Emergence of Housing Bubbles with Phase Transitions: The Role of Demand-Side Factors[1]

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Abstract

We analyze how equilibrium housing prices are determined along with economic development in an overlapping generations model with perfect housing and rental markets, in which housing prices and rents are both endogenous. We focus on demand-side factors: home buyers' income and the elasticity of substitution between consumption and housing. We characterize the long-run rent growth rate in all equilibria and show that, when this elasticity exceeds one (the empirically relevant case), rents grow more slowly than income. The economy then exhibits a two-stage phase transition in the income ratio of home buyers relative to home sellers. When this ratio is low, only fundamental equilibria exist. Above a first threshold, fundamental and bubbly equilibria coexist and the outcome is selected by self-fulfilling expectations. Above a second threshold, fundamental equilibria cease to exist and housing bubbles are necessary for equilibrium. We further prove that the fundamental equilibrium is always unique and the bubbly equilibrium is unique whenever the elasticity of intertemporal substitution is not far below 1/2. Uniqueness lets us study expectation-driven booms: if agents anticipate future income growth, housing prices rise and contain a bubble today even when current incomes lie in the fundamental region, with the price-income and price-rent ratios rising together. Finally, contrary to the common understanding that land eliminates dynamic inefficiency in overlapping generations models, we show that inefficient equilibria arise robustly, and only for intermediate income ratios.

Keywords: bubble, demand-side factors, expectations, housing, phase transition, rent, unbalanced growth.

JEL codes: D53, G12, R21.

1 Introduction

Over the past three decades, many countries have experienced sustained housing-price appreciation together with rising price-rent ratios.[1] Such episodes are often described as housing bubbles. Yet a rising price-rent ratio does not by itself establish that housing is overvalued, and existing theory offers limited guidance on when prices can deviate from fundamentals. Housing is a dividend-paying real asset: a unit of housing yields rental services, and the price of those services responds endogenously to income and housing demand. Theory faces a basic obstacle: rational bubbles are difficult to sustain on dividend-paying assets such as housing, land, and equity (see §1.1 Related literature for details). What remains missing is a tractable framework that jointly determines prices and rents, characterizes rent growth across equilibria, and establishes when a rational housing bubble is possible or necessary.

This paper develops such a framework. We focus on demand-side forces—home buyers' income and the elasticity of substitution between consumption and housing—rather than the supply-side forces emphasized in Hirano and Toda (2025a,c), such as productivity and the elasticity of substitution in production. We ask three questions. First, when can or must equilibrium housing prices exceed their fundamental value when prices and rents are both endogenous? Second, how do home buyers' income, access to credit, and expectations about future economic development determine whether housing prices reflect fundamentals or contain a bubble? Third, what are the welfare properties of these equilibria?

We study a two-period overlapping generations economy with a fixed housing stock and competitive, frictionless markets for both housing ownership and rental services. Each unit of housing produces a flow of housing services, and ownership and occupancy can be traded separately. The young are the natural home buyers and the old are the home sellers, so the income of the young relative to the old measures buyers' purchasing power relative to sellers'. Both the housing price and rent are endogenous. We call an equilibrium *fundamental* if the housing price equals the present value of rents and *bubbly* if it exceeds that value. Because economic growth raises the demand for housing services and therefore rents, an increase in the housing price does not mechanically imply a bubble. The central question is whether the price can or must outgrow rents despite

[1]See, for instance, Figure 1 of Amaral et al. (2024) for 27 major agglomerations in 15 OECD countries and U.S. Metropolitan Statistical Areas. Figure 1 of Bäcker-Peral et al. (2025), who exploit a natural experiment arising from long-term lease renewal in the U.K., documents a downward trend in housing yields.

the endogeneity of housing's dividend.

We obtain three main results. First, we identify the theoretical mechanism of generating housing bubbles, which crucially depends on demand-side factors for housing, namely the income of home buyers and the elasticity of substitution between consumption and housing. We prove that the economy experiences a *two-stage phase transition* in the process of economic development, which is captured by the long-run income ratio of the young (home buyers) relative to the old (home sellers). When the income ratio is sufficiently low, housing bubbles cannot arise, and a fundamental equilibrium exists, which we refer to as the *fundamental regime*. When the income ratio rises and exceeds the first critical value, a phase transition occurs.[2] Both a fundamental and a bubbly equilibrium exist, and the equilibrium is selected by agents' self-fulfilling expectations. We refer to this coexistence region as the *bubble possibility regime*. When the income ratio exceeds the second (and higher) critical value, another phase transition occurs to the *bubble necessity regime*, where fundamental equilibria do not exist, and housing bubbles become inevitable. Furthermore, we prove the uniqueness of equilibrium under weak conditions. We show that the fundamental equilibrium is always unique, and the bubbly equilibrium is unique if the elasticity of intertemporal substitution is not too much below $1/2$.

The two-stage transition is most transparent in terms of two interest-rate thresholds. Let $G > 1$ denote the long-run growth rate of the economy and let $\gamma > 0$ be the reciprocal of the elasticity of substitution between consumption and housing. In the empirically relevant case $\gamma < 1$,[3] Theorem 2 shows that rent grows at the rate $G^\gamma < G$ in every equilibrium. In a fundamental long-run equilibrium, the housing price must therefore also grow at G^γ. Housing expenditure then becomes negligible relative to income, so the interest rate converges to the marginal rate of intertemporal substitution at the autarkic allocation; denote this rate by R. As home buyers become richer relative to home sellers, R falls. The first transition occurs when R falls below G. A persistent bubble must grow at the same rate as the economy in the long run: it cannot grow faster than buyers' income, while a bubble growing more slowly would become asymptotically

[2] *Phase transition* is a technical term in the natural sciences that refers to a discontinuous change in the state as we continuously change a parameter. For instance, as we increase the temperature, the matter (e.g., H_2O) changes from solid (ice) to liquid (water) to gas (vapor). The analogy here is appropriate because the economy's regime abruptly shifts from fundamental to bubbly as income rises.

[3] Ogaki and Reinhart (1998, Table 2) estimate the elasticity of substitution between durable and nondurable goods using aggregate data and obtain $\gamma = 1/1.24 = 0.81$. Piazzesi et al. (2007, Appendix C) estimate a cointegrating equation between the price and quantity of housing service relative to consumption using aggregate data and obtain $\gamma = 1/1.27 = 0.79$. Howard and Liebersohn (2021, Table 2) estimate $\gamma = 0.79$ using cross-sectional data on income and rents. Appendix C shows that $\gamma = 1$ is knife-edge and $\gamma > 1$ produces counterfactual long-run behavior.

negligible. A bubbly long-run equilibrium therefore becomes possible when $R < G$. The second transition occurs when R falls below G^{γ}. A fundamental equilibrium would then value a stream of rents growing faster than the rate at which it is discounted, implying an infinite fundamental value and hence no finite equilibrium housing price. Because $G^{\gamma} < G$, the intermediate region $G^{\gamma} < R < G$ supports both fundamental and bubbly long-run equilibria, whereas $R < G^{\gamma}$ implies that every equilibrium is bubbly. Along a bubbly long-run path, the housing price grows at G while rent grows at G^{γ}, so the rental yield vanishes asymptotically and returns are dominated by capital gains.

The second main result concerns expectations and transitional dynamics. Because future equilibrium conditions determine current housing values through backward induction, news about future income affects prices before current fundamentals change. Suppose, for example, that home buyers' current relative income lies in the fundamental regime but agents learn that it will rise persistently into a region supporting a bubbly equilibrium. The housing price rises immediately and already contains a bubble, even before income changes. During the transition, the housing price can grow faster than both current income and rent, so the price-income and price-rent ratios rise together. If beliefs about future income subsequently reverse, the bubble collapses immediately, again before current income changes. Under our determinacy condition, this expectation-driven boom and collapse is the unique equilibrium transition path.

Third, we revisit dynamic efficiency in economies with productive non-reproducible assets. The Diamond (1965) model can exhibit dynamic inefficiency, whereas McCallum (1987) shows that introducing land eliminates it under balanced growth, a result that has supported the common view that land restores efficiency in overlapping generations economies (Mountford, 2004). Our analysis shows that this conclusion need not extend to unbalanced growth. Dynamically inefficient fundamental equilibria arise robustly even though housing is a productive, non-reproducible asset. Moreover, among the long-run equilibria we characterize, inefficiency is non-monotone in home buyers' relative income: equilibria are efficient in the fundamental regime; the fundamental equilibrium is inefficient while the bubbly equilibrium is efficient in the bubble possibility regime; and bubbly long-run equilibria are efficient in the bubble necessity regime. Dynamic inefficiency therefore arises only at intermediate income ratios.

The benchmark mechanism also extends naturally. External credit raises home buyers' available funds and can move an economy into a bubbly regime even when buyers' own income is low; once a bubbly equilibrium exists, additional credit is capitalized one-for-one into the long-run housing price. With multiple saving vehicles, the distribution of the bubble across individual assets may be indeterminate, but its total size and the associated macroeconomic allocation remain determinate. The theory also yields testable implications: housing bubbles should be more likely when the income or credit available to home buyers is high or expected to rise, and a bubbly long-run path should feature a rising price-rent ratio.

To our knowledge, this paper is the first to generate bubbles attached to a dividend-paying real asset through demand-side forces while determining the asset's dividend endogenously. The model is deliberately bare-bones, but it isolates a mechanism that can serve as a foundation for richer theoretical, empirical, and quantitative analyses.

1.1 Related literature

Our paper contributes to the literatures on housing valuation and rational bubbles. Quantitative housing models, reviewed by Piazzesi and Schneider (2016), seek to account for housing prices through fundamentals. For instance, Sommer et al. (2013) jointly determine house prices and rents in a quantitative housing model and study how income, interest rates, and lending standards affect the price-rent ratio. Their objective is to account for valuation movements through fundamentals; ours is to characterize when the equilibrium price can or must exceed the present value of endogenous rents. In contrast, we adopt the standard rational bubble concept developed by Samuelson (1958), Bewley (1980), Tirole (1985), Scheinkman and Weiss (1986), Kocherlakota (1992), and Santos and Woodford (1997), under which a bubble is the component of an asset's price not backed by the present value of its dividends. Further theoretical foundations and applications include Huang and Werner (2000), Caballero and Krishnamurthy (2006), Bloise and Citanna (2019), Brunnermeier, Merkel, and Sannikov (2024), Allen, Barlevy, and Gale (2025), Barlevy (2025), and Sorger (2025), among others.[4]

A central obstacle in rational bubble theory is the sharp distinction between zero-dividend and dividend-paying assets. Santos and Woodford (1997, Theorem 3.3 and Corollary 3.4) show that bubbles are impossible when an asset's dividends remain non-negligible relative to aggregate endowment. Kocherlakota (2008) and Werner (2014) extend this impossibility result to environments with alternative financial constraints.

[4]See Hirano and Toda (2024a) for a recent review of rational bubble theory. Brunnermeier and Oehmke (2013) survey the broader bubble literature, including models based on heterogeneous beliefs (Scheinkman and Xiong, 2003; Fostel and Geanakoplos, 2012), asymmetric information (Abreu and Brunnermeier, 2003; Barlevy, 2014; Allen et al., 2022), and liquidity (Branch et al., 2016; Lagos et al., 2017). See Hirano and Toda (2025b) for a discussion of distinctions among these approaches.

This obstacle helps explain why much of the literature studies pure bubble assets, such as fiat money or intrinsically worthless securities, rather than bubbles attached to real assets with positive dividends.[5]

Several papers study rational housing bubbles, including Caballero and Krishnamurthy (2006), Kocherlakota (2009, 2013), Arce and López-Salido (2011), Zhao (2015), and Chen and Wen (2017). In these models, however, either housing does not produce housing services or a rental market is absent. Housing therefore pays no rent and has a zero fundamental value, making it economically equivalent to a pure bubble asset. Moreover, most of these papers use logarithmic utility. In our model, logarithmic utility corresponds to the knife-edge case $\gamma = 1$, under which positive rents and housing prices grow at the same rate and a housing bubble cannot arise (Appendix C.2). Appendix C.2 shows that, in our environment, logarithmic utility rules out a bubble once rents are positive; the zero-rent assumption is therefore substantive. Our analysis therefore highlights two distinctions that are essential for housing: positive endogenous rents and an elasticity of substitution between consumption and housing that need not equal one.

Only a small literature attaches bubbles to assets with positive dividends, let alone establishes the necessity of bubbles and the uniqueness of bubbly equilibrium. Wilson (1981, §7) provides an early general equilibrium example.[6] Tirole (1985, Proposition 1(c)) argues that a bubble on a dividend-paying asset may be necessary when the bubbleless interest rate lies below the dividend growth rate. Tirole assumes an exogenous, constant dividend in the Diamond (1965) production economy. By contrast, both housing prices and rents are endogenous in our model, so one must first determine whether the price can outgrow rent. In addition, Pham and Toda (2026) show that Tirole's Proposition 1(c) is not valid as stated by constructing an economy satisfying its assumptions whose unique equilibrium is bubbleless. Finally, Tirole's mechanism operates through supply-side production forces, whereas ours operates through home buyers' income and demand for housing.

The closest papers to ours are Hirano and Toda (2025a) and Hirano and Toda (2025c). The former develops the concept of bubble necessity in modern macro-finance models, including overlapping generations and Bewley-type infinite-horizon economies. The latter proves a bubble necessity result with aggregate risk when land is a factor of production

[5]Pure-bubble models are useful for studying money and cryptocurrencies, but they have important limitations as descriptions of bubbles attached to real assets. See Hirano and Toda (2024a, §4.7) and Barlevy (2018, 2025).

[6]See Hirano and Toda (2025a, Example 1) for further discussion. Allen, Barlevy, and Gale (2017) provide a closely related example.

and productivity and the elasticity of substitution in production satisfy suitable conditions. We build on their bubble necessity logic (see, for example, Lemma B.2) but differ in several respects. First, our mechanism is demand-side: the key forces are home buyers' relative income and the elasticity of substitution between consumption and housing, rather than productivity and substitution in production.[7] Second, rents are endogenous. We characterize their long-run growth rate in every equilibrium (Theorem 2) and show how the bubble necessity condition emerges endogenously. Third, we characterize the long-run dynamics and establish determinacy and uniqueness, which allow us to analyze expectation-driven booms and collapses. Finally, the regime structure produces implications for welfare, credit, multiple assets, and empirical tests.

Our mechanism is also related to the literature on structural transformation and unbalanced growth (Baumol, 1967; Matsuyama, 1992; Acemoglu and Guerrieri, 2008; Buera and Kaboski, 2012; Fujiwara and Matsuyama, 2024). That literature distinguishes demand-side forces rooted in preferences from supply-side forces rooted in production (Acemoglu, 2009, §21.1–21.2). Unbalanced growth in our model is demand-driven. The key difference is that the structural-transformation literature generally abstracts from asset prices, whereas we show that unbalanced growth has first-order asset-pricing implications: it determines whether the price of a dividend-paying real asset can or must become disconnected from its dividend.

2 Model

2.1 Primitives

Time is discrete and indexed by $t = 0, 1, \dots$. We consider a deterministic overlapping generations (OLG) economy in which agents live for two periods (young and old age) and demand a consumption good and housing service. We employ an OLG model because it allows us to capture life-cycle behaviors regarding housing demand in a simple setting.

Commodities, asset, and endowments There are two perishable commodities (consumption good and housing service) and a durable non-reproducible asset (housing stock) in the economy. The housing service is the right to occupy a housing unit between two periods. Every period, one unit of housing stock inelastically produces one unit of hous-

[7] In addition, Hirano and Toda (2025c) impose Cobb-Douglas utility and zero income for the old for analytical tractability, whereas our preferences and endowments are more general.

ing service. The time t endowment of the consumption good is $e_t^y > 0$ for the young and $e_t^o > 0$ for the old. At $t = 0$, the housing stock (whose aggregate supply is normalized to 1) is owned by the old.

Preferences An agent born at time t lives for two periods and has utility function $U(c_t^y, c_{t+1}^o, h_t)$, where $c_t^y > 0$ is consumption when young, $c_{t+1}^o > 0$ is consumption when old, and $h_t > 0$ is housing service consumed when transitioning from young to old. As usual, we assume that $U : \mathbb{R}^3_{++} \to \mathbb{R}$ is continuously differentiable, has strictly positive first partial derivatives, is strictly quasi-concave, and satisfies Inada conditions to guarantee interior solutions. The initial old care only about their consumption c_0^o.

