One down, four to go? House prices have been falling for about one year in real (that is, inflation adjusted) terms. A typical down cycle lasts five years.

The focus on real prices is important because estimates of housing overvaluation are usually expressed in inflation-adjusted terms. Real prices are useful because they tell us what's happening to housing values relative to the prices of all other goods and services in the economy.

Several recent studies have estimated that real house prices are in the region of 25 per cent too high. A reasonable guess for average inflation (excluding mortgage repayments) over the medium term might be 2 per cent, the same rate as the European Central Bank's target for euro area inflation. If nominal house prices remain flat, it would take more than a decade to work off the froth.

That would be unusually long. A downturn of more typical duration would require a 17 per cent drop in housing values over the next four years. The remainder of the overvaluation would be unwound by inflation. Under that scenario, rental yields would move up to more reasonable levels around seven per cent by 2011, compared with a measly four per cent today—though only if rents continue to surge by 10 per cent per year.

The market could recover faster if sellers slashed prices. A short, sharp shock would probably be better than a protracted bust. Large developers with strong balance sheets could lead the way by swallowing up cash-strapped smaller players--and offering deep discounts on unsold homes.

From this perspective, commentators "talking up" the market are hampering adjustment. By creating unrealistic expectations about house prices, vested interests may be prolonging the pain and unwittingly doing enormous damage to the market and our economy.