



# Popular Economics

*Promoting the Popular Understanding of Economics*

## **Popular Economics Weekly**

*Week of October 22, 2007*

### **Housing's Future**

Dr. Edward Leamer, UCLA economist, gave what may be the best analysis of housing's affect on the business cycle at this year's Jackson Hole economic symposium. Housings' effect is negligible on current business activity, in a word, though it may be a predictor of future activity. And so we believe that economic growth will continue to increase at or near its current 3 percent rate into next year, before slowing down in late 2008.

U.S. Gross Domestic Product has grown a very robust 3.1 percent since 1970. Residential real estate contributed one of the smallest segments to that growth—4.2 percent of the total, or just 0.13 of the 3 percent average growth rate over that time—below even equipment and software sales, according to Dr. Leamer.

As a predictor of future growth, housing's wildest swings tend to come just before a downturn, but housing also recovered before the rest of the economy in 8 of the last 10 postwar recessions, says Dr. Leamer. And though residential sales continue to decline, they have not reached levels that affect overall activity, since overall activity is powered by other sectors.

Real estate activity would have to subtract approximately 1 percent from GDP growth, and it is now subtracting approximately three-quarters percent from the GDP growth rate. The housing industry employs a lot of workers, from construction to insurance, to banking, to of course sales. And when sales decline, so does the employment of those workers. Conversely those workers are the first to be hired during the recovery cycle.

Right now, the most important housing statistics to watch are housing starts (construction) and existing home sales. Starts fell 10 percent in September, while existing sales dropped 8 percent. Overall starts are down to 1.19 million units, from its 2005 high of 2 million, a 40 percent drop. Existing-sales are down to 5 million from 7 million units in 2005, a 29 percent drop.

Yet we are seeing very little effect of the housing downturn on employment, which has dropped from 4.5 to a 4.7 percent rate. This is because the service sector of our economy continues to generate the most activity, followed by exports, durable and nondurable goods, and equipment and software. They cumulatively have averaged 3.36 percent growth from 1985 through 2006. (Imports, which subtract from domestic sales, contributed a negative -0.81 percent to growth over that time.)

Business investment and commercial real estate investment are two sectors still growing robustly, as well. And consumer spending has increased 3 percent since 2005. Exports, meanwhile, are supporting the manufacturing sector, thanks to robust growth in the rest of the world. In fact the IMF says that global economic growth was a huge 5.2 percent this year, and will be 4.8 percent next year.

So, as much as real estate is contributing to the credit crunch, we do not believe that it will bring down the rest of the economy. In fact, it is because overall growth is so strong that we see sales stabilizing by the end of this year. Real estate prices

are notoriously “sticky”, according to Dr. Leamer, meaning sellers are reluctant to drop prices to levels that buyers can afford.

In fact, new-home sales are stabilizing, as builders have been cutting back on production. Sept. sales increased 4.8 percent, while inventories fell to an 8.3-month supply. The median price also rose 5 percent to \$238,000. It goes to show that reducing inventories is the key to restoring stability to the real estate market.

Copyright © 2007