Markets We consider an ideal world in which the ownership and occupancy of housing are separated and traded in competitive, frictionless markets: agents trade housing (a financial asset) only to store value (transfer resources across time), whereas they purchase housing service (a commodity) only to derive utility.[8]

Let r_t be the price of housing service (rent) and P_t be the housing price (excluding current rent) quoted in units of date-t consumption. Let x_t denote the demand for the housing stock. Then the budget constraints of generation t are

$$\text{Young:} \qquad c_t^y + P_t x_t + r_t h_t \leq e_t^y, \tag{2.1a}$$

$$\text{Old:} \qquad c_{t+1}^o \leq e_{t+1}^o + (P_{t+1} + r_{t+1}) x_t. \tag{2.1b}$$

The budget constraint of the young (2.1a) states that the young spend income on consumption, purchase of housing stock, and rent. The budget constraint of the old (2.1b) states that the old consume the endowment and the income from renting and selling housing.

Equilibrium As usual, an equilibrium is defined by individual optimization and market clearing.

Definition 1. A *rational expectations equilibrium* consists of a sequence of prices $\{(P_t, r_t)\}_{t=0}^\infty$ and allocations $\{(c_t^y, c_t^o, h_t, x_t)\}_{t=0}^\infty$ such that for each t, (i) (Individual optimization) the

[8]Therefore, nothing prevents agents from purchasing a mansion as an investment while renting a campsite to sleep, or vice versa. Owner-occupants can be thought of as agents who rent the houses they own to themselves. However, because in our model agents within a generation are homogeneous, in equilibrium each young agent demands one unit of housing and one unit of housing service, so the agents end up being owner-occupants.

young maximize utility $U(c_t^y, c_{t+1}^o, h_t)$ subject to the budget constraints (2.1), (ii) (Commodity market clearing) $c_t^y + c_t^o = e_t^y + e_t^o$, (iii) (Rental market clearing) $h_t = 1$, (iv) (Housing market clearing) $x_t = 1$.

Note that because the old exit the economy, the young are the natural buyers of housing, which explains the housing market clearing condition $x_t = 1$.

2.2 Equilibrium and housing bubble

We characterize the equilibrium and define housing bubbles. Using the rental and housing market clearing conditions $h_t = x_t = 1$ and the budget constraint (2.1), we obtain

$$(c_t^y, c_t^o) = (e_t^y - P_t - r_t, e_t^o + P_t + r_t) = (e_t^y - S_t, e_t^o + S_t), \tag{2.2}$$

where $S_t := P_t + r_t$ is total expenditure on housing. Throughout the paper, we refer to P_t as the *housing price* and S_t as the *housing expenditure*. Let

$$R_t := \frac{P_{t+1} + r_{t+1}}{P_t} = \frac{S_{t+1}}{P_t} \tag{2.3}$$

be the implied gross risk-free rate between time t and $t+1$. Then the two budget constraints in (2.1) can be combined into one as

$$c_t^y + \frac{c_{t+1}^o}{R_t} + r_t h_t \leq e_t^y + \frac{e_{t+1}^o}{R_t}. \tag{2.4}$$

In what follows, to simplify notation, we often use (y, z) in place of (c^y, c^o) and hence write $U(y, z, h)$ instead of $U(c^y, c^o, h)$.[9] Letting $\lambda_t \geq 0$ be the Lagrange multiplier associated with the combined budget constraint (2.4), we obtain the first-order conditions

$$(U_y, U_z, U_h) = \lambda_t(1, 1/R_t, r_t), \tag{2.5}$$

where we use the shorthand for partial derivatives $U_y := \partial U/\partial y$, $U_z := \partial U/\partial z$, and $U_h := \partial U/\partial h$, which are evaluated at

$$(y, z, h) = (e_t^y - S_t, e_{t+1}^o + S_{t+1}, 1). \tag{2.6}$$

[9]The mnemonic is that y is the first letter of “young” and z is the next letter of the alphabet.

Using (2.5), we obtain $1/R_t = U_z/U_y$ and $r_t = U_h/U_y$. Combining these two equations, the definition of R_t in (2.3), and $S_t = P_t + r_t$, we obtain

$$S_{t+1}U_z = S_t U_y - U_h, \tag{2.7}$$

where the partial derivatives of U are evaluated at (2.6). The following theorem establishes the existence of equilibrium and characterizes equilibrium quantities.

Theorem 1 (Existence and characterization of equilibrium)**.** *The following statements are true.*

(i) A rational expectations equilibrium exists.

(ii) An equilibrium has a one-to-one correspondence with the sequence $\{S_t\}_{t=0}^{\infty}$ *satisfying* $0 < S_t < e_t^y$ *and the nonlinear difference equation* (2.7).

(iii) The equilibrium quantities are given by

$$(c_t^y, c_t^o) = (e_t^y - S_t, e_t^o + S_t), \tag{2.8a}$$

$$P_t = S_t - (U_h/U_y)(e_t^y - S_t, e_{t+1}^o + S_{t+1}, 1), \tag{2.8b}$$

$$r_t = (U_h/U_y)(e_t^y - S_t, e_{t+1}^o + S_{t+1}, 1), \tag{2.8c}$$

$$R_t = (U_y/U_z)(e_t^y - S_t, e_{t+1}^o + S_{t+1}, 1). \tag{2.8d}$$

Proof. The existence of equilibrium is standard (Balasko and Shell, 1980) and follows from the same argument as the proof of Hirano and Toda (2025a, Theorem 1). The equilibrium quantities (2.8) follow from the preceding argument. □

By Theorem 1, an equilibrium is fully characterized by the sequence of housing expenditures $\{S_t\}_{t=0}^{\infty}$. For this reason, we often refer to $\{S_t\}_{t=0}^{\infty}$ as an equilibrium without specifying each object in Definition 1.

Following the standard definition of rational bubbles in the literature, we say there is a housing bubble if the housing price exceeds its fundamental value defined by the present value of rents. (See Appendix B for a self-contained exposition.) Let $R_t > 0$ be the equilibrium gross risk-free rate. Let $q_t > 0$ be the Arrow-Debreu price of date-t consumption in units of date-0 consumption, so $q_0 = 1$ and $q_t = 1/\prod_{s=0}^{t-1} R_s$. The *fundamental value* of housing is the present value of rents

$$V_t := \frac{1}{q_t} \sum_{s=t+1}^{\infty} q_s r_s. \tag{2.9}$$

Definition 2. A rational expectations equilibrium is *fundamental* if $P_t = V_t$ for all t and *bubbly* if $P_t > V_t$ for all t.

Appendix B shows that an equilibrium is either fundamental or bubbly.

2.3 Additional assumptions

To make qualitative predictions, we put more structure by specializing the utility function and endowments.

Assumption 1 (Endowments)**.** *There exist $G > 1$, $e_1, e_2 > 0$, and $T > 0$ such that the endowments are $(e_t^y, e_t^o) = (e_1 G^t, e_2 G^t)$ for $t \geq T$.*

Assumption 1 implies that in the long run, the economy exogenously grows at the rate $G > 1$ and the young-to-old income ratio is constant. We assume exogenous growth of endowments and a fixed supply of housing (which can also be interpreted as residential land) as the simplest benchmark to illustrate the key mechanism of housing bubbles.[10]

Assumption 2 (Utility)**.** *The utility function takes the form*

$$U(y, z, h) = u(c(y, z)) + mu(h), \tag{2.10}$$

where (i) the composite consumption $c(y, z)$ is homogeneous of degree 1 and quasi-concave, (ii) the utility of composite consumption/housing service is $u(c) = \frac{c^{1-\gamma}}{1-\gamma}$ for some $\gamma > 0$ ($u(c) = \log c$ if $\gamma = 1$), and (iii) $m > 0$ is a marginal utility parameter.

Assumption 2(i) implies that agents (apart from the initial old) care about consumption (c^y, c^o) only through the homothetic composite consumption $c(c^y, c^o)$, which (together

[10]In Figure 5 of Appendix D, we document empirical evidence that economic growth is faster than the growth of housing supply. In reality, due to zoning and land-use regulations, the supply of residential land is limited. Knoll, Schularick, and Steger (2017) provide evidence from 14 advanced economies that residential land prices, rather than construction costs, play a key role in explaining housing price booms. Glaeser and Gyourko (2018) and Glaeser, Gyourko, and Saks (2005) emphasize the role of supply constraints in accounting for the dynamics of housing prices. It would be straightforward to extend the model to include endogenous growth, as studied in Hirano, Jinnai, and Toda (2022), and variable housing supply by introducing the construction of new housing as in Toda (2025b).

with Assumption 1) allows us to study asymptotically balanced growth paths. Assumption 2(ii) implies that agents have constant elasticity of substitution $1/\gamma > 0$ between consumption and housing service.[11]

Throughout the main text, we focus on the case $\gamma < 1$ (so the elasticity of substitution between consumption and housing $1/\gamma$ exceeds 1) and defer the analysis of the case $\gamma \geq 1$ to Appendix C. There are three reasons for doing so. First, $\gamma < 1$ is the empirically relevant case (Footnote 3). Second, $\gamma = 1$ is a knife-edge case. Third, as we show in Proposition C.1, the equilibrium with $\gamma > 1$ is pathological and counterfactual: the young asymptotically spend all income on housing (purchase and rent); the price-rent ratio converges to zero; and the gross risk-free rate diverges to infinity. Hence the case $\gamma > 1$ is economically irrelevant.

Since by Assumption 2(i) c is homogeneous of degree 1 and quasi-concave, Theorem 11.14 of Toda (2025a, p. 158) implies that c is actually concave. Because we wish to study smooth interior solutions, we further strengthen the assumption on utility as follows.

Assumption 3 (Composite consumption)**.** *The composite consumption* $c : \mathbb{R}^2_{++} \to (0, \infty)$ *is homogeneous of degree 1, twice continuously differentiable, and satisfies* $c_y > 0$, $c_z > 0$, $c_{yy} < 0$, $c_{zz} < 0$, $c_y(0, z) = \infty$, $c_z(y, 0) = \infty$.

A typical functional form for c satisfying Assumption 3 is the constant elasticity of substitution (CES) specification

$$c(y,z) = \begin{cases} ((1-\beta)y^{1-\sigma} + \beta z^{1-\sigma})^{\frac{1}{1-\sigma}} & \text{if } 0 < \sigma \neq 1, \\ y^{1-\beta} z^{\beta} & \text{if } \sigma = 1, \end{cases} \tag{2.11}$$

where $1/\sigma$ is the elasticity of intertemporal substitution and $\beta \in (0, 1)$ dictates time preference.

3 Housing prices in the long run

In this section, we study the long-run behavior of equilibrium housing prices.

[11]The functional form (2.10) implies that we first aggregate young and old consumption, and then housing service. Our main results are not affected if we change the utility function to $U(y, z, h) = c(u^{-1}(u(y) + mu(h)), z)$ so that we first aggregate young consumption and housing service, and then old consumption.

3.1 Long-run properties of equilibria

We present two results that are crucial for the subsequent analysis.

Lemma 3.1 (Backward induction)**.** *Suppose Assumptions 2 and 3 hold. If $\mathcal{S}_T = \{S_t\}_{t=T}^\infty$ is an equilibrium starting at $t = T$, there exists a unique equilibrium $\mathcal{S}_0 = \{S_t\}_{t=0}^\infty$ starting at $t = 0$ that agrees with $\mathcal{S}_T$ for $t \geq T$.*

Lemma 3.1 shows that once we establish the existence of equilibrium starting at $t = T$, we may uniquely extend the equilibrium path backward in time, which allows us to focus on the long-run behavior of the economy and guarantees the uniqueness of the transitional dynamics. Since by Assumption 1 the endowments eventually grow at a constant rate G, unless otherwise stated, without loss of generality we assume that endowments are $(e_t^y, e_t^o) = (e_1 G^t, e_2 G^t)$ for all t.

In our model, housing rents are endogenous, unlike the setting in Hirano and Toda (2025a). To apply the Bubble Necessity Theorem (Lemma B.2), we need to characterize the long-run rent growth rate. The following theorem, which is the main technical contribution of this paper, exactly achieves this.

Theorem 2 (Long-run rent growth)**.** *Suppose Assumptions 1–3 hold and $\gamma < 1$. Then in any equilibrium, the long-run rent growth rate is*

$$G_r \coloneqq \limsup_{t\to\infty} r_t^{1/t} = G^\gamma. \tag{3.1}$$

The intuition for Theorem 2 is the following. Since endowments grow at the rate G and the elasticity of substitution between consumption and housing service is $1/\gamma$, the marginal rate of substitution (which equals rent) must grow at the rate G^γ. Of course, the proof is not straightforward because Theorem 2 refers to *any* equilibrium.[12]

We next define the long-run equilibrium. By Assumption 2, the equilibrium dynamics (2.7) becomes

$$S_{t+1} c_z = S_t c_y - m c^\gamma, \tag{3.2}$$

where c, c_y, c_z are evaluated at $(y, z) = (e_t^y - S_t, e_{t+1}^o + S_{t+1})$. To study asymptotically balanced growth paths, let $s_t \coloneqq S_t / e_t^y = S_t/(e_1 G^t)$ be the housing expenditure normalized

[12]For readers who are curious but do not wish to read the proof, we provide a brief explanation. We first prove the intermediate result $\liminf G^{-t} S_t < e_1$, implying that the young's saving rate is strictly positive. To prove this by contradiction, assume $\liminf G^{-t} S_t \geq e_1$ and hence $G^{-t} S_t \to e_1$ (because $G^{-t} S_t \leq e_1$ necessarily by the budget constraint). Then we can show that the equilibrium is *simultaneously* bubbly and fundamental, which is impossible. The rest of the proof is straightforward.

by the income of the young. Since c is homogeneous of degree 1, its partial derivatives c_y, c_z are homogeneous of degree 0. Therefore, dividing both sides of (3.2) by $e_1 G^t$, we obtain

$$G s_{t+1} c_z = s_t c_y - m e_1^{\gamma-1} G^{(\gamma-1)t} c^\gamma, \tag{3.3}$$

where c, c_y, c_z are evaluated at $(y, z) = (1 - s_t, G(w + s_{t+1}))$ for the old-to-young income ratio $w := e_2/e_1$.

When $\gamma < 1$, the difference equation (3.3) explicitly depends on time t (is non-autonomous), which is inconvenient for analysis. To convert it to an autonomous system, define the auxiliary variable $\xi_t = (\xi_{1t}, \xi_{2t})$ by $\xi_{1t} = s_t = S_t/(e_1 G^t)$ and $\xi_{2t} = e_1^{\gamma-1} G^{(\gamma-1)t}$. Then the one-dimensional non-autonomous nonlinear difference equation (3.3) reduces to the two-dimensional autonomous nonlinear difference equation $\Phi(\xi_t, \xi_{t+1}) = 0$, where

$$\Phi_1(\xi, \eta) = G\eta_1 c_z - \xi_1 c_y + m c^\gamma \xi_2, \tag{3.4a}$$

$$\Phi_2(\xi, \eta) = \eta_2 - G^{\gamma-1}\xi_2 \tag{3.4b}$$

and c, c_y, c_z are evaluated at $(y, z) = (1 - \xi_1, G(w + \eta_1))$ with $w := e_2/e_1$. We can now define a long-run equilibrium.

Definition 3. A rational expectations equilibrium $\{S_t\}_{t=0}^\infty$ is a *long-run equilibrium* if the sequence of auxiliary variables $\{\xi_t\}_{t=0}^\infty$ is convergent.

If $\xi_t \to \xi$, since $G > 1$ and $\gamma \in (0, 1)$, we have $\Phi(\xi, \xi) = 0$ if and only if $\xi_2 = 0$ and $\xi_1(Gc_z - c_y) = 0$, where c_y, c_z are evaluated at $(y, z) = (1 - \xi_1, G(w + \xi_1))$. Clearly $\xi_f^* := (0, 0)$ is a steady state of Φ, which we refer to as the *fundamental* steady state.[13] In order for Φ to have a nontrivial ($\xi_1 = s > 0$) steady state, which we refer to as the *bubbly* steady state, it is necessary and sufficient that $Gc_z - c_y = 0$.

