

Anchoring and Loss Aversion in the Housing Market: Implications on Price Dynamics

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Summary

In this paper we develop a simple model with anchoring and loss aversion to explain house price dynamics. We have two testable implications: 1) when both cognitive biases are present, price dispersion and trade volume are pro-cyclical; 2) if anchoring decreases with time, then price dispersion and trade volume are higher for transactions whose previous purchase is more recent. Using a dataset that contains most real estate transactions in Hong Kong from 1992 to 2006, we find strong and significant anchoring and loss aversion which are robust to type of housing and sample period. The finding is consistent with the strong correlation between house price, price dispersion, and volume in the data. Moreover, anchoring decreases with time since previous transaction, and both price dispersion and volume show the same pattern. Our results suggest that anchoring and loss aversion can induce cyclicity in house prices.