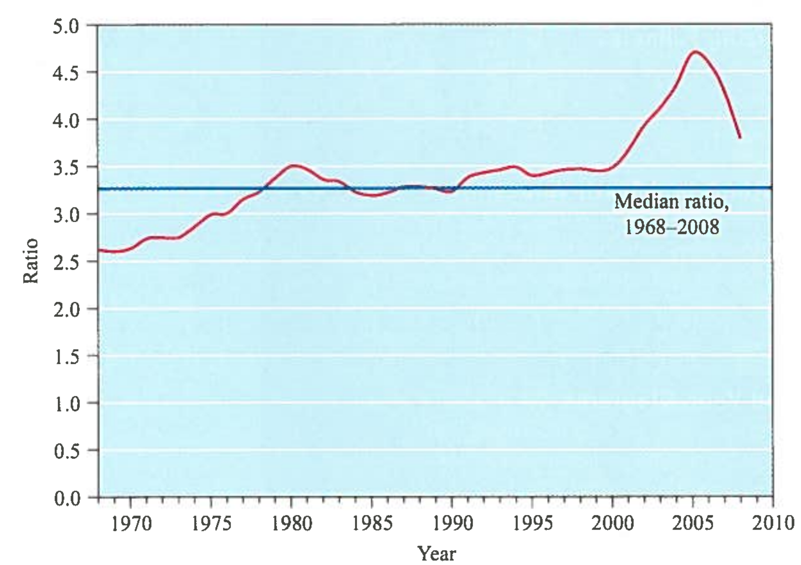
ACTIVITY Bursting Bubble

Use this activity to gain a sense of the kinds of problems this chapter will enable you to study. Try working through it before you begin the chapter, then return to it after you've learned the chapter material.

The deep global recession that began in 2007 was spurred in large part by a collapse in housing prices, which led many homeowners to default on their home mortgages, which in turn created a crisis for banks and other institutions that bought, sold, or insured home mortgages. If we hope to avoid similar crises in the future, a key question is whether there were early warning signs that might have allowed both individuals and policy makers to make decisions that could have prevented the problems before they occurred.

The graph below shows how average (median) home prices have compared to average income over the past four decades. A ratio of 3, for example, means that the average home price is three times the average annual household income of Americans; that is, if you had a household income of $50,000 per year and bought an average house, the price of your house would be $150,000. Notice that the ratio remained below about 3.5 until 2001, when it suddenly started shooting up, which is why the period from 2001 to about 2006 has become known as the *housing bubble*.

Median Home Price/Median Household Income Ratio (1968–2008)



Source: Data from *The State of the Nation's Housing 2009*, used with permission from the Joint Center for Housing Studies of Harvard University. All rights reserved.

Was the change in the home price to income ratio a warning sign that should have been heeded? Use your powers of logic—the topic of this chapter—to discuss the following questions.

1. Consider a family with an annual income of $50,000. If they bought an average home, how much would they have spent in 2000, when the home price to income ratio was 3.5? How much would they have spent in 2005, when the ratio was 4.7?
2. In percentage terms, a rise in the ratio from 3.5 to 4.7 is an increase of nearly 35%. Because the ratio was *below* 3.5 for decades before 2001, we can conclude that the average home was at least 35% more expensive relative to income in 2005 than it had been historically. What can you conclude about how the percentage of income that a family spent on housing changed during the housing bubble? (Note: Ignore changes in mortgage interest rates; although these changes affect affordability, other factors played greater roles during this period.)
3. In general, a family can increase the percentage of their income that they spend on housing only if some combination of the following three things happens: (1) their income increases, so they can afford to spend more of it on housing; (2) they cut expenses in other areas; or (3) they borrow more money. Based on your understanding of the housing crisis, what happened in most cases during the housing bubble?
4. Overall, do you think it was inevitable that the bubble would burst? Why or why not?
5. How could you use the data on the home price to income ratio to help *you* make a decision about how much to spend when you are looking to buy a home?
6. *Bonus:* As home prices rose during the bubble, the optimists claimed that the higher prices could be sustained. Do a bit of Web research to learn how they justified this belief. Do you think their arguments sounded reasonable at the time? Do they still sound reasonable with hindsight?
7. *Additional Research:* The data shown here reflect a nationwide average, but the home price to income ratio varies considerably in different cities and regions. Find data for a few different cities or regions, and discuss the differences.

UNIT 1A Recognizing Fallacies

We often try to persuade other people of our views. These discussions take many different forms, some of which are more useful than others. Consider the following "argument" between two classmates.

Mike: *The death penalty is immoral.*
Erica: *No it isn't.*
Mike: *Yes it is! Judges who give the death penalty should be impeached.*
Erica: *You don't even know how the death penalty is decided.*
Mike: *I know a lot more than you know!*
Erica: *I can't talk to you; you're an idiot!*

> People generally quarrel because they cannot argue.
> —G. K. Chesterton (1874–1936), English author

This type of heated conversation is fairly common, but it accomplishes little. Rather than helping Mike or Erica sway the other, it is likely to leave both of them upset and angry. Fortunately, there is a better way to argue. We can use skills of logic—the study of the methods and principles of reasoning. Arguing logically may not change Mike's or Erica's position, but it can help them understand each other.

In this book, the term **argument** refers to reasoned or thoughtful processes. Specifically, an argument uses a set of facts or assumptions, called premises, to support a conclusion. Some arguments provide strong support for their conclusions, but others do not. An argument that fails to make a compelling case for its conclusion may contain some error in reasoning, or **fallacy** (from the Latin for "deceit" or "trick"). In other words, a fallacious argument tries to persuade in a way that doesn't really make sense when analyzed carefully.