3.2 (Non)existence of fundamental equilibria

As a benchmark, we start our analysis with the existence, and possibly nonexistence, of fundamental equilibria. By Theorem 2, the rent must asymptotically grow at the rate G^γ. Hence if the housing price equals its fundamental value (present value of rents), it must also grow at the rate G^γ. But since endowments grow faster at the rate $G > G^\gamma$,

[13] The terminology "steady state" is subtle. The steady state ξ^* corresponds to the detrended system $\Phi(\xi_t, \xi_{t+1}) = 0$, not the original economy. The long-run equilibrium in the original economy is an asymptotically balanced growth path that corresponds to a particular sequence $\{\xi_t\}_{t=0}^\infty \subset \mathbb{R}_{++}^2$ converging to ξ^* that is consistent with the initial conditions and the equilibrium condition $\Phi(\xi_t, \xi_{t+1}) = 0$.

the expenditure share of housing converges to zero in the long run and the consumption allocation becomes autarkic: $(c_t^y, c_t^o) \sim (e_1 G^t, e_2 G^t)$. This argument suggests that in any fundamental equilibrium, the interest rate behaves like

$$R_t = \frac{c_y}{c_z}(c_t^y, c_{t+1}^o) \sim \frac{c_y}{c_z}(e_1 G^t, e_2 G^{t+1}) = \frac{c_y}{c_z}(1, Gw), \tag{3.5}$$

where $w := e_2/e_1$ is the old-to-young income ratio and we have used the homogeneity of c (Assumption 2(i)). Obviously, for the fundamental value of housing to be finite, the interest rate cannot fall below the rent growth rate G^γ in the long run. This heuristic argument motivates the following (non)existence result.

Theorem 3 ((Non)existence of fundamental equilibria)**.** *Suppose Assumptions 1–3 hold, $\gamma < 1$, and let $w = e_2/e_1$. Then the following statements are true.*

(i) There exists a unique $w_f^* > 0$ satisfying

$$\frac{c_y}{c_z}(1, Gw_f^*) = G^\gamma. \tag{3.6}$$

(ii) If $w > w_f^*$, there exists a fundamental long-run equilibrium. The equilibrium objects have the order of magnitude

$$(c_t^y, c_t^o) \sim (e_1 G^t, e_2 G^t), \tag{3.7a}$$

$$(P_t, r_t) \sim \left(m e_1^\gamma \frac{G^\gamma c_z}{c_y - G^\gamma c_z} \frac{c^\gamma}{c_y} G^{\gamma t}, m e_1^\gamma \frac{c^\gamma}{c_y} G^{\gamma t} \right), \tag{3.7b}$$

$$R_t \sim \frac{c_y}{c_z} > G^\gamma, \tag{3.7c}$$

where c, c_y, c_z are evaluated at $(y, z) = (1, Gw)$.

(iii) If $w < w_f^*$, there are no fundamental equilibria. All equilibria are bubbly with $\liminf_{t\to\infty} G^{-t} P_t > 0$.

Although the conclusion that fundamental equilibria may fail to exist (unlike in pure bubble models, in which fundamental equilibria always exist) is surprising, its intuition is actually straightforward. As discussed above, in any fundamental equilibrium, the consumption allocation is asymptotically autarkic, and the interest rate is pinned down as the marginal rate of intertemporal substitution evaluated at the autarkic allocation. Hence, the order of magnitude (3.7) immediately follows from the general analysis in Theorem 1. Because both the housing price and rent grow at the rate G^γ, the interest rate (which equals the return on housing by no-arbitrage) must exceed G^γ as in (3.7c). Hence, the no-bubble condition holds and the housing price just reflects the fundamentals. As the young-to-old income ratio $1/w = e_1/e_2$ rises, the autarkic interest rate falls. But it cannot fall below the rent growth rate G^γ, for otherwise the fundamental value would become infinite, which is impossible in equilibrium. Therefore, there cannot be any fundamental equilibria if the young are sufficiently rich. The threshold for the nonexistence of fundamental equilibria is determined by equating the marginal rate of intertemporal substitution to the rent growth rate G^γ, which is precisely the condition (3.6).

It is important to recognize the differences in statements (ii) and (iii). Statement (ii) claims only that there exists a fundamental long-run equilibrium satisfying the order of magnitude (3.7). It does not rule out the possibility that there are other equilibria that are potentially cyclic or chaotic. In contrast, statement (iii) is much stronger. Under the condition $w < w_f^*$, it claims that no fundamental equilibria can exist at all, regardless of whether the asymptotic behavior is convergent, cyclic, or chaotic. The proof of Theorem 3(iii) is an application of the Bubble Necessity Theorem (Lemma B.2), where the long-run rent growth rate established in Theorem 2 plays a crucial role.

3.3 Existence of bubbly equilibria

Theorem 3 establishes a necessary and sufficient condition for the existence of a fundamental equilibrium. In particular, if the young are sufficiently rich and $w < w_f^*$, fundamental equilibria do not exist and hence bubbles are inevitable. The following theorem provides a necessary and sufficient condition for the existence of a bubbly long-run equilibrium.

Theorem 4 (Existence of bubbly long-run equilibrium)**.** *Suppose Assumptions 1–3 hold, $\gamma < 1$, and let $w = e_2/e_1$. Then the following statements are true.*

(i) There exists a unique $w_b^* > w_f^*$ satisfying

$$\frac{c_y}{c_z}(1, Gw_b^*) = G, \tag{3.8}$$

which depends only on G and c. A bubbly steady state of the system (3.4) exists if and only if $w < w_b^*$, which is uniquely given by $\xi_b^* = (s^*, 0)$ with $s^* = \frac{w_b^* - w}{w_b^* + 1}$.

(ii) For generic $G > 1$ and $w < w_b^*$, there exists a bubbly long-run equilibrium. The

equilibrium objects have the order of magnitude

$$(c_t^y, c_t^o) \sim ((1-s^*)e_1 G^t, (w+s^*)e_1 G^t), \tag{3.9a}$$

$$(P_t, r_t) \sim \left(s^* e_1 G^t, m e_1^\gamma \frac{c^\gamma}{c_y} G^{\gamma t}\right), \tag{3.9b}$$

$$R_t \sim G, \tag{3.9c}$$

where c, c_y *are evaluated at* $(y, z) = (1-s^*, G(w+s^*))$.

We explain the intuition for the following points: (i) Why does the bubbly equilibrium interest rate R equal the economic growth rate G? (ii) Why do the young need to be sufficiently rich for the emergence of bubbles? (iii) Why is the condition $\gamma < 1$ important for the emergence of bubbles? The intuition for (i) is the following. In order for a housing bubble to exist in the long run, the housing price must asymptotically grow at the same rate G as the economy as in (3.9b): clearly the housing price cannot grow faster than G (otherwise the young cannot afford housing); if it grows at a lower rate than G, housing becomes asymptotically irrelevant. Because the housing price grows at the rate G but the rent grows at the rate $G^\gamma < G$, the interest rate (2.3) must converge to G as in (3.9c). The intuition for (ii) is the following. With bubbles, we know $R = G$. Because the young are saving through the purchase of housing, the lowest possible interest rate in the economy is the autarkic interest rate. Therefore, for the emergence of bubbles, the autarkic interest rate must be lower than the economic growth rate, or equivalently the young must be sufficiently rich. The condition (3.8), which equates the marginal rate of intertemporal substitution to the growth rate (long-run interest rate), determines the income ratio threshold for which such a situation is possible. The intuition for (iii) is the following. With bubbles, we know $R = G$ and the housing price grows at the same rate. Then the no-arbitrage condition (2.3) forces rents to become negligible relative to prices—that is, to grow more slowly, for otherwise the interest rate will exceed the housing price growth rate and there will be no bubbles. Thus for the emergence of bubbles, we need $G > G^\gamma$ and hence $\gamma < 1$.

In this bubbly equilibrium, the housing expenditure S_t and rent r_t asymptotically grow at rates G and $G^\gamma < G$, respectively. On the other hand, since the gross risk-free rate (3.9c) converges to G and the rent grows at the rate $G^\gamma < G$, the present value of rents—the fundamental value of housing V_t in (2.9)—is finite and grows at the rate G^γ. Then the ratio S_t/V_t grows at the rate $G^{1-\gamma} > 1$, so the housing price eventually exceeds the fundamental value and there is a bubble. Moreover, from a backward induction argument, we will have housing bubbles at all dates.

In the bubbly equilibrium, the housing price grows faster than the rent and is disconnected from fundamentals in the sense that the housing price is asymptotically independent of the preferences for housing. To see this, note that the threshold w_b^* in (3.8) depends only on the growth rate G and the utility of consumption c. Then the steady state s^* depends only on G, c, and incomes (e_1, e_2), and so does the asymptotic housing price in (3.9b). In particular, the housing price is asymptotically independent of the marginal utility of housing m as well as the elasticity of substitution $1/\gamma$ between consumption and housing. In contrast, the rent in (3.9b) does depend on these parameters.

3.4 Uniqueness of equilibria

Although it is natural to focus on equilibria converging to steady states (i.e., long-run equilibria), there may be other equilibria. In general, an equilibrium is called *locally determinate* if there are no other equilibria in a neighborhood of the given equilibrium. If a model does not make determinate predictions, its value as a tool for economic analysis is severely limited (Kehoe and Levine, 1985). Therefore, local determinacy of equilibrium is crucial for applications.

It is well known that equilibria in Arrow-Debreu economies are generically locally determinate (Debreu, 1970) but not necessarily so in OLG models (Gale, 1973; Geanakoplos and Polemarchakis, 1991). In our context, local determinacy means that there are no other equilibria converging to the same steady state. However, we already know the uniqueness of steady states, and we also know that Lemma 3.1 allows us to establish global properties of equilibrium. Thus in our model, local determinacy implies equilibrium uniqueness, which justifies comparative statics and dynamics.

The local determinacy of equilibrium in a dynamic general equilibrium model often depends on the elasticity of intertemporal substitution (EIS) defined by

$$\varepsilon(y, z) = -\left(\frac{\mathrm{d}\log(c_y/c_z)}{\mathrm{d}\log(y/z)}\right)^{-1}; \tag{3.10}$$

see the discussion in Flynn et al. (2023). When c is homogeneous of degree 1, we can show that $\varepsilon = \frac{c_y c_z}{c c_{yz}}$ (Lemma A.1). The following proposition provides a sufficient condition for the uniqueness of equilibria.

Proposition 3.1 (Uniqueness of equilibria)**.** *Suppose Assumptions 1–3 hold and $\gamma < 1$. Let $w = e_2/e_1$ and w_f^*, w_b^* be as in (3.6) and (3.8). Then the following statements are* *true.*

(i) If $w > w_f^*$, there exists a unique fundamental long-run equilibrium.

(ii) If $w < w_b^*$ and the elasticity of intertemporal substitution (3.10) satisfies

$$\frac{1-w_b^*}{2}\frac{1-w/w_b^*}{1+w} < \varepsilon(y,z) \neq \frac{1-w/w_b^*}{1+w} \tag{3.11}$$

at $(y,z) = (1-s^*, G(w+s^*))$ with $s^* = \frac{w_b^*-w}{w_b^*+1}$, then there exists a unique bubbly long-run equilibrium.

Theorem 3(ii) shows that all fundamental long-run equilibria are asymptotically equivalent. Proposition 3.1(i) shows that the fundamental equilibrium is actually unique. The right-hand side of (3.11) is less than 1 because $0 < w < w_b^*$. Therefore, the left-hand side of (3.11) is less than 1/2. Proposition 3.1(ii) thus states that the bubbly equilibrium in Theorem 4(ii) is locally determinate as long as the elasticity of intertemporal substitution (EIS) is not too much below 1/2.[14]

The intuition for Proposition 3.1 is as follows. Whether the bubbly equilibrium is locally determinate or not depends on the stability of the linearized system around the steady state ξ_b^*. It turns out that one eigenvalue is $\lambda_2 := G^{\gamma-1} < 1$, which is stable. The other eigenvalue λ_1 could be greater than 1 in modulus (unstable) or less than 1 in modulus (stable), depending on the model parameters. We find that as long as the EIS is not too much below 1/2 (namely the left inequality of (3.11) holds) and is distinct from the special value on the right-hand side of (3.11) (in which case linearization is inapplicable due to a singularity), then $|\lambda_1| > 1$ (unstable). Since the dynamic system has one endogenous initial condition (because $\xi_0 = (s_0, e_1^{\gamma-1})$ and the initial young income e_1 is exogenous), the equilibrium is locally determinate: there exists a unique equilibrium path converging to the steady state if e_1 is large enough. Then the existence and uniqueness of equilibrium with arbitrary e_1 follow from the backward induction argument in Lemma 3.1. The same argument applies to the fundamental equilibrium, although in this case we have $\lambda_1 > 1$ regardless of the EIS.

[14]In general equilibrium theory, it is well known that multiple equilibria are possible if the elasticity is low; see Toda and Walsh (2017) for concrete examples and Toda and Walsh (2024) for a recent review.

4 Possibility, necessity, and phase transition

Having established the existence and determinacy of equilibria, in this section we further develop the intuition, discuss expectation-driven housing bubbles, and present comparative dynamics exercises using a numerical example.

4.1 Two-stage phase transition along economic development

Theorems 3 and 4 imply that, as the young (more precisely, home buyers) become richer, the economy experiences *two* phase transitions in the process of economic development, as illustrated in Figure 1, which shows how the elasticity of substitution between consumption and housing service $1/\gamma$ and young-to-old income ratio $1/w = e_1/e_2$ affect the equilibrium housing price regimes. (The case $1/\gamma \leq 1$ is treated in Appendix C.) We capture economic development with changes in the long-run income ratio of the young (home buyers) relative to the old (home sellers).

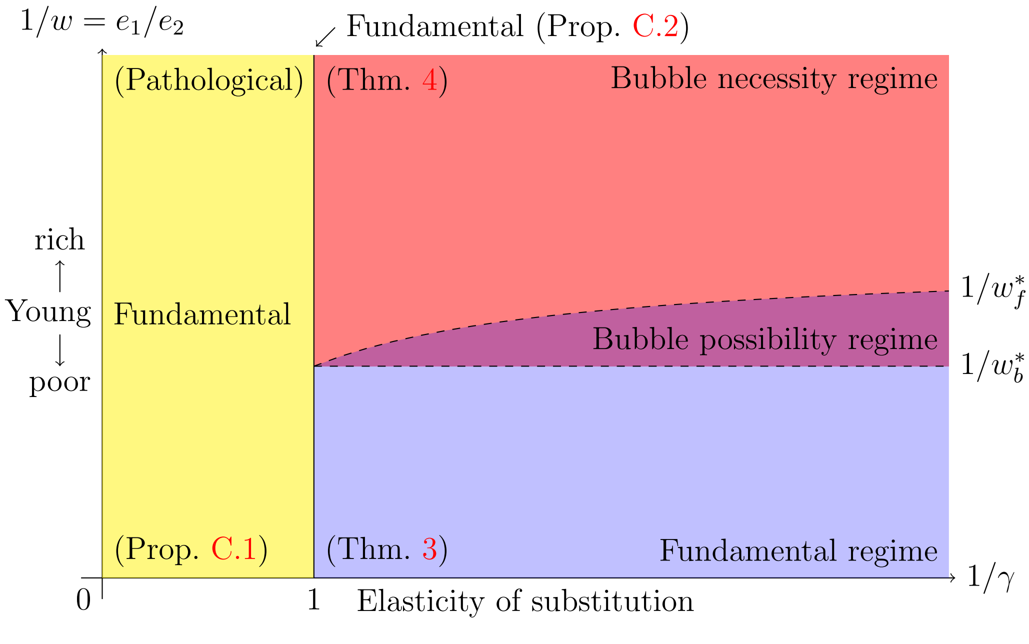


Figure 1: Phase transition of equilibrium housing price regimes.

Note: $1/w = e_1/e_2$ is the young-to-old income ratio and w_f^*, w_b^* are the thresholds for the bubble necessity and possibility regimes defined by (3.6) and (3.8), respectively. The figure corresponds to the CES utility (2.11) with $\beta = 1/2$, $\sigma = 1$, and $G = 1.5$.

When the young-to-old income ratio $1/w = e_1/e_2$ is below the bubbly equilibrium threshold $1/w_b^*$, the young do not have sufficient purchasing power to drive up the housing price and only fundamental equilibria exist (Theorem 3(ii)). In this fundamental regime, the housing price grows at the rate G^γ, which is lower than both the interest rate R and the economic growth rate G. In the long run, the expenditure share of housing converges to zero, and the consumption allocation becomes autarkic (see (3.7a)).

When the income ratio of the young exceeds the first critical value $1/w_b^*$, the economy transitions to the bubble possibility regime in which fundamental and bubbly equilibria coexist (Theorem 4). In this regime, although each equilibrium is determinate, the equilibrium selected depends on agents' expectations.

