business School

House prices, fundamentals and bubbles

By

Angela Black, Patricia Fraser and Martin Hoesli

Discussion Paper 2006-02
January 2006

Editor: Dr W David McCausland
www.abdn.ac.uk/business/

HOUSE PRICES, FUNDAMENTALS AND BUBBLES

Angela Black[*], *Patricia Fraser*[**] *and Martin Hoesli*[***]

This paper studies actual (real) house prices relative to fundamental (real) house values. Such a focus is warranted since housing constitutes a large fraction of most household portfolios, and its characteristics are such that, in contrast to what prevails in financial markets, arbitrage will be limited and hence correction toward 'true' value is likely to be a prolonged process. Using UK data and a time-varying present value approach, our results preclude the existence of an explosive rational bubble due to non-fundamental factors. We further find that intrinsic bubbles have an important role to play in determining actual house prices although price dynamics appear to impact, particularly in periods of strong deviation from fundamental value. Price dynamics are found to by driven by momentum behaviour.

Key words: real house prices; real disposable income; fundamentals; present value; time-varying risk; bubbles.

JEL Classification Codes: G12, R31, G18.

---

[*] University of Aberdeen Business School, University of Aberdeen, Edward Wright Building, Dunbar Street, Aberdeen AB24 3QK, Scotland, email: angela.j.black@abdn.ac.uk
[**] University of Aberdeen Business School, University of Aberdeen, Edward Wright Building, Dunbar Street, Aberdeen AB24 3QK, Scotland, email: prof.p.fraser@abdn.ac.uk
[***] University of Geneva (HEC and FAME), 40 boulevard du Pont-d'Arve, CH-1211 Geneva 4, Switzerland and University of Aberdeen Business School, University of Aberdeen, Edward Wright Building, Dunbar Street, Aberdeen AB24 3QK, Scotland, email: martin.hoesli@hec.unige.ch