

*Can Easy Credit Explain the Housing Bubble?*

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Between 1996 and 2006, real housing prices rose by 42 percent according to the Federal Housing Finance Agency price index. One explanation of this boom is that it was caused by easy credit in the form of low real interest rates, high loan-to-value levels and permissive mortgage approvals. We revisit the standard user cost model of housing prices and conclude that the predicted impact of interest rates on prices is much lower once the model is generalized to include mean-reverting interest rates, mobility, prepayment, elastic housing supply, and credit-constrained home buyers. The modest predicted impact of interest rates on prices is in line with empirical estimates, and it suggests that lower real rates can explain only one-fifth of the rise in prices from 1996 to 2006. Similarly, changes in approval rates and loan-to-value levels can only explain a modest amount of the increase, although these variables have more of an ability to explain the rise during the shorter period from 2000 to 2005.