When the income ratio of the young exceeds the second, higher critical value $1/w_f^*$, fundamental equilibria cease to exist and all equilibria become bubbly (Theorem 3(iii)). Bubbles are necessary for the existence of equilibrium, and the bubble necessity regime emerges. In this regime, the housing price is asymptotically determined solely by the economic growth rate G and the preference for consumption goods c, and thus it inevitably becomes disconnected from fundamentals.

The intuition for the necessity of housing bubbles when the young are sufficiently rich is the following. As discussed above, in any fundamental equilibrium, the expenditure share of housing converges to zero, and the consumption allocation becomes autarkic. However, as the young get richer (the young-to-old income ratio $1/w$ increases), the interest rate $R = (c_y/c_z)(1, Gw)$ falls (Figure 2). If R falls below a critical value, the economy enters the bubble possibility regime. Hence, housing bubbles driven by optimistic expectations may be possible. As the income ratio increases further, the fundamental equilibrium interest rate becomes lower than the rent growth rate G^γ. If the economy enters that situation, the only possible equilibrium is one with a housing bubble.

Furthermore, we emphasize that once the state of the economy changes to the housing bubble economy, whether because of expectations or necessity, the determination of housing prices becomes purely demand-driven: the housing price continues to rise due to sustained demand growth arising from income growth of the young (home buyers). In contrast, when the housing price reflects fundamentals, it equals the present value of housing rents (what a rentier expects to receive in the future), and hence its determination is supply-driven. This demand-driven housing-price path is a distinctive feature of the housing bubble economy.

We would like to add an important remark concerning the knife-edge case with $\gamma = 1$, i.e., the Cobb-Douglas case, which is often employed in housing models or macroeconomic analyses (Kocherlakota, 2009; Arce and López-Salido, 2011). When $\gamma = 1$, steady-state (balanced) growth emerges, in which case housing rents and prices grow at the same

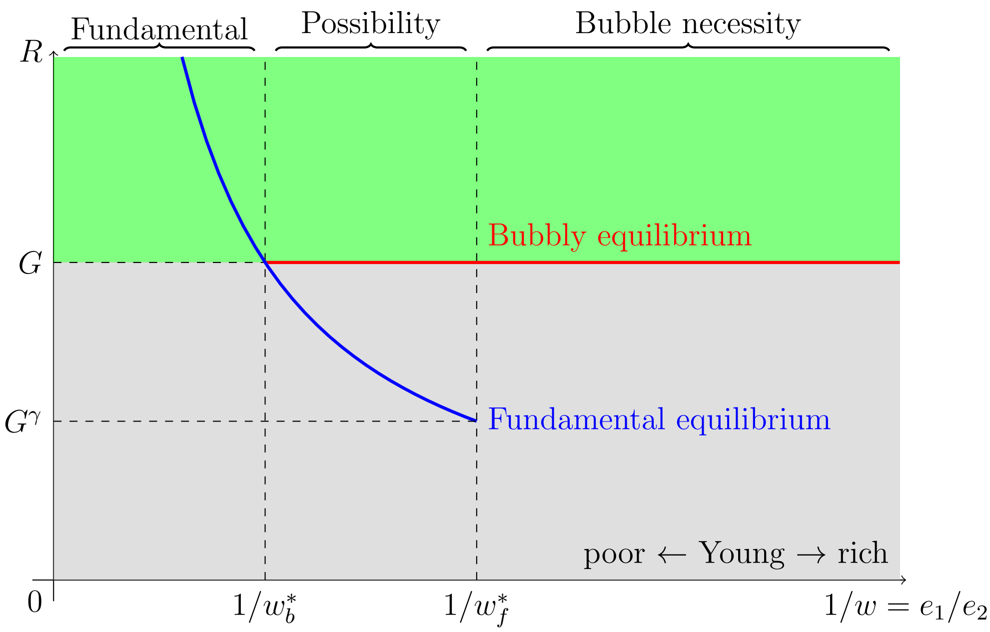


Figure 2: Housing price regimes and equilibrium interest rate.

Note: see Figure 1 for explanation of parameters.

rate and therefore housing bubbles are impossible. This result has critically important implications for the method of macroeconomic modeling. As long as we construct a model in which only steady-state growth emerges, by model construction, housing bubbles can never occur. What our analysis show is that once we deviate from the knife-edge restriction,[15] asset pricing implications become markedly different. This implies that the essence of housing bubbles is nonstationarity. (See also the introduction and concluding remarks in Hirano and Toda (2024a).)

4.2 Expectation-driven housing bubbles along economic development

We illustrate the preceding analysis and the role of expectations with a numerical example. Suppose the composite consumption takes the CES form (2.11). A straightforward calculation yields

$$c_y = (1-\beta)(y/c)^{-\sigma} \quad \text{and} \quad c_z = \beta(z/c)^{-\sigma}. \tag{4.1}$$

[15]As is well known from the "Uzawa steady-state (balanced) growth theorem" (Uzawa, 1961), any growth model that produces a balanced growth path is a knife-edge theory. Indeed, Grossman, Helpman, Oberfield, and Sampson (2017, p. 1306) clearly note "As with any model that generates balanced growth, knife-edge restrictions are required to maintain the balance".

Using (3.6), (3.8), and (4.1), we can solve for the critical values for the existence of fundamental and bubbly equilibria as

$$\frac{1-\beta}{\beta}(Gw_f^*)^\sigma = G^\gamma \iff w_f^* = \left(\frac{\beta}{1-\beta}G^{\gamma-\sigma}\right)^{1/\sigma}, \tag{4.2a}$$

$$\frac{1-\beta}{\beta}(Gw_b^*)^\sigma = G \iff w_b^* = \left(\frac{\beta}{1-\beta}G^{1-\sigma}\right)^{1/\sigma}. \tag{4.2b}$$

Substituting (4.1) into (3.2), we obtain

$$\beta S_{t+1}z^{-\sigma} = (1-\beta)S_t y^{-\sigma} - mc^{\gamma-\sigma}, \tag{4.3}$$

where $(y,z) = (e_t^y - S_t, e_{t+1}^o + S_{t+1})$. To solve for the equilibrium numerically, we can take a large enough T, set $S_T = s^* e_T^y$ with steady state value s^* defined by

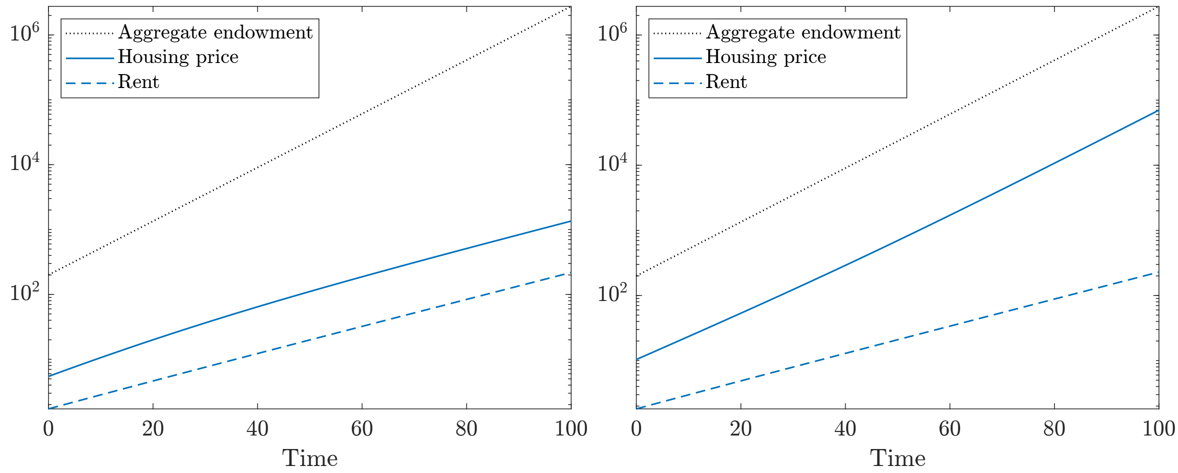
$$s^* = \begin{cases} 0 & \text{if fundamental equilibrium,} \\ \frac{w_b^*-w}{w_b^*+1} & \text{if bubbly equilibrium,} \end{cases}$$

and solve the nonlinear equation (4.3) backwards for $S_{T-1},\dots,S_0$. Note that the backward calculations of $\{S_t\}_{t=0}^T$ are always possible by Lemma 3.1.

As a numerical example, we set $\beta = 1/2$, $\sigma = 1$, $\gamma = 1/2$, $m = 0.1$, and $G = 1.1$. The income ratio threshold for the bubble possibility regime (4.2b) is then $w_b^* = 1$. Figure 3a shows the equilibrium housing price dynamics when $(e_1, e_2) = (95, 105)$ so that $e_2/e_1 > w_b^*$ and hence only a fundamental equilibrium exists. The housing price and rent asymptotically grow at the same rate G^γ, which is lower than the endowment growth rate G. Furthermore, the distance on a semilog scale between the housing price and rent converges, suggesting that the price-rent ratio converges. These observations are consistent with Theorem 3.

Figure 3b repeats the same exercise for $(e_1, e_2) = (105, 95)$ so that $e_2/e_1 < w_b^*$ and a bubbly equilibrium exists. The housing price asymptotically grows at the same rate as endowments, while the rent grows at a slower rate. Consequently, the price-rent ratio increases. These observations are consistent with Theorem 4.

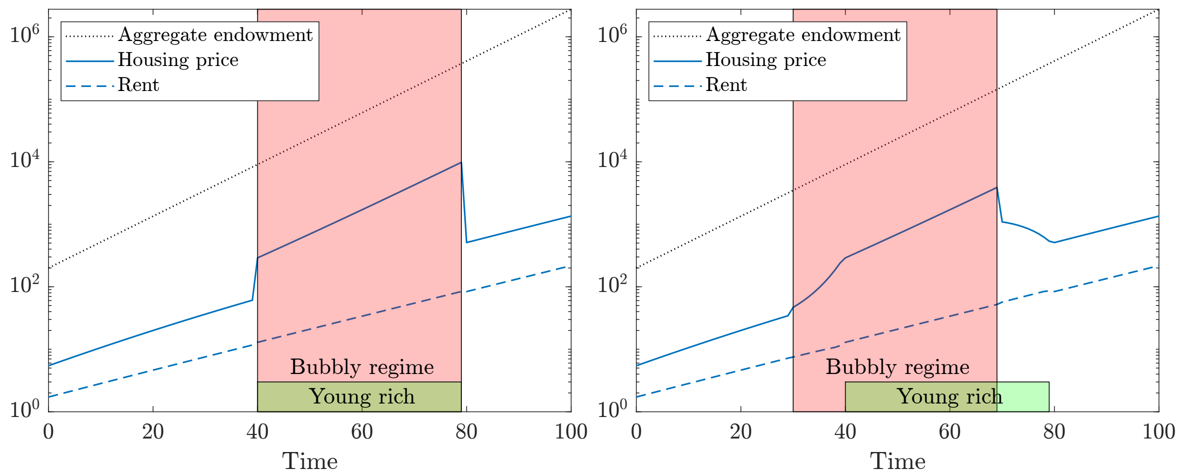
We next study how expectations about economic development and incomes in the future affect the current housing price. In Figure 4a, we consider phase transitions between the fundamental and bubbly regimes. The economy starts with $(e_0^y, e_0^o) = (95, 105)$ and agents believe that the endowments grow at the rate G and the income ratio e_t^o/e_t^y is



(a) Fundamental equilibrium. (b) Bubbly equilibrium.

Figure 3: Equilibrium housing price dynamics.

constant at 105/95. At $t = 40$, the income ratio e_t^o/e_t^y unexpectedly changes to 95/105 and agents believe that this new ratio will persist. Thus the economy takes off to the bubbly regime. Finally, at $t = 80$ the income ratio e_t^o/e_t^y unexpectedly reverts to the original value 105/95. Note that as the economy enters the bubbly regime, rents are hardly affected but the housing price increases and grows at a faster rate, generating a housing bubble.



(a) Unexpected income change. (b) Expected income change.

Figure 4: Phase transition between fundamental and bubbly regimes.

Figure 4b repeats the same exercise except that the income changes are anticipated. Specifically, agents learn at $t = 30$ that the income ratio will change to 95/105 (so the young will be relatively rich) starting at $t = 40$ and will remain so forever. Similarly, agents learn at $t = 70$ that the income ratio will revert to $105/95$ (so the young will be relatively poor) starting at $t = 80$ and will remain so forever. In this case, the economy takes off to the bubbly regime at $t = 30$ and reenters the fundamental regime at $t = 70$ due to rational expectations. We can see that the housing price jumps up at $t = 30$ and grows fast even before the fundamentals change. The housing price already contains a bubble, even if the current income of the young is relatively low and appears to be incapable of generating bubbles. This is due to a backward induction argument: if there is a bubble in the future (so (B.3) holds with strict inequality and the no-bubble condition fails), there is a bubble in every period. Once the young become relatively rich at $t = 40$, the housing price increases at the same rate as endowments, consistent with Theorem 4. The housing bubble collapses at $t = 70$ when agents learn that the young will be relatively poor in the future, even though the young remain relatively rich until $t = 80$.

From this analysis, we can draw an interesting implication. During expectation-driven housing bubbles, housing prices grow faster than rents. The price-income ratio continues to rise and hence the dynamics may appear unsustainable. Moreover, the greater the time gap between when news of rising incomes arrives ($t = 30$) and when incomes actually start to rise ($t = 40$), the longer the duration of the seemingly unsustainable dynamics. These expectation-driven housing bubbles and their collapse may capture realistic transitional dynamics. For instance, Miles and Monro (2021) emphasize that the decline in the real interest rate has produced large effects on the evolution of housing prices in the U.K. In our model, the (real) interest rate is endogenously determined and is closely related to the income of home buyers. As their income rises and the interest rate falls below the rent growth rate, a housing bubble necessarily emerges. Mankiw and Weil (1989) and Kiyotaki, Michaelides, and Nikolov (2011, 2024) stress the importance of expectation formation of long-run aggregate income growth and the interest rate in accounting for the fluctuations in housing prices. Our expectation-driven housing bubbles and their collapse show that even small changes in home buyers' incomes, or in expectations about those incomes, could produce large swings in housing prices. A critical difference is that housing prices in their papers reflect fundamentals, while our main focus is to identify the economic conditions under which housing prices reflect fundamentals or contain bubbles and to study expectation-driven housing price bubbles.

5 Discussion and extensions

5.1 Multiple saving vehicles

By Theorem 1, an equilibrium always exists. By Theorem 3(iii), fundamental equilibria do not exist when $w < w_f^*$. Therefore, under this condition, all equilibria are bubbly. In our model, housing is the only financial asset. In less developed economies, means of saving are limited, and housing is often an important saving vehicle.[16] To capture this situation and illustrate the key mechanism of the emergence of housing bubbles, we have assumed that housing is the only financial asset in our model. A natural question would be what happens with multiple saving vehicles. To address this issue, take any (bubbly) equilibrium with housing price $P_t = V_t + B_t$, where V_t is the fundamental value (2.9) and $B_t := P_t - V_t \geq 0$ is the bubble component. By the definitions of the interest rate (2.3) and the fundamental value (2.9), we obtain

$$P_t = \frac{1}{R_t}(P_{t+1} + r_{t+1}), \qquad V_t = \frac{1}{R_t}(V_{t+1} + r_{t+1}).$$

Taking the difference, we obtain $B_{t+1} = R_t B_t$, so the bubble component grows at the rate of interest, as is well known. Now, take any $\theta \in [0, 1]$ and define an alternative housing price by $P_t' = V_t + (1 - \theta)B_t$. Then we can easily construct an equilibrium in which the housing price is P_t' and there is an additional pure bubble asset (an intrinsically worthless asset that pays no dividends) with market capitalization θB_t. This argument (which is the same as the "bubble substitution" argument in Tirole (1985, §5)) shows that once there are multiple assets, the size of the bubble attached to each individual asset may become indeterminate (here parametrized by $\theta \in [0, 1]$) because all assets are perfect substitutes. However, the total size of the bubble is determinate (equal to B_t) and hence the consumption allocation and all macroeconomic implications are identical regardless of θ.[17] Hence, from a macroeconomic perspective, this indeterminacy is unimportant. This result differs from standard pure bubble models, where equilibria exhibit real indeterminacy (Gale, 1973; Hirano and Toda, 2024b).

This analysis with multiple assets has the following implication. Suppose that as economies develop, other means of saving besides housing emerge, which would be natural

[16] Even in developed economies, housing plays a major role as a means of saving over the life cycle due to pension uncertainty and a lack of trust in nominal assets, etc.

[17] Although the model is rather different, Hirano, Jinnai, and Toda (2022) develop a macro-finance model in which there are multiple saving vehicles including capital, land, and bonds, and show that land price bubbles necessarily emerge when the financial leverage gets sufficiently high.

in reality. Then, with economic development, bubbles may be attached to a variety of assets, leading to contagion across assets.

5.2 Welfare implications

In §3, we saw that housing bubbles can or must emerge as the young get richer. A natural question is whether housing bubbles are socially desirable or not. In this section, we discuss the welfare implications of housing bubbles.

Let $\{(c_t^y, c_t^o, h_t)\}_{t=0}^\infty$ be an arbitrary allocation with $c_t^y, c_t^o > 0$ and $c_t^y + c_t^o = e_t^y + e_t^o$. Since only the young have a preference for housing service, which is perishable, it is obviously efficient to assign all housing service to the young. Using Assumption 2, the utility of generation t becomes $U(c_t^y, c_{t+1}^o, 1) = u(c(c_t^y, c_{t+1}^o)) + mu(1)$, which is a monotonic transformation of $c(c_t^y, c_{t+1}^o)$. Therefore, the welfare analysis (in terms of Pareto efficiency) reduces to that of an endowment economy without housing and with a utility function $c(y, z)$ for goods.

Let $G_t = e_{t+1}^y / e_t^y$ be the growth rate of young income and $w_t = e_t^o / e_t^y$ be the old-to-young income ratio at time t. Let $s_t = 1 - c_t^y / e_t^y$ be the saving rate. Then the utility of generation t becomes

$$c(c_t^y, c_{t+1}^o) = c(e_t^y(1 - s_t), e_{t+1}^y(w_{t+1} + s_{t+1})) = e_t^y c(1 - s_t, G_t(w_{t+1} + s_{t+1})),$$

which is a monotonic transformation of $c(1 - s_t, G_t(w_{t+1} + s_{t+1}))$. This argument shows that the welfare analysis reduces to the case in which the time t aggregate endowment is $1 + w_t$, the utility function of generation t is $u_t(y, z) := c(y, G_t z)$, and the proposed allocation is $(y_t, z_t) = (1 - s_t, w_t + s_t)$. Since Assumption 1 implies that $w_t = e_t^o / e_t^y$ is constant for $t \geq T$, we can apply the characterization of Pareto efficiency in OLG models with bounded endowments provided by Balasko and Shell (1980). We thus obtain the following proposition.

Proposition 5.1 (Characterization of equilibrium efficiency). *Suppose Assumptions 1–3 hold, $\gamma < 1$, and let $w = e_2/e_1$. Then the following statements are true.*

(i) If $w \geq w_b^*$, any equilibrium is efficient.

(ii) If $w < w_b^*$, any bubbly long-run equilibrium is efficient.

(iii) If $w < w_b^*$, any fundamental long-run equilibrium is inefficient.

Recalling that $w < w_b^*$ implies $R < G$ in the fundamental equilibrium (Figure 2), fundamental equilibria are inefficient whenever $R < G$. Therefore, in Figure 2, all equilibria in the green region (including the boundary) are efficient, whereas all equilibria in the gray region (excluding the boundary) are inefficient.

The intuition for the Pareto inefficiency of fundamental equilibria when $w < w_b^*$ is the following. In equilibrium, since endowments grow at the rate G and rents grow at the rate G^γ (Theorem 2), if the housing price equals its fundamental value, it must also grow at the rate G^γ. Since $G^\gamma < G$, the housing price is asymptotically negligible relative to endowments, so the equilibrium consumption becomes autarkic. Now when $w < w_b^*$, the young are richer, so the interest rate becomes so low that it is below the economic growth rate (see (3.8)). Housing prices are too low to absorb the savings desired by the young. In other words, housing does not provide a saving vehicle with a sufficiently high return. In this situation if we consider a social contrivance such that for each large enough t the young at time t gives the old ϵG^t of the good (hence the old at time $t+1$ receives ϵG^{t+1} of the good), it is as if agents are able to save at the rate G, which is higher than the interest rate, which improves welfare. Since this argument holds for all large enough t, we have a Pareto improvement, which implies the inefficiency of the fundamental equilibrium.

While the statements in Proposition 5.1(i)(ii) are hardly surprising given the results of Diamond (1965) and Tirole (1985), we note that statement (iii) that fundamental equilibria are inefficient in the bubble possibility regime may not be entirely obvious. In fact, as noted in the introduction, the well-known result of McCallum (1987) shows that the introduction of a productive non-reproducible asset eliminates dynamic inefficiency in OLG models. Contrary to the common understanding, this result is not necessarily true. This apparent conflict is due to the fact that McCallum (1987) implicitly assumes steady state growth (see his discussion around Endnotes 20 and 21), which holds only for the knife-edge Cobb-Douglas case (which corresponds to $\gamma = 1$ in our model, treated in Appendix C.2). Once we consider the global parameter space with respect to γ, the region with dynamically inefficient equilibria always exists when $\gamma < 1$ (the gray region in Figure 2). Furthermore, inefficient equilibria arise only in the intermediate region of the income ratio e_2/e_1, so there is a non-monotonic relationship between the income ratio and the existence of dynamically inefficient equilibria.

It is fair to say that there are diverse views on the welfare implications of asset price bubbles.[18] Although the following examples are anecdotal, it is often noted that in

[18] In our model, both the housing and rental markets are frictionless. Even if the rental market is missing, because agents are homogeneous, they end up being owner-occupants. In reality, rental markets

Russia, people do not trust banks and government bonds because of the experience of the collapse of the Soviet Union and the default of Russian government bonds in 1998. Similarly, in the United Kingdom, there are concerns about the sustainability of pensions. These circumstances imply that there are not enough saving vehicles with high returns, and instead, housing is an effective means of saving. In these situations, welfare would improve if the housing bubble raised housing yields. Proposition 5.1 captures the positive aspects of these housing bubbles.

5.3 Credit-driven housing bubbles

In our model, because the young are homogeneous and the old exit the economy, there cannot be any borrowing or lending in equilibrium. In reality, housing is usually purchased using credit. To study the role of credit in generating housing bubbles in the simplest setting, we consider an open economy in which an external banking sector (e.g., foreign investors in mortgage-backed securities) provides exogenous credit.

To construct such a model, let $\{(\tilde{e}_t^y, \tilde{e}_t^o)\}_{t=0}^\infty$ be the endowment of some (closed) economy with corresponding equilibrium risk-free rate and housing expenditure $\{(R_t, S_t)\}_{t=0}^\infty$. Take any sequence $\{\ell_t\}_{t=0}^\infty$ such that $\ell_t \in [0, \tilde{e}_t^y)$ and define $e_0^o = \tilde{e}_0^o$ and $(e_t^y, e_{t+1}^o) = (\tilde{e}_t^y - \ell_t, \tilde{e}_{t+1}^o + R_t\ell_t)$ for $t \ge 0$. Then we can construct an equilibrium in which the endowment is (e_t^y, e_t^o), the interest rate is R_t, the housing expenditure is S_t, and the external banking sector provides a loan ℓ_t to the young at time t. We can see this as follows. At time t, the available funds of the young are $e_t^y + \ell_t = \tilde{e}_t^y$. At time $t+1$, because the old repay $R_t\ell_t$, the available funds are $e_{t+1}^o - R_t\ell_t = \tilde{e}_{t+1}^o$. Therefore, given the available funds and the interest rate R_t, it is optimal for the young to spend S_t on housing, so we have an equilibrium.

Combining this argument with the analysis in §3, even if the income share of the young e_t^y/e_t^o is low and a bubbly equilibrium may not exist, if the young have access to sufficient credit, a housing bubble may emerge.

Proposition 5.2. *Let everything be as in Theorem 4 and suppose the banking sector is willing to lend $\ell_t = \ell G^t$ to the young. If the loan-to-income ratio satisfies*

$$w > \lambda := \frac{\ell}{e_1} > \frac{w - w_b^*}{w_b^* + 1}, \tag{5.1}$$

could have frictions, perhaps due to moral hazard issues. Then the welfare implications could change when agents are heterogeneous.

then there exists a bubbly long-run equilibrium. Under this condition, the housing price has the order of magnitude

$$P_t \sim e_1 \left(\frac{w_b^* - w}{w_b^* + 1} + \lambda \right) G^t = s^* e_1 G^t + \ell_t, \tag{5.2}$$

so credit increases the housing price one-for-one.

Proposition 5.2 has two implications. First, the fact that external credit may drive housing bubbles is at least consistent with some narratives during the U.S. housing boom in the early 2000s, including the famous remarks by Bernanke (2005) on the "global saving glut". Bertaut et al. (2012) document that a substantial fraction of mortgages were financed through mortgage-backed securities purchased by European investors ("external banking sector"). Barlevy and Fisher (2021) document that the share of interest-only mortgages is correlated with the housing price growth rates across regions. Second, using (5.2) and $G^\gamma < G$, by calculation similar to that in (3.9a), the consumption of the young has the order of magnitude

$$c_t^y = e_t^y + \ell_t - P_t - r_t \sim e_1 G^t + \ell_t - (s^* e_1 G^t + \ell_t) = (1 - s^*) e_1 G^t,$$

which is independent of credit ℓ_t. Therefore, once home buyers have access to sufficient credit such that a housing bubble emerges, increasing credit further ends up raising the housing price one-for-one with no real effect on the long-run consumption allocation and hence welfare. Note that in reality there are financing costs, so a housing bubble driven by excessive credit could hurt welfare. (See Barlevy (2018) for a discussion of policy issues regarding bubbles.)

6 Concluding remarks

The theory of housing bubbles remains largely underdeveloped due to the fundamental difficulty of attaching bubbles to dividend-paying assets (Santos and Woodford, 1997). In this paper, we have taken the first step towards building a theory of rational housing bubbles. We have presented a bare-bones model of housing bubbles caused by demand-side factors. In conclusion, we discuss directions for future research.

To analyze how equilibrium housing prices are determined along with economic development in a tractable way, we used the classical overlapping generations model. However, a variety of generalizations are possible, including Bewley-type models with infinitelylived agents as in Hirano and Toda (2025a, §5). We hope that our bare-bones model of housing bubbles will lead to a variety of extensions in both theoretical and quantitative analyses.

Our theoretical analysis also provides testable implications. First, from the analysis of the long-run behavior, housing bubbles are more likely to emerge if the incomes (or available funds through credit) of home buyers are higher or expected to be higher in the process of economic development. If the incomes of home buyers rise as economic development progresses, housing bubbles may naturally arise first by optimistic expectations, and then inevitably emerge as the optimistic fundamentals materialize. There is some empirical evidence consistent with this narrative. Gyourko et al. (2013) document that an increase in the high-income population in a metropolitan area is associated with higher housing appreciation. The demographic structure could also be exploited to test our theory (e.g., improved longevity or early retirement makes the old "poorer"). Second, if there is a housing bubble on the long-run trend, rents grow at the rate G^γ, whereas housing prices grow at the rate G, implying that the price-rent ratio will rise. Hence, an upward trend in the price-rent ratio could signal a housing bubble. The findings of Amaral et al. (2024, Fig. 1) and Bäcker-Peral et al. (2025, Fig. 1) are consistent with this narrative, and the bubble detection literature (Phillips and Shi, 2020) could be applied. We hope that our theoretical framework will be useful for empirical researchers investigating these issues further.

A Proofs

A.1 Proofs of lemmas

The following lemma lists a few implications of Assumption 3 that will be repeatedly used.

Lemma A.1. *Suppose Assumption 3 holds and let $g(x) \coloneqq c(x,1)$. Then the following statements are true.*

(i) The first partial derivatives of c are given by

$$c_y(y,z) = g'(y/z) > 0, \tag{A.1a}$$
$$c_z(y,z) = g(y/z) - (y/z)g'(y/z) > 0 \tag{A.1b}$$

and are homogeneous of degree 0.

(ii) The second partial derivatives are given by

$$c_{yy}(y,z) = \frac{1}{z} g''(y/z) < 0, \tag{A.2a}$$
$$c_{yz}(y,z) = -\frac{y}{z^2} g''(y/z) > 0, \tag{A.2b}$$
$$c_{zz}(y,z) = \frac{y^2}{z^3} g''(y/z) < 0. \tag{A.2c}$$

(iii) Fixing $z > 0$, the marginal rate of substitution c_y/c_z is continuously differentiable and strictly decreasing in y and has range $(0, \infty)$.

(iv) The elasticity of intertemporal substitution is $\varepsilon(y,z) = \frac{c_y c_z}{c c_{yz}} > 0$.

Proof. By definition, $g(x) = c(x,1)$. Therefore, $g'(x) = c_y(x,1) > 0$ and $g''(x) = c_{yy}(x,1) < 0$ by Assumption 3. Since c is homogeneous of degree 1, we have $c(y,z) = zc(y/z,1) = zg(y/z)$. Then (A.1) and (A.2) are immediate by direct calculation.

Fixing $z > 0$, define the marginal rate of substitution $M(y) = (c_y/c_z)(y,z)$. Then M is continuously differentiable because c is twice continuously differentiable and $c_y, c_z > 0$. Since c_y, c_z are homogeneous of degree 0, we have

$$M(y) = \frac{c_y(y,z)}{c_z(y,z)} = \frac{c_y(y/z,1)}{c_z(1,z/y)}. \tag{A.3}$$

Since $c_y, c_z > 0$ and $c_{yy}, c_{zz} < 0$, the numerator (denominator) is positive and strictly decreasing (increasing) in y. Therefore, M is strictly decreasing. Furthermore, since $c_y(0,z) = c_z(y,0) = \infty$, letting $y \downarrow 0$ and $y \uparrow \infty$ in (A.3), we obtain $M(0) = \infty$ and $M(\infty) = 0$, so M has range $(0, \infty)$.

Finally, we derive the elasticity of intertemporal substitution (EIS) ε. Since c is homogeneous of degree 1, we have $c(\lambda y, \lambda z) = \lambda c(y,z)$. Differentiating both sides with respect to λ and setting $\lambda = 1$, we obtain

$$y c_y + z c_z = c. \tag{A.4}$$

Letting $\sigma = 1/\varepsilon$ and $x = y/z$, by the chain rule we obtain

$$\begin{aligned}
\sigma &= -\frac{\partial \log(c_y/c_z)(xz,z)}{\partial \log x} = -x\frac{c_z}{c_y}\frac{zc_{yy}c_z - c_y z c_{yz}}{c_z^2} \\
&= y\frac{c_y c_{yz} - c_z c_{yy}}{c_y c_z} = \frac{(yc_y + zc_z)c_{yz}}{c_y c_z} = \frac{c c_{yz}}{c_y c_z},
\end{aligned}$$

where the last line uses (A.2) and (A.4). $\square$

Proof of Lemma 3.1. Let $\mathcal{S}_T = \{S_t\}_{t=T}^\infty$ be an equilibrium starting at $t = T$. Set $t = T-1$ and define the function $f : [0, e^y_{T-1}) \to \mathbb{R}$ by $f(S) = S_T c_z - S c_y + m c^\gamma$, where c, c_y, c_z are evaluated at $(y, z) = (e^y_{T-1} - S, e^o_T + S_T)$. Then

$$f'(S) = -S_T c_{yz} - c_y + S c_{yy} - m\gamma c^{\gamma-1} c_y < 0$$

by Lemma A.1. Clearly $f(0) = S_T c_z + m c^\gamma > 0$. Define

$$\tilde{u}(y, z) := u(c(y, z)) = \begin{cases} \frac{1}{1-\gamma} c(y, z)^{1-\gamma} & \text{if } \gamma \neq 1, \\ \log(c(y, z)) & \text{if } \gamma = 1. \end{cases} \tag{A.5}$$

Take any $\bar{y} > 0$ and let $0 < y < \bar{y}$. Using the chain rule and the monotonicity of c, we obtain

$$\tilde{u}_y(y, z) = c(y, z)^{-\gamma} c_y(y, z) > c(\bar{y}, z)^{-\gamma} c_y(y, z) \to \infty \tag{A.6}$$

as $y \downarrow 0$ by Assumption 3. Using the definition of f, we obtain $f(S)c^{-\gamma} = S_T \tilde{u}_z - S\tilde{u}_y + m$. Letting $S \uparrow e^y_{T-1}$ and using (A.6), we obtain $f(S)c^{-\gamma} \to -\infty$. Hence by the intermediate value theorem, there exists a unique $S_{T-1} \in (0, e^y_{T-1})$ such that $f(S_{T-1}) = 0$. Therefore, there exists a unique equilibrium $\mathcal{S}_{T-1} = \{S_t\}_{t=T-1}^\infty$ starting at $t = T-1$ that agrees with $\mathcal{S}_T$ for $t \geq T$. The claim follows from backward induction. $\square$

A.2 Proof of Theorem 2

Take any equilibrium $\{S_t\}_{t=0}^\infty$. Using (2.8c) and Assumption 2, the rent is

$$r_t = m \frac{c^\gamma}{c_y}(e_1 G^t - S_t, e_2 G^{t+1} + S_{t+1}). \tag{A.7}$$

We first show

$$\limsup_{t\to\infty} r_t^{1/t} \leq G^\gamma. \tag{A.8}$$

Using the trivial bound $0 \leq S_t \leq e_1 G^t$, noting that c is increasing in both arguments and c_y is decreasing (increasing) in y (z) by Lemma A.1, and using the homogeneity of c and c_y, it follows from (A.7) that

$$r_t \leq m \frac{c(e_1 G^t, (e_1 + e_2)G^{t+1})^\gamma}{c_y(e_1 G^t, e_2 G^{t+1})} = m e_1^\gamma \frac{c(1, G(1 + w))^\gamma}{c_y(1, Gw)} G^{\gamma t} =: \bar{r} G^{\gamma t}.$$

Taking the $1/t$-th power, we obtain $r_t^{1/t} \le G^\gamma \bar{r}^{1/t}$ for all t. Letting $t \to \infty$, we obtain (A.8).

We next show

$$\liminf_{t\to\infty} G^{-t} S_t < e_1. \tag{A.9}$$

Suppose to the contrary that $\liminf_{t\to\infty} G^{-t} S_t \ge e_1$. Using the trivial bound $S_t \le e_1 G^t$, we obtain $\lim_{t\to\infty} G^{-t} S_t = e_1$. Take $\epsilon > 0$ such that $G^{-t} S_t > e_1 - \epsilon$ for large enough t. Then

$$\frac{r_t}{P_t} = \frac{r_t}{S_t - r_t} \le \frac{\bar{r} G^{\gamma t}}{(e_1 - \epsilon) G^t - \bar{r} G^{\gamma t}} \sim \frac{\bar{r}}{e_1 - \epsilon} G^{(\gamma - 1)t}$$

as $t \to \infty$, so $\sum_{t=1}^\infty r_t / P_t < \infty$ because $\gamma < 1$. By the Bubble Characterization Lemma B.1, there is a bubble. Using (2.8d), the homogeneity of c, and Assumption 3, the equilibrium interest rate satisfies

$$\begin{aligned} R_t &= \frac{c_y}{c_z}(e_t^y - S_t, e_{t+1}^o + S_{t+1}) \\ &= \frac{c_y}{c_z}(e_1 - G^{-t} S_t, G(e_2 + G^{-t-1} S_{t+1})) \to \frac{c_y}{c_z}(0, G(e_1 + e_2)) = \infty \end{aligned}$$

as $t \to \infty$. Therefore, for any $R > G$, we can take $T > 0$ such that $R_t \ge R > G$ for $t \ge T$. Letting $q_t > 0$ be the Arrow-Debreu price, it follows that

$$q_t P_t = \left(q_T / \prod_{s=T}^{t-1} R_s \right) P_t \le q_T R^{T-t} e_1 G^t = e_1 q_T R^T (G/R)^t \to 0$$

as $t \to \infty$, so the no-bubble condition holds and there is no bubble, which is a contradiction.

Finally, we show

$$\limsup_{t\to\infty} r_t^{1/t} \ge G^\gamma. \tag{A.10}$$

Since (A.9) holds, we can take $\bar{s} < 1$ such that $S_t / e_t^y \le \bar{s}$ infinitely often. For such a subsequence, by an argument similar to that used to prove (A.8), we obtain

$$r_t \ge m \frac{c((1-\bar{s}) e_1 G^t, e_2 G^{t+1})^\gamma}{c_y((1-\bar{s}) e_1 G^t, (e_1 + e_2) G^{t+1})} = m e_1^\gamma \frac{c(1-\bar{s}, Gw)^\gamma}{c_y(1-\bar{s}, G(1+w))} G^{\gamma t} =: \underline{r} G^{\gamma t}.$$

Taking the $1/t$-th power, we obtain $r_t^{1/t} \ge G^\gamma \underline{r}^{1/t}$. Letting $t \to \infty$, we obtain (A.10). The long-run rent growth rate (3.1) follows from (A.8) and (A.10). $\square$

A.3 Proof of Theorem 3

Proof of Theorem 3(i). By Lemma A.1, $(c_y/c_z)(y,G)$ is strictly decreasing in y and has range $(0,\infty)$. Therefore, there exists a unique y satisfying $(c_y/c_z)(y,G) = G^\gamma$. Since by Lemma A.1 c_y, c_z are homogeneous of degree 0, we have $(c_y/c_z)(1,G/y) = G^\gamma$, so $w_f^* = 1/y$ uniquely satisfies (3.6). □

Proof of Theorem 3(ii). We divide the proof into several steps.

Step 1. Derivation of an autonomous nonlinear difference equation.

By (3.7b), if a fundamental long-run equilibrium exists, then $S_t = P_t + r_t$ asymptotically grows at the rate G^γ. Define the detrended variable $s_t := S_t/(e_1^\gamma G^{\gamma t})$. Using the homogeneity of c, c_y, c_z, (3.2) implies

$$e_1^\gamma s_{t+1} G^{\gamma(t+1)} c_z - e_1^\gamma s_t G^{\gamma t} c_y + m e_1^\gamma G^{\gamma t} c^\gamma = 0, \tag{A.11}$$

where c, c_y, c_z are evaluated at

$$(y,z) = (1 - s_t e_1^{\gamma-1} G^{(\gamma-1)t}, G(w + s_{t+1} e_1^{\gamma-1} G^{(\gamma-1)(t+1)})).$$

Dividing (A.11) by $e_1^\gamma G^{\gamma t}$ and defining the auxiliary variable $\xi_t = (\xi_{1t}, \xi_{2t}) = (s_t, e_1^{\gamma-1} G^{(\gamma-1)t})$, it follows that (3.2) can be rewritten as $\Phi(\xi_t, \xi_{t+1}) = 0$, where $\Phi : \mathbb{R}^4 \to \mathbb{R}^2$ is given by

$$\Phi_1(\xi,\eta) = G^\gamma \eta_1 c_z - \xi_1 c_y + m c^\gamma, \tag{A.12a}$$
$$\Phi_2(\xi,\eta) = \eta_2 - G^{\gamma-1}\xi_2 \tag{A.12b}$$

and c, c_y, c_z are evaluated at $(y,z) = (1 - \xi_{1t}\xi_{2t}, G(w + \xi_{1,t+1}\xi_{2,t+1}))$.[19]

Step 2. Existence and uniqueness of a fundamental steady state.

If a steady state ξ_f^* of (A.12) exists, it must be $\xi_2 = 0$. Then the steady state condition is

$$G^\gamma s c_z - s c_y + m c^\gamma \iff s = m \frac{c^\gamma}{c_y - G^\gamma c_z},$$

where c, c_y, c_z are evaluated at $(y,z) = (1, Gw)$. For $s > 0$, it is necessary and sufficient that $c_y/c_z > G^\gamma$ at $(y,z) = (1, Gw)$. Since by Lemma A.1 c_y, c_z are homogeneous of

[19] Obviously, (A.12) and (3.4) are different because they correspond to the fundamental and bubbly equilibria, respectively.

degree 0 and c_y/c_z is strictly increasing in z, there exists a fundamental steady state if and only if $w > w_f^*$.

Step 3. Existence and local determinacy of equilibrium.

Define Φ by (A.12) and write $s = s^*$ to simplify notation. Noting that $\xi_f^* = (s^*, 0)$, a straightforward calculation yields

$$D_\xi \Phi(\xi_f^*, \xi_f^*) = \begin{bmatrix} -c_y & -G^\gamma s^2 c_{yz} + s^2 c_{yy} - sm\gamma c^{\gamma-1} c_y \\ 0 & -G^{\gamma-1} \end{bmatrix},$$
$$D_\eta \Phi(\xi_f^*, \xi_f^*) = \begin{bmatrix} G^\gamma c_z & G^{\gamma+1} s^2 c_{zz} - G s^2 c_{yz} + G sm\gamma c^{\gamma-1} c_z \\ 0 & 1 \end{bmatrix},$$

where all functions are evaluated at $(y, z) = (1, Gw)$. Since $D_\eta \Phi$ is invertible, we may apply the implicit function theorem to solve $\Phi(\xi, \eta) = 0$ around $(\xi, \eta) = (\xi_f^*, \xi_f^*)$ as $\eta = \phi(\xi)$, where

$$D\phi(\xi_f^*) = -[D_\eta \Phi]^{-1} D_\xi \Phi = \begin{bmatrix} \frac{c_y}{G^\gamma c_z} & \phi_{12} \\ 0 & G^{\gamma-1} \end{bmatrix}$$

and ϕ_{12} is unimportant. Since $c_y > G^\gamma c_z$, the eigenvalues of $D\phi$ are $\lambda_1 = c_y/(G^\gamma c_z) > 1$ and $\lambda_2 = G^{\gamma-1} \in (0, 1)$. Therefore, the steady state ξ_f^* is a hyperbolic fixed point and the local stable manifold theorem (Toda, 2025a, Theorem 8.9) implies that for any sufficiently large $e_1 > 0$ (so that $\xi_{20} = e_1^{\gamma-1}$ is close to the steady state value 0), there exists a unique orbit $\{\xi_t\}_{t=0}^\infty$ converging to the steady state ξ_f^*. However, by Assumption 1, choosing a large enough $e_1 > 0$ is equivalent to starting the economy at large enough $t = T$. Lemma 3.1 then implies that there exists a unique equilibrium converging to the steady state regardless of the early endowments $\{(e_t^y, e_t^o)\}_{t=0}^{T-1}$.

Step 4. The equilibrium objects have the order of magnitude in (3.7) and the housing price equals its fundamental value.

The order of magnitude (3.7) is obvious from $\lim_{t\to\infty} G^{-t} S_t = 0$, the homogeneity of c, and Theorem 1. In equilibrium, both the housing price P_t and rent r_t asymptotically grow at the rate G^γ. Therefore, $\sum_{t=1}^\infty r_t/P_t = \infty$, so there is no bubble by Lemma B.1. $\square$

Proof of Theorem 3(iii). Take any equilibrium. Because $h_t = 1$ in equilibrium, in which case the utility $U(y, z, 1) = u(c(y, z)) + mu(1)$ is a monotonic transformation of $c(y, z)$, we can construct an equilibrium of an endowment economy without housing service in which agents have utility $c(y, z)$, the income of the young is $a_t := e_t^y - r_t$, the income of the old is $b_t := e_t^o$, and the asset pays dividend r_t. Condition (i) of Lemma B.2 follows from Assumptions 2 and 3. Condition (ii) of Lemma B.2 follows from Assumption 1, Theorem 2, and $\gamma < 1$. By (3.1), the long-run rent growth rate is $G_r := G^\gamma$. Finally, since by Lemma A.1 c_y/c_z is strictly decreasing in y (hence strictly increasing in z), if $w < w_f^*$, the autarky interest rate satisfies

$$R = \frac{c_y}{c_z}(e_1, e_2) = \frac{c_y}{c_z}(1, Gw) < \frac{c_y}{c_z}(1, Gw_f^*) = G^\gamma = G_r < G,$$

which is the bubble necessity condition (B.5). Therefore, all assumptions of Lemma B.2 are satisfied and the claim holds. □

A.4 Proof of Theorem 4

We divide the proof into several steps.

Step 1. Existence and uniqueness of a bubbly steady state.

The proof of the existence and uniqueness of w_b^* satisfying (3.8) is identical to that of Theorem 3(i). Since $G > 1$ and $\gamma < 1$, it follows from (3.6) and (3.8) that

$$(c_y/c_z)(1, Gw_f^*) = G^\gamma < G = (c_y/c_z)(1, Gw_b^*).$$

Since c_y/c_z is strictly increasing in z, we obtain $w_f^* < w_b^*$.

The steady state condition is $Gc_z - c_y = 0$, where c_y, c_z are evaluated at $(y, z) = (1 - s, G(w + s))$. Using the homogeneity of c_y, c_z, this condition is equivalent to $(c_y/c_z)(y, G) = G$ for $y = \frac{1-s}{w+s}$, so the bubbly steady state is uniquely determined by

$$\frac{1-s}{w+s} = \frac{1}{w_b^*} \iff s = \frac{w_b^* - w}{w_b^* + 1}. \tag{A.13}$$

Since $s \in (0, 1)$, a necessary and sufficient condition for the existence of a bubbly steady state is $w < w_b^*$.

Step 2. Order of magnitude of equilibrium objects and asset pricing implications.

In any equilibrium converging to the bubbly steady state, by definition we have $S_t \sim se_1G^t$, where $s = s^*$ is the bubbly steady state. Therefore, (3.9a) follows from (2.8a).

Using (2.8c) and Assumption 2, the rent is

$$r_t = \frac{mu'(1)}{u'(c)c_y} = m\frac{c(e_t^y - S_t, e_{t+1}^o + S_{t+1})^\gamma}{c_y(e_t^y - S_t, e_{t+1}^o + S_{t+1})}. \tag{A.14}$$

Substituting (3.9a) into (A.14) and using the fact that c is homogeneous of degree 1 and c_y is homogeneous of degree 0, we obtain

$$r_t \sim me_1^\gamma \frac{c(1-s, G(w+s))^\gamma}{c_y(1-s, G(w+s))} G^{\gamma t}.$$

Since r_t asymptotically grows at the rate $G^\gamma < G$ because $\gamma < 1$, we have $r_t/S_t \to 0$, so $P_t = S_t - r_t \sim S_t$ and (3.9b) holds. Finally, (3.9c) follows from (2.3) and (3.9b).

Since the housing price P_t and rent r_t asymptotically grow at rates G and $G^\gamma < G$, respectively, the rent-price ratio r_t/P_t decays geometrically at the rate $G^{\gamma-1} < 1$. Therefore, $\sum_{t=1}^\infty r_t/P_t < \infty$, so there is a housing bubble by Lemma B.1.

Step 3. Generic existence of equilibrium.

Define Φ by (3.4) and write $s = s^*$ to simplify notation. Noting that $\xi_b^* = (s^*, 0)$, a straightforward calculation yields

$$\begin{aligned}
D_\xi \Phi(\xi_b^*, \xi_b^*) &= \begin{bmatrix} -Gsc_{yz} - c_y + sc_{yy} & mc^\gamma \\ 0 & -G^{\gamma-1} \end{bmatrix}, \\
D_\eta \Phi(\xi_b^*, \xi_b^*) &= \begin{bmatrix} Gc_z + G^2 sc_{zz} - Gsc_{yz} & 0 \\ 0 & 1 \end{bmatrix},
\end{aligned}$$

where all functions are evaluated at $(y, z) = (1-s, G(w+s))$. If $D_\eta \Phi$ is invertible, we may apply the implicit function theorem to solve $\Phi(\xi, \eta) = 0$ around $(\xi, \eta) = (\xi_b^*, \xi_b^*)$ as $\eta = \phi(\xi)$, where

$$D\phi(\xi_b^*) = -[D_\eta \Phi]^{-1} D_\xi \Phi = \begin{bmatrix} \phi_{11} & \phi_{12} \\ 0 & G^{\gamma-1} \end{bmatrix}$$

with

$$\phi_{11} = \frac{Gsc_{yz} + c_y - sc_{yy}}{Gc_z + G^2 sc_{zz} - Gsc_{yz}} =: \frac{n}{d} \tag{A.15}$$

and ϕ_{12} is unimportant. Therefore, $D\phi(\xi_b^*)$ has two real eigenvalues; one is $\lambda_1 := \phi_{11}$ and the other is $\lambda_2 := G^{\gamma-1} \in (0,1)$ because $G > 1$ and $\gamma \in (0,1)$.

Let us estimate λ_1. Using (A.2), the numerator of (A.15) is

$$\begin{aligned} n &= c_y + s(Gc_{yz} - c_{yy}) = c_y + s\left(-G\frac{y}{z^2}g'' - \frac{1}{z}g''\right) \\ &= c_y - s\frac{Gy+z}{z^2}g'' = c_y - \frac{s(1+w)}{G(w+s)^2}g'', \end{aligned}$$

where we have used $(y, z) = (1-s, G(w+s))$. Similarly, the denominator is

$$\begin{aligned} d &= Gc_z + Gs(Gc_{zz} - c_{yz}) = Gc_z + Gs\left(G\frac{y^2}{z^3}g'' + \frac{y}{z^2}g''\right) \\ &= Gc_z + Gs\frac{y(Gy+z)}{z^3}g'' = Gc_z + \frac{s(1-s)(1+w)}{G(w+s)^3}g''. \end{aligned}$$

At the steady state, we have $Gc_z = c_y = g'$, so

$$n = g' - \frac{s(1+w)}{G(w+s)^2}g'', \qquad d = g' + \frac{s(1-s)(1+w)}{G(w+s)^3}g''. \tag{A.16}$$

Since $s \in (0, 1)$ and $g'' < 0$, clearly $n > d$.

We now study each case by the magnitude of the denominator d.

Case 1: $d > 0$. If $d > 0$, then $0 < d < n$ and hence $\lambda_1 = n/d > 1$. Since $\lambda_1 > 1 > \lambda_2 > 0$, the steady state ξ_b^* is a saddle point. The existence and uniqueness of an equilibrium path converging to the steady state ξ_b^* follows by the same argument as in the proof of Theorem 3.

Case 2: $d = 0$. If $d = 0$, the implicit function theorem is inapplicable and we cannot study the local dynamics by linearization.

Case 3: $d \in (-n, 0)$. If $-n < d < 0$, then $\lambda_1 = n/d < -1$. Therefore, ξ_b^* is a saddle point and there exists a unique equilibrium by the same argument as in the case $d > 0$.

Case 4: $d = -n$. If $d = -n$, then $\lambda_1 = n/d = -1$, the fixed point is not hyperbolic, and the local stable manifold theorem is inapplicable.

Case 5: $d < -n$. If $d < -n$, then $\lambda_1 = n/d \in (-1, 0)$. Therefore, ξ_b^* is a sink and there exists a continuum of equilibria by the same argument as in the case $d > 0$.

In summary, there exists an equilibrium converging to the bubbly steady state except when $d = 0$ or $d = -n$. Therefore, for generic G and w, there exists an equilibrium. □

A.5 Proof of Proposition 3.1

We have already proved the uniqueness of the fundamental long-run equilibrium if $w > w_f^*$ in the proof of Theorem 3.

Suppose $w < w_b^*$. Let $s = \frac{w_b^*-w}{w_b^*+1}$ be the bubbly steady state and $(y,z) = (1-s, G(w+s))$. By the proof of Theorem 4, there exists a unique equilibrium converging to the bubbly steady state if $d \in (-n,0) \cup (0,\infty)$, where d,n are the denominator and numerator in (A.16). We rewrite this condition using the EIS defined by $\varepsilon = \frac{c_y c_z}{c c_{yz}}$. Using (A.1), (A.2), (A.4), and $Gc_z = c_y$ at the steady state, we obtain

$$\varepsilon = \frac{c_y c_z}{(yc_y + zc_z)c_{yz}} = \frac{c_y}{(Gy+z)c_{yz}} = -\frac{g'}{g''}\frac{G(w+s)^2}{(1-s)(1+w)}.$$

Therefore, (A.16) can be rewritten as

$$n = \left(1 + \frac{1}{\varepsilon}\frac{s}{1-s}\right)g', \qquad d = \left(1 - \frac{1}{\varepsilon}\frac{s}{w+s}\right)g'. \tag{A.17}$$

Since $g' > 0$, we have

$$\begin{aligned} d = 0 &\iff \varepsilon = \frac{s}{w+s} = \frac{1-w/w_b^*}{1+w}, \\ n + d > 0 &\iff \varepsilon > \frac{s(1-w-2s)}{2(1-s)(w+s)} = \frac{1-w_b^*}{2}\frac{1-w/w_b^*}{1+w}. \end{aligned}$$

Therefore, the sufficient condition (3.11) follows. □

A.6 Proof of Proposition 5.1

To prove Proposition 5.1, we need the following lemma.

Lemma A.2 (Characterization of equilibrium efficiency). *Suppose Assumptions 1–3 hold and let $\{S_t\}_{t=0}^\infty$ be an equilibrium. Let $G_t = e_{t+1}^y/e_t^y$, $w_t = e_t^o/e_t^y$, and $s_t = S_t/e_t^y$. Let*

$$R_t = \frac{c_y}{c_z}(1-s_t, G_t(w_{t+1}+s_{t+1})) \tag{A.18}$$

be the equilibrium risk-free rate and define the Arrow-Debreu price by $q_0 = 1$ and $q_t = 1/\prod_{s=0}^{t-1} R_s$ for $t \geq 1$. Then the following statements are true.

(i) If $\liminf_{t\to\infty} R_t > G$, then the equilibrium is Pareto efficient.

(ii) If $\limsup_{t\to\infty} s_t < 1$*, then the equilibrium is Pareto efficient if and only if*

$$\sum_{t=0}^{\infty} \frac{1}{G^t q_t} = \infty. \tag{A.19}$$

Proof of Lemma A.2. Let $u_t(y,z) = c(y, G_t z)$ be the utility function in the detrended economy. Then the implied gross risk-free rate at the proposed allocation $(c_t^y, c_{t+1}^o) = (1 - s_t, w_{t+1} + s_{t+1})$ is

$$\tilde{R}_t := \frac{u_{ty}}{u_{tz}}(1 - s_t, w_{t+1} + s_{t+1}) = \frac{1}{G_t} \frac{c_y}{c_z}(1 - s_t, w_{t+1} + s_{t+1}) = \frac{R_t}{G_t}.$$

Therefore, the Arrow-Debreu price in the detrended economy is $\tilde{q}_t = \prod_{s=0}^{t-1}(G_s/R_s)$.

We now apply the results of Balasko and Shell (1980). If $\liminf_{t\to\infty} R_t > G$, then by Assumption 1 we can take $R > G$ such that $R_t \geq R > G = G_t$ for t large enough. Then $G_t/R_t \leq G/R < 1$, so we have $\lim_{t\to\infty} \tilde{q}_t = 0$. Proposition 5.3 of Balasko and Shell (1980) then implies that the equilibrium is efficient.

We next consider the case $\bar{s} := \limsup_{t\to\infty} s_t < 1$. We verify each assumption of Proposition 5.6 of Balasko and Shell (1980). Since the partial derivatives of c can be signed as in Lemma A.1, the Gaussian curvature of indifference curves is strictly positive. Since the time t aggregate endowment of the detrended economy is $1 + w_t$, which is bounded by Assumption 1, it follows that the Gaussian curvature of indifference curves within the feasible region (weakly preferred to endowments) is uniformly bounded and bounded away from 0 because $1 - \bar{s} > 0$. Therefore, assumptions (a) and (b) hold. Since $\bar{s} < 1$ and G_t, w_{t+1} are bounded, the gross risk-free rate (A.18) can be uniformly bounded from above and away from 0. Therefore, assumption (c) holds. Assumption (d) holds because w_t is bounded, and assumption (e) holds because $\liminf_{t\to\infty}(1 - s_t) = 1 - \bar{s} > 0$. Since all assumptions are verified, Proposition 5.6 of Balasko and Shell (1980) implies that the equilibrium is efficient if and only if

$$\infty = \sum_{t=0}^{\infty} \frac{1}{\tilde{q}_t} = \sum_{t=0}^{\infty} \frac{1}{q_t} \prod_{s=0}^{t-1}(1/G_s). \tag{A.20}$$

Since by Assumption 1 we have $G_t = G$ for large enough t, (A.20) is clearly equivalent to (A.19). $\square$

Proof of Proposition 5.1. Suppose $\gamma < 1$ and consider any equilibrium. Using (A.18), Assumption 1, Lemma A.1, and $s_t \geq 0$, we obtain

$$R_t = \frac{c_y}{c_z}(1 - s_t, G_t(w_{t+1} + s_{t+1})) \geq \frac{c_y}{c_z}(1, Gw) \tag{A.21}$$

for large enough t. If $w \geq w_b^*$, then (A.21), Lemma A.1, and (3.8) imply

$$R_t \geq \frac{c_y}{c_z}(1, Gw) \geq \frac{c_y}{c_z}(1, Gw_b^*) = G.$$

Since $R_t \geq G$ eventually, the sequence $1/(G^t q_t) = \prod_{s=0}^{t-1}(R_s/G)$ is positive and bounded away from 0. Therefore, (A.19) holds, and the equilibrium is efficient.

Suppose $w < w_b^*$ and take any bubbly equilibrium converging to the bubbly steady state. By (3.9b), we can take $p > 0$ such that $P_t \geq pG^t$ for large enough t. Then

$$G^t q_t = \frac{1}{p} q_t p G^t \leq \frac{1}{p} q_t P_t \leq \frac{1}{p} P_0$$

using (B.2). Since $G^t q_t$ is positive and bounded above, $1/(G^t q_t)$ is positive and bounded away from 0, so (A.19) holds and the equilibrium is Pareto efficient.

Suppose $w < w_b^*$ and take the (unique) fundamental equilibrium. Then by Theorem 3 we have $s_t := S_t/(e_1 G^t) \to 0$. Then (A.18), $s_t \to 0$, and $w < w_b^*$ imply that

$$\lim_{t\to\infty} R_t = \frac{c_y}{c_z}(1, Gw) < \frac{c_y}{c_z}(1, Gw_b^*) = G.$$

Therefore, we can take $R < G$ and $T > 0$ such that $R_t \leq R < G$ for $t \geq T$. Since

$$\frac{1}{G^t q_t} = \prod_{s=0}^{t-1}(R_s/G) \leq \frac{1}{G^T q_T}(R/G)^{t-T},$$

the sum $\sum_{t=0}^{\infty} 1/(G^t q_t)$ converges to a finite value, so by Lemma A.2(ii) the equilibrium is inefficient. $\square$

A.7 Proof of Proposition 5.2

By the discussion before the proposition, the available funds to the young at time t are $\tilde{e}_t^y = e_t^y + \ell_t = (e_1 + \ell)G^t$ and the available funds of the old at time t are $\tilde{e}_t^o = e_t^o - G\ell_{t-1} = (e_2 - \ell)G^t$ at interest rate G. Therefore, by Theorem 4, a bubbly long-run equilibrium exists if

$$0 < \frac{e_2 - \ell}{e_1 + \ell} < w_b^* \iff w > \frac{\ell}{e_1} > \frac{w - w_b^*}{w_b^* + 1},$$

which is (5.1). Under this condition, because the old-to-young available funds ratio is $\tilde{w} := \frac{e_2 - \lambda e_1}{e_1 + \lambda e_1} = \frac{w-\lambda}{1+\lambda}$, using (3.9b) we obtain the asymptotic housing price

$$P_t \sim e_1(1+\lambda)\frac{w_b^* - \tilde{w}}{w_b^* + 1}G^t = e_1\frac{(1+\lambda)w_b^* - (w-\lambda)}{w_b^* + 1}G^t,$$

which simplifies to (5.2). $\square$

Declaration of generative AI and AI-assisted technologies in the manuscript preparation process

During the preparation of this work the authors used ChatGPT 5.5 Pro in order to polish the abstract and introduction and check for grammar throughout the paper. After using this tool, the authors reviewed and edited the content as needed and take full responsibility for the content of the published article.

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Online Appendix

B Definition and characterization of bubbles

B.1 Definition of housing bubbles

Following the standard definition of rational bubbles in the literature (Hirano and Toda, 2024a, 2025b), we define a housing bubble as a situation in which the housing price exceeds its fundamental value defined by the present value of rents. Let $R_t > 0$ be the equilibrium gross risk-free rate. Let $q_t > 0$ be the Arrow-Debreu price of date-t consumption in units of date-0 consumption, so $q_0 = 1$ and $q_t = 1/\prod_{s=0}^{t-1} R_s$. Because $q_{t+1} = q_t/R_t$ by definition, (2.3) implies the no-arbitrage condition

$$q_t P_t = q_{t+1}(P_{t+1} + r_{t+1}). \tag{B.1}$$

Iterating (B.1) forward, for all $T > t$ we obtain

$$q_t P_t = \sum_{s=t+1}^{T} q_s r_s + q_T P_T. \tag{B.2}$$

Since $q_s r_s \geq 0$, letting $T \to \infty$ in (B.2), we have $\sum_{s=t+1}^{\infty} q_s r_s \leq q_t P_t < \infty$, so we may define the *fundamental value* of housing by the present value of rents

$$V_t := \frac{1}{q_t} \sum_{s=t+1}^{\infty} q_s r_s.$$

Letting $T \to \infty$ in (B.2), we obtain the limit

$$0 \leq \lim_{T\to\infty} q_T P_T = q_t(P_t - V_t). \tag{B.3}$$

When the limit in (B.3) equals 0, we say that the *no-bubble condition* holds and the asset price P_t equals its fundamental value V_t. When $\lim_{T\to\infty} q_T P_T > 0$, we say that the no-bubble condition fails and the asset price contains a *bubble*. Note that under rational expectations, we have either $P_t = V_t$ for all t or $P_t > V_t$ for all t. Throughout the rest of the paper, we refer to an equilibrium with (without) a housing bubble as a *bubbly (fundamental) equilibrium*.

The economic meaning of $\lim_{T\to\infty} q_T P_T$ is that it captures a speculative aspect, that is, agents buy housing now for the purpose of resale in the future, in addition to receiving rents. The limit $\lim_{T\to\infty} q_T P_T$ captures its impact on current housing prices. When the no-bubble condition holds, the aspect of speculation becomes negligible and housing prices are determined only by factors that are backed in equilibrium, namely rents. On the other hand, when the no-bubble condition is violated, equilibrium housing prices contain a speculative aspect.

B.2 Characterization and necessity of bubbles

In general, proving the existence or nonexistence of bubbles is challenging because in the limit (B.3), both the Arrow-Debreu price q_t and the housing price P_t are endogenous. Here we discuss two useful results. Because the context does not matter, we consider a general asset that pays a dividend $D_t \geq 0$ and trades at price P_t (both in units of the consumption good). The first is the following Bubble Characterization Lemma due to Montrucchio (2004).

Lemma B.1 (Bubble Characterization, Montrucchio, 2004). *If $P_t > 0$ for all t, the asset price exhibits a bubble if and only if $\sum_{t=1}^{\infty} D_t/P_t < \infty$.*

Proof. See Hirano and Toda (2025a, Lemma 2.1). □

Lemma B.1 is useful because it does not involve the Arrow-Debreu price q_t and provides a necessary and sufficient condition for the existence of bubbles.

The second result is the Bubble Necessity Theorem due to Hirano and Toda (2025a). To make the paper self-contained but to avoid technicalities, here we specialize the setting of Hirano and Toda (2025a). As in §2, consider a two-period OLG model with a long-lived asset but assume that there is a single perishable good and the date-t dividend $D_t \geq 0$ is exogenous (unlike our setting with endogenous rents). Define the long-run dividend growth rate by

$$G_d := \limsup_{t\to\infty} D_t^{1/t}. \tag{B.4}$$

Let (a_t, b_t) be the date-t endowments of the young and old, and let $P_t \geq 0$ be the (endogenous) equilibrium asset price.

Lemma B.2 (Hirano and Toda, 2025a, Theorem 2). *Suppose that (i) the utility function $U(y, z)$ is continuously differentiable, homothetic, and quasi-concave, and (ii) the endowments satisfy $G^{-t}(a_t, b_t) \to (a, b)$ as $t \to \infty$, where $G > 0$, $a > 0$, and $b \geq 0$. Define the* *long-run autarky interest rate by* $R := (U_y/U_z)(a,b)$*. If*

$$R < G_d < G, \tag{B.5}$$

then all equilibria are bubbly with asset price P_t *satisfying* $\liminf_{t\to\infty} P_t/a_t > 0$.

Although the proof of Lemma B.2 is technical and we refer the reader to Hirano and Toda (2025a), the intuition is clear. If a fundamental equilibrium exists, the asset price must grow at the same rate as dividends, which is G_d. If $G_d < G$, the asset price becomes negligible relative to the size of the economy, and hence the allocation approaches autarky. With an autarky interest rate of $R < G_d$, the present value of dividends (and hence the asset price) becomes infinite, which is impossible. Therefore, a fundamental equilibrium cannot exist.

C Elasticity of substitution at most 1

The analysis in the main text focused on the empirically relevant case of $\gamma < 1$ (Footnote 3), that is, the elasticity of substitution between consumption and housing $1/\gamma$ exceeds 1. For completeness, we present an analysis for the case $\gamma \geq 1$.

C.1 Elasticity of substitution below 1

We first consider the case $\gamma > 1$, so the elasticity of substitution $1/\gamma$ is less than 1. In this case we cannot study the local dynamics around the steady state by linearization because the implicit function theorem is not applicable due to a singularity. Nevertheless, we may characterize the asymptotic behavior of all equilibria as follows.

Proposition C.1 (Equilibrium with $\gamma > 1$)**.** *Suppose Assumptions 1–3 hold,* $\gamma > 1$*, and let* $w = e_2/e_1$*. Then the following statements are true.*

(i) In any equilibrium, the equilibrium objects satisfy

$$\lim_{t\to\infty} (c_t^y, c_t^o)/(e_1 G^t) = (0, 1+w), \tag{C.1a}$$

$$\lim_{t\to\infty} (P_t, r_t)/(e_1 G^t) = (0, 1), \tag{C.1b}$$

$$\lim_{t\to\infty} R_t = \infty. \tag{C.1c}$$

(ii) There is no housing bubble and the price-rent ratio converges to 0.

(iii) Any equilibrium is Pareto efficient.

Proof. Let $\tilde{u}$ be defined by (A.5). Then the equilibrium dynamics (3.3) can be written as

$$Gs_{t+1}\tilde{u}_z = s_t\tilde{u}_y - me_1^{\gamma-1}G^{(\gamma-1)t}, \tag{C.2}$$

where $\tilde{u}_y, \tilde{u}_z$ are evaluated at $(y,z) = (1-s_t, G(w+s_{t+1}))$. Define $\underline{s} = \liminf_{t\to\infty} s_t$. Since $s_t \in (0,1)$, we have $0 \le \bar{s} \le 1$. Take a subsequence of (s_t, s_{t+1}) such that $(s_t, s_{t+1}) \to (\underline{s}, \tilde{s})$ for some $\tilde{s}$. Letting $t \to \infty$ in (C.2) along this subsequence, we obtain

$$0 \le G\tilde{s}\tilde{u}_z(1-\underline{s}, G(w+\tilde{s})) = \underline{s}\tilde{u}_y(1-\underline{s}, G(w+\tilde{s})) - \infty. \tag{C.3}$$

Noting that $\tilde{u}_y(0,z) = \infty$ by (A.6), the only possibility for (C.3) to hold is $\underline{s} = 1$. Then $s_t \to 1$, and

$$\lim_{t\to\infty} \frac{S_t}{e_1G^t} = \lim_{t\to\infty} s_t = 1. \tag{C.4}$$

Noting that $c_t^y = e_1G^t - S_t$ and $c_t^o = e_2G^t + S_t$, we obtain (C.1a). Using (2.7) and (2.8c), we obtain

$$r_t = S_t - S_{t+1}\frac{U_z}{U_y} = S_t - S_{t+1}\frac{c_z}{c_y}, \tag{C.5}$$

where c_y, c_z are evaluated at $(y,z) = (1-s_t, G(w+s_{t+1}))$. Dividing both sides of (C.5) by e_1G^t, letting $t\to\infty$, and using Lemma A.1, we obtain

$$\lim_{t\to\infty} \frac{r_t}{e_1G^t} = 1 - G\cdot 0 = 1.$$

Since $S_t = P_t + r_t$, we immediately obtain (C.1b). Finally, the risk-free rate is

$$R_t = \frac{S_{t+1}}{P_t} = G\frac{S_{t+1}/(e_1G^{t+1})}{(S_t - r_t)/(e_1G^t)} \to G\frac{1}{1-1} = \infty,$$

which is (C.1c).

Since $P_t \le S_t \sim e_1G^t$ grows at a rate no greater than G and the risk-free rate diverges to infinity (hence eventually exceeds the housing price growth rate), the no-bubble condition holds and there is no housing bubble. Using (C.1b), we obtain $P_t/r_t \to 0$, so the price-rent ratio converges to 0. The Pareto efficiency of equilibrium follows from (C.1c) and Lemma A.2(i). □

C.2 Elasticity of substitution equal to 1

We next consider the case $\gamma = 1$ (log utility), which is commonly used in applied theory. When $u(c) = \log c$, the difference equation (3.3) reduces to

$$G s_{t+1} c_z = s_t c_y - mc, \tag{C.6}$$

which is an autonomous nonlinear implicit difference equation. The following theorem shows that this difference equation admits a unique steady state, which defines a balanced growth path equilibrium.

Proposition C.2 (Equilibrium with $\gamma = 1$). *Suppose Assumptions 1–3 hold, $\gamma = 1$, and let $w = e_2/e_1$. Then the following statements are true.*

(i) There exists a unique steady state $s^* \in (0,1)$ of (C.6), which depends only on G, w, c, m.

(ii) There exists a unique balanced growth path equilibrium. The equilibrium objects satisfy

$$\begin{aligned}
(c_t^y, c_t^o) &= ((1-s^*)e_1 G^t, (w+s^*)e_1 G^t), && \text{(C.7a)}\\
(P_t, r_t) &= \left(\frac{G s^* c_z}{c_y} e_1 G^t, m\frac{c}{c_y} e_1 G^t\right), && \text{(C.7b)}\\
R_t &= \frac{c_y}{c_z} > G, && \text{(C.7c)}
\end{aligned}$$

where c, c_y, c_z are evaluated at $(y,z) = (1-s^*, G(w+s^*))$.

(iii) In the equilibrium (C.7), there is no housing bubble and the price-rent ratio P_t/r_t is constant.

(iv) Any equilibrium converging to the balanced growth path is Pareto efficient.

(v) If in addition the elasticity of intertemporal substitution satisfies

$$\frac{1}{\varepsilon(y,z)} := \frac{c c_{yz}}{c_y c_z} < \frac{1 + w/s^*}{1+w}\left(1 + Gw\frac{c_z}{c_y}\right) \tag{C.8}$$

at $(y,z) = (1-s^*, G(w+s^*))$, then the equilibrium is locally determinate.

Proof. We divide the proof into several steps.

Step 1. Existence and uniqueness of s^*.

Letting $s_t = s_{t+1} = s$ in (C.6) and rearranging terms, we obtain the steady state condition

$$Gsc_z = sc_y - mc \iff \frac{Gc_z - c_y}{c} + \frac{m}{s} = 0, \tag{C.9}$$

where c, c_y, c_z are evaluated at $(y, z) = (1 - s, G(w + s))$. Define $f : (0, 1) \to \mathbb{R}$ by

$$f(s) := \log c(1 - s, G(w + s)) + m \log s.$$

Then (C.9) is equivalent to $f'(s) = 0$. Since $s \mapsto (1-s, G(w+s))$ is affine, the logarithmic function is increasing and strictly concave, and $m > 0$, Proposition 11.4 of Toda (2025a, p. 150) implies that f is strictly concave. Clearly $f'(0) = \infty$. Letting $\tilde{u}(y, z) = \log c(y, z)$, an argument similar to the derivation of (A.6) shows $\tilde{u}_y(0, z) = \infty$. Therefore, $f'(1) = -\infty$. Since f is strictly concave, it has a unique global maximum $s^* \in (0, 1)$, which satisfies $f'(s^*) = 0$ and hence (C.9). Clearly this s^* depends only on G, w, c, m.

Step 2. Existence, uniqueness, and characterization of a balanced growth path.

In any balanced growth path equilibrium, we must have $S_t = s^* e_1 G^t$ for some $s^* \in (0, 1)$. The previous step establishes the existence and uniqueness of s^*. The consumption allocation (C.7a) follows from (2.8a) and Assumption 1. The rent in (C.7b) follows from (2.8c), Assumption 2, and Lemma A.1. Using (C.9), we obtain the housing price

$$P_t = S_t - r_t = e_1 G^t \left(s - m \frac{c}{c_y} \right) = e_1 G^t \frac{sc_y - mc}{c_y} = e_1 G^t \frac{Gsc_z}{c_y},$$

which is (C.7b). Using (C.9), we obtain the gross risk-free rate

$$R_t = \frac{S_{t+1}}{P_t} = \frac{se_1 G^{t+1}}{e_1 Gs(c_z/c_y) G^t} = \frac{c_y}{c_z} = G + \frac{mc}{sc_z} > G,$$

which is (C.7c). Clearly the price-rent ratio is constant by (C.7b). Since $R > G$, we obtain

$$\lim_{T \to \infty} R^{-T} P_T = \lim_{T \to \infty} e_1 \frac{Gsc_z}{c_y} (G/R)^T = 0,$$

so the no-bubble condition holds and there is no housing bubble. The Pareto efficiency of equilibrium follows from (C.7c) and Lemma A.2(i).

Step 3. Sufficient condition for local determinacy of equilibrium.

Define the function $\Phi : (0,1) \times (0,\infty) \to \mathbb{R}$ by

$$\Phi(\xi, \eta) = G\eta c_z - \xi c_y + mc, \tag{C.10}$$

where c, c_y, c_z are evaluated at $(y,z) = (1-\xi, G(w+\eta))$. Then (C.6) can be written as $\Phi(s_t, s_{t+1}) = 0$ and $\Phi(s,s) = 0$ holds, where we write $s = s^*$. Assuming that the implicit function theorem applies, we can differentiate (C.10) and solve the local dynamics as $s_{t+1} = \phi(s_t)$, where

$$\begin{aligned}\phi'(s) = -\frac{\Phi_\xi}{\Phi_\eta} &= -\frac{-Gsc_{yz} + sc_{yy} - (1+m)c_y}{-Gsc_{yz} + G^2 sc_{zz} + G(1+m)c_z} \\ &= \frac{(1+m)c_y + Gsc_{yz} - sc_{yy}}{G(1+m)c_z - Gsc_{yz} + G^2 sc_{zz}} =: \frac{n}{d}.\end{aligned} \tag{C.11}$$

By exactly the same argument as in the proof of Theorem 4, we obtain

$$\begin{aligned} n &= (1+m)c_y - \frac{s(1+w)}{G(w+s)^2} g'', \\ d &= G(1+m)c_z + \frac{s(1-s)(1+w)}{G(w+s)^3} g''. \end{aligned}$$

If $\phi'(s) > 1$, then $s = s^*$ is a source and hence the balanced growth path equilibrium is locally determinate.

We now seek to derive a sufficient condition for local determinacy. Since $g'' < 0$, we have

$$n - d > (1+m)(c_y - Gc_z) = m(1+m)\frac{c}{s} > 0,$$

where we have used (C.9). Therefore, if $\Phi_\eta = d > 0$, then $\phi'(s) = n/d > 1$ and we have local determinacy.

Using (C.11), (A.2), and $\sigma := \frac{cc_{yz}}{c_y c_z}$, the sign of Φ_η becomes

$$\begin{aligned}\operatorname{sgn}(\Phi_\eta) &= \operatorname{sgn}\left(-\frac{Gy+z}{z} sc_{yz} + (1+m)c_z\right) \\ &= \operatorname{sgn}\left(-\frac{Gy+z}{z} s\sigma \frac{c_y c_z}{c} + (1+m)c_z\right) \\ &= \operatorname{sgn}\left(-\frac{Gy+z}{z} s\sigma c_y + (1+m)c\right).\end{aligned}$$

Using (A.4) and (C.9), we obtain

$$\operatorname{sgn}(\Phi_\eta) = \operatorname{sgn}\left(-\frac{Gy+z}{z}s\sigma c_y + yc_y + zc_z + sc_y - Gsc_z\right).$$

Substituting $(y, z) = (1-s, G(w+s))$, dividing by $c_y > 0$, and rearranging terms, we obtain

$$\operatorname{sgn}(\Phi_\eta) = \operatorname{sgn}\left(-\frac{G(1+w)}{G(w+s)}s\sigma + 1 + Gw\frac{c_z}{c_y}\right).$$

Therefore, we have $\Phi_\eta > 0$ if and only if

$$\frac{1}{\varepsilon} = \sigma < \frac{1+w/s}{1+w}\left(1 + Gw\frac{c_z}{c_y}\right),$$

which is exactly (C.8). □

D Stylized facts

This appendix presents stylized facts regarding housing prices and rents.

We use the regional housing price data from `Realtor.com`, which provides detailed monthly data at the county level since July 2016.[20] We use the median listing price in July because the sales volume tends to be higher in spring and summer.

Regional rents are the Fair Market Rents (FMRs) from the U.S. Department of Housing and Urban Development (HUD).[21] FMRs are estimates of 40th percentile gross rents for standard quality units within a metropolitan area or non-metropolitan county and are available for housing units with 0–4 bedrooms. We use the values for three bedrooms.

The number of housing units is the series "All housing units" in Quarterly Estimates of the Total Housing Inventory for the United States from the Census Bureau,[22] available from 1965 onward.

Figure 5 shows the time series of U.S. real GDP and the total number of housing units, where we normalize the values in 1965 to 1. Real GDP has grown faster than the number of housing units, justifying our assumption $G > 1$ in the model.

Let r_{it} and P_{it} be the rent and housing price in county i in year t, constructed as

[20] https://www.realtor.com/research/data/
[21] https://www.huduser.gov/portal/datasets/fmr.html
[22] https://www.census.gov/housing/hvs/data/histtab8.xlsx

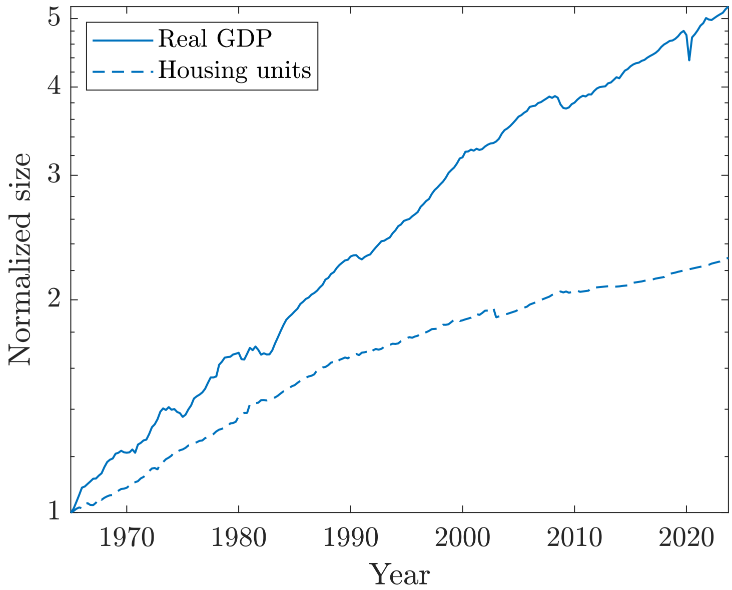

Figure 5: Growth of GDP and housing units.

described above. Figure 6 plots $\log P_{it}$ against $\log r_{it}$ for the year 2023 and estimates

$$\log P_{it} = \alpha + \beta \log r_{it} + \epsilon_{it}, \quad i = 1, \dots, I$$

by ordinary least squares (OLS) regression. The results for other years are all similar. Although this figure documents only a correlation, the coefficient $\hat{\beta} = 1.46 > 1$ would correspond to $1/\gamma$ in the model.

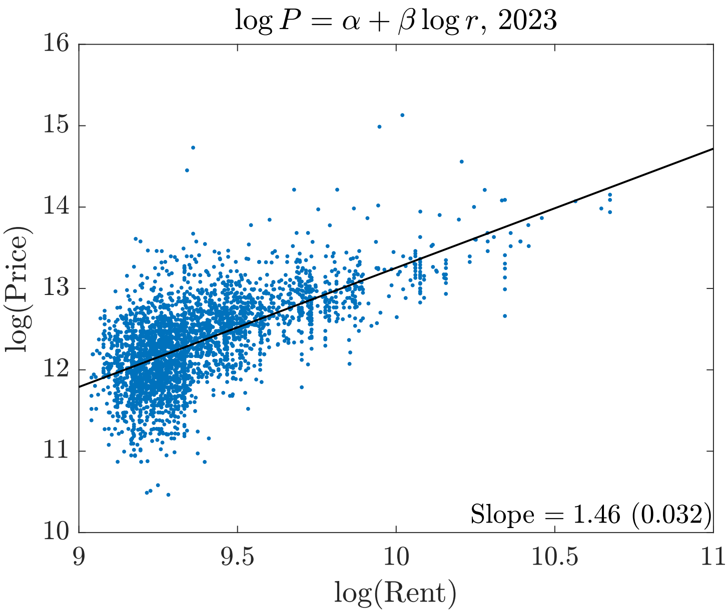

Figure 6: Rents and housing prices across counties.